Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation

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INTRODUCTION

Within a six-month period, the regulatory model of the "bulge-bracket" investment bank that dominated Wall Street for three-quarters of a century became obsolete. The acquisition of Bear Stearns[1] and Merrill Lynch[2] by commercial

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1. Bear Stearns, like many investment banks, financed its operations in part through short-term borrowings secured by a portfolio of investment-grade assets. In March 2008, after the demise of two of its hedge funds that were invested heavily in collateralized debt obligations backed by subprime mortgages, rumors began circulating regarding Bear Stearns' financial condition; in response, customers began withdrawing funds, and

banks, the bankruptcy of Lehman Brothers,[3] and the transformation of Goldman Sachs and Morgan Stanley into bank holding companies[4] have all but ended the role of the Securities and Exchange Commission (SEC) in the prudential oversight of major investment bank holding companies for the time being.[5]

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counterparties declined to provide short-term financing on customary terms. These developments placed enormous stress on Bear Stearns' ability to meet short-term liquidity demands. To avoid insolvency, Bear Stearns obtained $30 billion in funding from the Federal Reserve Bank of New York (FRBNY) through JPMorgan Chase, pending acquisition and assumption of its obligations by JPMorgan Chase. *See In re* Bear Stearns Cos., Inc. S'holder Litig., C.A. No. 3643-VCP, 2008 WL 959992, at *2–3 (Del. Ch. Apr. 9, 2008); *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators: Hearings Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2008) (LexisNexis Congressional) [hereinafter *Turmoil in the U.S. Credit Markets*] (testimony regarding the role of the regulators in the Bear Stearns transactions); Bryan Burrough, *Bringing Down Bear Stearns*, VANITY FAIR, Aug. 2008, at 106 (describing the liquidity crisis).

2. Financial regulators orchestrated Bank of America's eleventh-hour acquisition of Merrill Lynch once it became apparent that Merrill Lynch was on the brink of insolvency as a result of its exposure to subprime mortgages through synthetic collateralized debt obligations. *See, e.g.*, *In re* Bank of America Corp. Sec., Derivative & ERISA Litig., 258 F.R.D. 260 (S.D.N.Y. 2009) (discussing the circumstances surrounding the acquisition of Merrill Lynch); *see also infra* note 320 (describing the alleged pressure brought to bear on Bank of America to close the merger). The House Committee on Oversight and Government Reform is currently investigating the circumstances leading up to the acquisition. *See, e.g.*, Louise Story, *Congress Presses for Details from Bank of America on Talks*, N.Y. TIMES, Sept. 21, 2009, at B1.

3. Lehman Brothers' failure has similarly been attributed to its overexposure to subprime mortgages, coupled with high leverage and strong reliance on short-term financing. *See, e.g.*, *The Causes and Effects of the Lehman Brothers Bankruptcy: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. (2008) (testimony of Professor Luigi Zingales), *available at* http://oversight.house.gov/images/stories/Hearings/110th_Congress/Zingales_Statement.pdf; GILLIAN TETT, FOOL'S GOLD: HOW UNRESTRAINED GREED CORRUPTED A DREAM, SHATTERED GLOBAL MARKETS AND UNLEASHED A CATASTROPHE 230–33 (2009); James B. Stewart, *Eight Days*, NEW YORKER, Sept. 21, 2009, at 59 (describing the circumstances that led to financial regulators' decision to let Lehman Brothers enter insolvency and to negotiate an acquisition of Merrill Lynch); Louise Story & Ben White, *The Road to Lehman's Failure Was Littered With Lost Chances*, N.Y. TIMES, Oct. 5, 2008, at B1.

4. As bank holding companies, The Goldman Sachs Group, Inc. and Morgan Stanley are regulated at the holding company level by the Board of Governors of the Federal Reserve System (the FRB or "Federal Reserve Board"). Fed. Reserve Sys., Order Approving Formation of Bank Holding Companies (Sept. 21, 2008), http://www.federalreserve.gov/newsevents/press/orders/orders20080922a1.pdf (approving applications of The Goldman Sachs Group, Inc. and Goldman Sachs Bank USA Holdings LLC to become bank holding companies); Fed. Reserve Sys., Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities (Sept. 21, 2008), http://www.federalreserve.gov/newsevents/press/orders/orders20080922a2.pdf (approving similar applications of Morgan Stanley, Morgan Stanley Capital Management LLC, and Morgan Stanley Domestic Holdings, Inc.).

5. *See, e.g.*, Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), *available at* 2008 WL 4370014.

These events, together with the ongoing turmoil in the financial services sector,[6] have reignited debate over the regulation of securities, derivatives, and other activities of U.S. financial services conglomerates,[7] be they bank holding companies (BHCs), investment bank holding companies, or other financial service providers.[8] Regulators' inability, unwillingness, or lack of authority to intervene in the affairs of troubled firms has raised the question whether a new regulatory paradigm is necessary to prevent (or mitigate the severity of) recurring market crises involving financial firms other than deposit-taking institutions.[9] At the center of the debate, the Treasury Department, under successive administrations, has put forth various regulatory proposals that would assign primary responsibility for the monitoring of systemic risk across all financial services conglomerates to the Federal Reserve Board, while delegating authority for prudential and business-conduct regulation of individual firms to other federal agencies.[10]

I question whether any regulatory agency or collection of agencies can possess the authority, independence, and incentive to combat the inherent procyclicality of the systemic risk inherent in the financial services industry.[11] Financial

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6. *See, e.g.*, *Emergency Economic Stabilization Act—One Year Later: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (describing progress toward stability in financial markets); Alex Berenson, *A Year Later, Little Change on Wall St.*, N.Y. TIMES, Sept. 11, 2009, at A1 (describing the state of the financial services industry one year after Lehman's failure).

7. For purposes of this Article, I use the phrase "financial services conglomerates" to refer generally to holding companies of depository institutions, broker/dealers, insurance companies, and other financial services providers, and I use the terms "commercial banks" and "investment banks" to refer colloquially to the holding companies of depository institutions and broker/dealers respectively. I use the terms "bank holding company" (BHC), "financial holding company" (FHC), "supervised investment bank holding company" (SIBHC), "consolidated supervised entity" (CSE), and "Tier 1 FHC" to refer to specific statutorily defined entities as defined herein throughout the footnotes.

8. *Systemic Risk and the Financial Markets: Hearings Before the H. Financial Servs. Comm.*, 110th Cong. 46–66 (July 24, 2008) (Serial No. 110-130), *available at* http://frwebgate.access.gpo.gov/cgi-in/getdoc.cgi?dbname=110_house_hearings&docid=f:44903.pdf (testimony of SEC Chairman Christopher Cox and Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York). *See generally* Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 39 (2009) (summarizing the "bewildering proliferation of alternatives" for reforming financial regulation in response to the current crisis).

9. *See generally Modernizing America's Financial Regulatory Structure, Hearing Before the Congressional Oversight Panel*, 111th Cong. 10–34 (2009) (statement of Gene L. Dodaro, Acting Comptroller General) (describing the fragmented nature of the current regulatory system and proposing a framework for crafting and evaluating reform proposals).

10. *See generally* DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter PAULSON BLUEPRINT]; DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009) [hereinafter GEITHNER REPORT].

11. Several commentators have written about the relationship between the business cycle and the regulatory cycle in financial regulation. *See, e.g.*, Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV.

professionals have exercised considerable dexterity in eroding, avoiding, or arbitraging burdensome regulation to reap substantial profits from financially innovative products.[12] Moreover, as models for measuring the risks inherent in financial activity become more refined, regulators have—whether begrudgingly or enthusiastically—come to rely upon proprietary risk management, rather than agency-promulgated rules or bank supervision, to manage capital and liquidity in commercial and investment banking.[13] The efficacy of regulation thus may well turn less on defining the proper rules or standards by which to measure risk management, and more on the mechanisms by which regulators may intervene in the affairs of troubled firms or remediate the fallout of a failed entity.

In this respect, the divergent philosophies of investment bank and commercial bank regulation have traditionally pointed to different conclusions. In the world of commercial banking, history has created an expectation that federal authorities (whether by statute or on an ad hoc basis) will save diffuse and unsophisticated depositors from default, whereas in the world of investment banking, the marketplace—that is, one's counterparties and creditors—has determined whether a bailout or a bankruptcy is the more cost-effective way to resolve the marketplace's exposure to a failing firm.[14] On the one hand, extending the safety net for commercial banks to investment banking would raise the questions of whether the speculative activities of investment banks create an undue risk of moral hazard and whether the risks inherent in investment banking may be prudentially regulated to limit such moral hazard.[15] On the other hand, eliminating or further restricting

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393, 423–24 (2006); Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1 (2002) (describing the evolution of securities law as "punctuated" by capital market events spurring regulation); Steven L. Molinari & Nelson S. Kibler, *Broker-Dealers' Financial Responsibility Under the Uniform Net Capital Rule—A Case for Liquidity*, 72 GEO. L.J. 1, 25–33 (1983). *See generally* Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003) (discussing the cycle of trust and distrust in boom-bust cycles and the regulatory responses thereto).

12. *See infra* text accompanying notes 129–32.

13. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2006), *available at* http://www.bis.org/publ/bcbs128a.pdf [hereinafter BASEL II FRAMEWORK]. A "significant innovation" of the Basel II Accords is "the greater use of assessments of risk provided by banks' internal systems as inputs to capital calculations" under the first pillar of the Basel II Framework, subject to "a detailed set of minimum requirements designed to ensure [their] integrity . . . ." *Id.* ¶ 6, at 2. Moreover, "[w]hile the Framework . . . stops short of allowing the results of [internal] credit risk models to be used for regulatory capital purposes, the Committee recognises the importance of continued active dialogue regarding both the performance of such models and their comparability across banks." *Id.* ¶ 18, at 5.

14. *See, e.g.*, David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 733–42 (2008) (reviewing CURTIS J. MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD (2008)) (contrasting the role of federal regulators in traditional commercial bank failures with the actions of the Treasury and the FRB in rescuing Bear Stearns from bankruptcy and describing the consequences that would have followed from alternate approaches).

15. *See* Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium: Reducing

investment banks' access to the FRB's lending window might simply encourage unorthodox and arbitrary actions by financial regulators in extreme situations in spite of legal constraints.[16]

I argue that the most efficient way to regulate investment banks for financial responsibility is to formalize the existing expectation that *financial services conglomerates* participate (at least, to a degree commensurate with their interest) in the rescue of an insolvent competitor that the industry deems "too interconnected" to fail. To that end, this Article proposes a self-regulatory framework for holding companies of commercial banks and other financial service providers both to make such determinations and help shoulder the burden in addressing the consequences. As discussed below, Congress should enact legislation creating the framework of such an organization, as well as principles for information sharing among participating firms, to be implemented by specific rules. The organization would be responsible for identifying risks, determining the flow of information necessary to contain those risks, and building mechanisms to share that information. More importantly, the organization would be expected to participate in the financing (and share in the profits or loss resulting from) any bailout of a member entity, pursuant to rules established by the organization.

The organization must play a significant role in making a determination whether an industry bailout is preferable to a privately negotiated bailout or bankruptcy, along with the extent of such a bailout. Thus, an industry regulator (similar to the SEC) would be responsible for overseeing rule making that establishes procedures for making such determinations and enforcing compliance with those rules; such a regulator might also manage the flow of confidential information among members to ensure that they are apprised of emerging risks, without revealing proprietary or counterparty positions. The FRB, meanwhile, would have the authority to monitor the activities of individual member firms, to set the terms for any acquisition of an insolvent member firm within the parameters established by the industry framework, and (at its discretion) to finance or fund a bailout, in part or in whole, if it is determined to be in the public interest.

Part I of this Article summarizes the history of SEC regulation of broker/dealers and investment banks for capital adequacy and systemic risk. Part II discusses the ends and means of financial regulation. Part III reviews some of the alternative structures for reforming the regulation of investment banks and the financial markets generally, and Part IV analyzes recent proposals against their light. Finally, Part V sets out a proposed framework for combining the participation of the FRB,

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Systemic Risk (Aug. 22, 2008), *available at* http://www.federalreserve.gov /newsevents/speech/bernanke20080822a.htm; *see also* Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab*, 41 MCGEORGE L. REV. 131, 156–57 (2009) (analyzing the incentives of government officials under such an approach).

16. Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 541 (2009) ("There is no question that executive and independent agencies have stretched their legal authority during the bailout crisis. In some cases they have done so beyond recognition; the Federal Reserve's broad interpretation of the set of candidates to whom it could open its discount window during the crisis has made a mockery of the view that the law should not be interpreted to disturb the settled expectations of those affected by it.").

SEC, and the financial services industry in addressing systemic crises in the financial community.

I. History of the Financial Regulation of Investment Banks

While investment banking exhibits many parallels to commercial banking, the regulatory regimes applicable to such activities in the United States differ significantly.[17] The core business of commercial banks is financing illiquid assets (loans) with liquid assets (short-term deposits).[18] Because of the significant risks to the integrity of the financial system posed by bank runs, the bank regulatory system entails both significant ex ante supervision and examination, as well as significant supervisory and remedial authority with respect to troubled institutions.[19] By contrast, the core business of broker/dealers has historically been brokerage, dealing, and underwriting financed by private capital. Because such activities have historically been deemed too speculative to provide any sort of federal guarantee, the focus of broker/dealer regulation has been to protect customer assets—but not other creditors—from the risk of a broker/dealer's proprietary dealing and trading

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17. While there is no standard definition of an "investment bank," the term is generally understood to refer to holding companies that perform a variety of securities and derivatives activities—such as securities brokerage, dealing, market making, underwriting, writing derivatives contracts, and proprietary trading—that are not otherwise subject to FRB regulation because they do not hold an affiliate operating as a depository institution. *See, e.g.*, 15 U.S.C. § 78q(i)(5) (2006) (defining "investment bank holding company" to mean any person that owns or controls one or more brokers or dealers and its associated persons); LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 140 (2003) (defining "investment banks" as "[b]rokerage firms that engage in large capital transactions," such as block trading, underwritings, and mergers and acquisitions). The term "financial holding company" (FHC) was defined in the Gramm-Leach-Bliley Act to refer to an FRB-regulated bank holding company that elects to be regulated as an FHC pursuant to 12 U.S.C. § 1843(*l*)(1) in order to engage in certain additional financial activities through its affiliates, such as underwriting, dealing, market making, and selling insurance. 12 U.S.C. § 1841(p) (2006). To qualify as an FHC, among other criteria, subsidiaries that are insured depository institutions must be "well managed" and "well capitalized." *Id.* § 1843(*l*)(1)(A), (B); *see infra* note 163 (discussing 12 U.S.C. § 1843(*l*)(1)(A)).

18. Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 306–07 (1987) (arguing that banks' unique ability to "hold illiquid assets (loans) against their liquid liabilities (deposits)" is possible, inter alia, because banks are able to pool the risk of withdrawal demands by holding the deposits of numerous consumers).

19. *See, e.g.*, 3 MICHAEL P. MALLOY, BANKING LAW AND REGULATION § 11.2 (1994 & Supp. 2007). Regardless of the depository institution's appropriate regulatory agency for purposes of supervision and examination (e.g., the Office of the Comptroller of the Currency for national banks or the FRB for state-chartered banks that are members of the Federal Reserve System), the Federal Deposit Insurance Corporation (FDIC), as federally designated receiver, has broad authority over the supervision and ultimate resolution of any FDIC-insured financial institution that is experiencing financial difficulty. *Id.* (noting that the Federal Deposit Insurance Act (FDIA) contains a "more or less unified body of enforcement provisions" applicable to all depository institutions).

activity.[20] From the origins of broker/dealer regulation to the voluntary regulation of investment banks, congressional policy has thus been to let investment banks succeed or fail on their own merits.[21]

Since the failure of Drexel Burnham Lambert Group, Inc. in 1990, if not before, the SEC and its staff have been acutely aware of the potential for investment bank defaults to impact the broader securities, derivatives, and credit markets.[22] Nevertheless, because it has lacked the mandate to regulate financial markets for systemic risk,[23] the SEC has leveraged its regulatory authority to promote the financial responsibility of broker/dealers to provide some degree of risk management for the broader marketplace.[24] Through a combination of specialized rule making for bulge-bracket firms,[25] outsourcing of prudential supervision to self-regulatory organizations,[26] and voluntary industry compliance efforts,[27] Congress

20. Ancillary services, such as research and analysis and investment-advisory services in connection with mergers and acquisitions and other financial transactions, do not generally pose threats to the financial responsibility of a firm, although they may raise conflicts of interest or result in other practices that are deemed to be "fraudulent," "deceptive," or "manipulative," 15 U.S.C. §§ 78j, 78o(c) (2006), or otherwise inconsistent with "just and equitable principles of trade." *Id.* §§ 78f(b)(5), 78o(b)(6).

21. *Cf.* 2 MALLOY, *supra* note 19, § 7.2 (observing that, from the perspective of the historical English model of financial services regulation, "investment banking is . . . a risky, speculative venture and consequently . . . an inappropriate activity for an institution devoted to the care of deposits from the public").

22. *See* Cynthia C. Lichtenstein, *International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk*, 19 BROOK. J. INT'L L. 137, 138–40, 146–50 (1993) (discussing the concerns of the SEC and SEC officials about systemic risks posed by broker/dealers and their holding companies).

23. *See* Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 998–1004 (2006) (questioning whether the SEC possesses the mandate or expertise to regulate hedge funds for "systemic risk").

24. *See, e.g.*, Net Capital Rule, Exchange Act Release No. 28,927, 56 Fed. Reg. 9124, 9125 (Mar. 5, 1991) ("The primary purpose of the net capital rule . . . is to protect customers and creditors of registered broker-dealers from monetary losses and delays when a broker-dealer fails. In this way, the rule acts to prevent systemic risk from the failure of a financial intermediary.").

25. *See* 17 C.F.R. § 240.15c3-1e (2009) (noting that capital requirements for broker/dealer subsidiaries of unregulated holding companies are subject to voluntary SEC oversight); *id.* § 240.15c3-1g (capital requirements for unregulated holding companies of broker/dealers that voluntarily undertake compliance with SEC supervision).

26. *See, e.g.*, 17 C.F.R. § 240.17d-1 (2009) (describing the process by which the SEC designates the responsibility to a self-regulatory organization for examining its members for compliance with applicable financial responsibility rules); Net Capital Rule, Exchange Act Release No. 39,456, 62 Fed. Reg. 68,011, 68,013 (Dec. 30, 1997) (describing the use of The Options Clearing Corporation's Theoretical Options Pricing Model by broker/dealers with the permission of their designated examining authority).

27. *Id.* at 68,012-13 (describing the Framework for Voluntary Oversight developed by the Derivatives Policy Group, under which the members of the Group agreed to report voluntarily to the Commission on their activities in the over-the-counter (OTC) derivatives market).

and the SEC has created a regulatory structure for investment banks that parallels the FRB's oversight of commercial banks and bank holding companies.

A. Origins

The New Deal financial services legislation of the 1930s attempted to deal with specific practices that were thought to have contributed to the Great Depression, such as excessive speculation in securities fueled by credit that led to a series of bank failures throughout the country.[28] On the theory that underwriting and other investment-banking activities posed a significant risk to the safety and soundness of banks and their depositors, the Glass-Steagall Act of 1933 sought to bar affiliations between commercial banks and investment banks.[29] The Act also sought to restore depositor confidence in the banking system by creating the Federal Deposit Insurance Corporation (FDIC) to guarantee customer deposits of insured institutions.[30] The Securities Act of 1933 and the Securities Exchange Act of 1934, meanwhile, subjected the underwriting, brokerage, and dealing activity of broker/dealers to significant regulation by a new Securities and Exchange Commission.[31]

Financial-responsibility rules for broker/dealers were motivated by a desire not only to dampen speculation fueled by credit[32] but also to ensure that broker/dealers possessed enough excess capital to satisfy counterparty obligations and civil judgments under the federal securities acts, as well as a desire to maintain continuity of business and a serious commitment to the profession.[33] The Exchange Act federalized certain financial safeguards, including the permissible sources of

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28. *See, e.g.*, Glass-Steagall Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.) ("An Act to provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes."); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78oo (2006)) (determining that "transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, . . . in order to protect interstate commerce, the national credit, the federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions").

29. 12 U.S.C. §§ 78, 377, *repealed by* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341.

30. Glass-Steagall Act § 8, 48 Stat. at 168; *see* 2 MALLOY, *supra* note 19, § 7.2 (providing the history of the Glass-Steagall Act).

31. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78oo (2006).

32. *See* Molinari & Kibler, *supra* note 11, at 4–5.

33. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95, pt. 1, at 82 (1963) [hereinafter SPECIAL STUDY]. Some commentators have criticized financial regulators' excessive reliance on minimum capital requirements in lieu of other prophylactic measures. *See, e.g.*, Bruce S. Darringer, *Swaps, Banks, and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accord's Treatment of Swaps*, 16 U. PA. J. INT'L BUS. L. 259, 327–36 (1995).

securities credit for brokers and dealers,[34] a 20:1 aggregate indebtedness-to-net-capital ratio for firms engaged in brokerage activity,[35] and certain limitations on rehypothecation of customer securities.[36] The Exchange Act, moreover, delegated uniform authority to the FRB to regulate credit extended against securities collateral for all bank, broker, and unregulated lenders.[37]

The Commission's initial rule making focused on the risks posed to customer accounts. The Commission's net capital rule (Exchange Act Rule 15c3-1), for example, exempted broker/dealers who did not extend credit to customers in connection with the purchase or sale of securities and who did not carry money or securities for, or owe money or securities to, their customers.[38] Nevertheless, the availability of liquid assets was considered of paramount importance to the sound operation of the brokerage industry;[39] as a result, the Commission rejected, after public notice and comment, a proposal to segregate customer free credit balances and unmargined securities from proprietary positions, because broker/dealers relied on the ability to finance their brokerage and dealing activities with customer funds and securities.[40]

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34. Securities Exchange Act of 1934 § 8(a), 48 Stat. at 888, *repealed by* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 104(b), 110 Stat. 3416, 3423.

35. *Id.* § 8(b), 48 Stat. at 888–89, *repealed by* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 5, 89 Stat. 97, 109.

36. *Id.* § 8(c)–(d), 48 Stat. at 889 (codified as amended at 15 U.S.C. § 78h(c), (d) (2006)).

37. 15 U.S.C. § 78g(c) (2006); 12 C.F.R. pt. 220 (2009) (regulating credit extended by brokers and dealers; entitled Regulation T). The FRB rules primarily distinguished "cash" transactions (in which the customer is to pay the full purchase price of a security) from "margin" transactions (for which the customer seeks to borrow a specified percentage of the purchase price of a security). A broker/dealer could itself borrow funds against a customer's margined securities (subject to the Act's limitations on rehypothecation) essentially on the same terms as the broker/dealer's own securities portfolio. To ensure uniform understanding of the terms of such transactions, margin agreements were standardized by the exchanges. SPECIAL STUDY, *supra* note 33, at 390.

38. Ratio of Aggregate Indebtedness to Net Capital, Exchange Act Release No. 3323, 7 Fed. Reg. 8844 (Nov. 3, 1942) (adopting the net capital rule, codified at 17 C.F.R. § 240.15c3-1). The Commission also chose to limit the application of its first net capital rule to broker/dealers operating in the OTC market, on the grounds that exchange members were subject to more rigorous requirements under New York Stock Exchange (NYSE) rules. 17 C.F.R. § 240.15c3-1 (1942); *see supra* note 47 (eliminating this exception).

39. Molinari & Kibler, *supra* note 11, at 5–6.

40. SPECIAL STUDY, *supra* note 33, at 399–400. National Association of Securities Dealers (NASD) rules and NYSE rules required segregation of customer securities, although such securities could be held in "bulk" on behalf of all customers. *Id.* at 402–04. Self-Regulatory Organization (SRO) rules also recommended segregation of free credit balances, although most firms could use customer funds to finance their proprietary trading activities without restriction. *Id.* at 402. The Commission had also considered more broadly whether to require segregation of all brokerage and dealing activities to eliminate conflicts of interest in the over-the-counter market, but it ultimately settled for the authority to regulate broker/dealers for recordkeeping and financial responsibility and to prohibit fraudulent activity in the over-the-counter market. *See generally* Securities Exchange Act § 15, 15

B. Federalization of Financial-Responsibility Regulation

In the late 1960s, Congress and the Commission became increasingly concerned with the increasing use of leverage by the securities industry.[41] Firms were able to support a relatively significant amount of securities and assets with thin capital by financing proprietary positions with customer free-credit balances or loans secured by customer securities; devices such as securities loans or repurchase agreements and letters of credit, moreover, allowed brokerage firms to borrow greater amounts than prudential restrictions on secured bank loans would permit.[42] Impermanent forms of capital—such as subordinated loan agreements—could also result in a sudden violation of the net capital rule if withdrawn.[43] Meanwhile, the failure of a significant number of brokerage firms from the back-office crisis of the 1960s to the market decline of 1969 ultimately resulted in Commission recommendations for legislation to improve the financial responsibility of broker/dealers.[44]

The Securities Investor Protection Act of 1970 created the Securities Investor Protection Corporation (SIPC) to protect customers' funds and securities when a broker/dealer encounters financial difficulty.[45] The Act, moreover, required the Commission to implement a number of additional measures, including safeguards for the "acceptance of custody and use of customers' securities, and the carrying

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U.S.C. § 78o (2006); U.S. SEC. & EXCH. COMM'N, REPORT ON THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER (1936) [hereinafter SEGREGATION REPORT].

41. JOEL SELIGMAN, TRANSFORMATION OF WALL STREET 450–66 (3d ed. 2003) (describing the SEC's reaction to the "back-office" crisis from 1967–1970 and the perceived inefficacy of exchange capital requirements in ensuring that firms maintained sufficient liquid assets to meet their obligations).

42. *See* Molinari & Kibler, *supra* note 11, at 26–32.

43. *See, e.g.*, SELIGMAN, *supra* note 41, at 458 (noting that "subordinated loans or secured demand notes from customers or partners . . . as of 1970, made up 40 percent of the capital of all [New York Stock] Exchange member partnerships and 34 percent of the capital of all Exchange member corporations"); Nicholas Wolfson & Egon Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603, 624–26, 636 (1972) (describing subordinated loan agreements and the theoretical concerns with treating them as capital for purposes of net capital computation).

44. *See* U.S. SEC. & EXCH. COMM'N, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 92-231, at 13–30 (1971) (summarizing findings regarding unsafe and unsound practices by broker/dealers that contributed to the demise of several brokerage firms in 1969–70 and the SEC's recommendations for legislative action in response thereto).

45. 15 U.S.C. §§ 78aaa–78*lll* (2006). SIPC is empowered to file an application for a protective decree and to seek appointment of a trustee for the liquidation of a failing broker/dealer's business and distribution of customer property pursuant to the special provisions of the Act. *Id.* §§ 78eee(b), 78fff, 78fff-2. SIPC may also advance funds to the trustee for the prompt payment and satisfaction of net equity claims of customers (not to exceed $500,000 per customer, and for cash claims, $100,000 per customer). *Id.* § 78fff-3. As part of its risk-management function, SIPC consults with broker/dealer SROs to ensure that SIPC members are in compliance with applicable financial responsibility rules and develop procedures reasonably designed to detect firms approaching financial difficulty. *Id.* § 78iii(e). The SIPC fund is maintained through periodic assessments upon its members. *Id.* § 78ddd(c).

and use of customers' deposits or credit balances."[46] The SEC's customer-protection and net capital rules implemented the specific statutory mandate to require "the maintenance of reserves with respect to customers' deposits or credit balances" and "minimum financial responsibility requirements for all brokers and dealers."[47] The Securities Acts Amendments of 1975 advanced this trend by requiring the creation of a national clearance and settlement system.[48]

Ironically, the 1970 amendments and the customer protection rule *weakened* the case for minimum-liquidity and net capital requirements for broker/dealers. Because the reserve and custody requirements of the customer-protection rule were designed to protect customer assets against a broker's insolvency, the need for a separate net capital requirement was considerably lessened.[49] While some Commission staff members maintained that the net capital rule had a more systemic role to play in the "highly cyclical nature" of the securities industry,[50] the Commission nevertheless acknowledged that its rules should "avoid[] the inefficient and costly commitment of capital within the securities industry where such a commitment is not necessary for customer protection."[51] The amended net capital rule thus incorporated an "alternative" formula, which permitted firms to compute net capital based on customer indebtedness instead of the firm's aggregate indebtedness.[52]

C. The Move to Consolidated Regulation

In the 1970s, facing the need to raise additional capital to computerize their outmoded back-office operations, several major investment banks sought access to public equity markets.[53] The New York Stock Exchange liberalized its rules to permit broker/dealers to become publicly traded companies.[54] Most of the major

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46. *Id.* § 78o(c)(3)(A).

47. *Id.* The Commission's uniform net capital rule thus dispensed with the exemption for exchange member broker/dealers. Adoption of Uniform Net Capital Rule and an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11,497, 40 Fed. Reg. 29,795 (July 16, 1975).

48. *See* 15 U.S.C. § 78q-1 (2006).

49. *See* Exchange Act Release No. 11,497, 40 Fed. Reg. at 29,797 ("Ultimately, it may be possible for [the customer protection rule] in some form to replace the liquidity requirements of the net capital rule . . . ."); Molinari & Kibler, *supra* note 11, at 26 n.154.

50. Molinari & Kibler, *supra* note 11, at 22–33.

51. Exchange Act Release No. 11,497, 40 Fed. Reg. at 29,798.

52. The alternative formula "presupposes that the debits in the Reserve Formula are collectible, that they will be applied to pay off customer claims in a liquidation, and that the cushion of two percent of customer-related receivables . . . will be applied against administrative costs in the event of a liquidation." Molinari & Kibler, *supra* note 11, at 16–17. Because the firm was required to segregate excess credit balances and fully paid customer securities, all of the firm's customer claims would have been satisfied by the combination of segregated funds, securities, and collection of customer receivables, plus the regulatory cushion under the rule. 17 C.F.R. § 240.15c3-1(a)(ii) (2009).

53. *See* SELIGMAN, *supra* note 41, at 466–86.

54. Donaldson, Lufkin & Jenrette (DLJ) filed a registration statement with the SEC for a public issue of common stock in May 1969; the NYSE voted later that year to "support the

investment banks continued to operate as partnerships or closely held enterprises, since their reputation relied on "tacit" transmission of skills and connections among partners or voting members and they viewed other activities as potentially diluting their franchise.[55] The emergence of computer-driven trading and arbitrage activity, however, reinforced the dramatic increase in the balance sheets of the most highly capitalized financial institutions and the corresponding leverage necessary to mine financial activities with increasingly thin margins.[56] By the 1990s, the major investment banks had gradually shifted to a public-holding-company structure.[57]

The gradual deregulation of core commercial[58] and investment-banking activity[59] over this period contributed to this trend.[60] The willingness of regulators

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concept of public ownership of equity securities issued by member corporations," and it eventually voted to amend its constitution to permit public ownership of member firms in March 1970. SELIGMAN, *supra* note 41, at 466–67.

55. Professors Morrison and Wilhelm suggest that retail-oriented firms specializing in brokerage activity (such as DLJ, Merrill Lynch, EF Hutton, Bache, Paine Webber, and Dean Witter), were among the earliest firms to seek access to public capital in order to finance the cost of computerizing their back-office operations; firms known for their advisory services, such as Goldman Sachs and Lazard Frères, were among the last to convert into public corporations (in 1999 and 2005, respectively) because of the reputational benefits of the partnership structure. *See* ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 236–38, 276–80 (2007).

56. Commentators observe, for example, that profits may be increasingly mined from derivatives and other banking activity through the application of technical financial skills, rather than reputational skills or private information culled over years of experience. *See id.* at 225–64 (describing the impact of computerization and modern financial economics on the profitability of investment banks); Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 338 (1989) (describing the shift from "craft" to "theory"). Because of significant competition, however, only the most highly capitalized firms can profitably deploy such techniques to generate consistent returns. *See* MORRISON & WILHELM, *supra* note 55, at 278–80 (describing the "wave of investment flotations" by wholesale-oriented investment banks, which was motivated by their need for capital to support the expansion of computerized trading activity). The result is an increasing divergence between the most highly capitalized banks and the smaller commercial banks, brokerage firms, and investment advisors providing more traditional financial services. *Id.* at 293–310.

57. Public capitalization is a mixed blessing for investment banks. As reporting companies, such holding companies are required to disclose a greater amount of information about the business risks of their proprietary activities to the public. Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 10 (discussing Item 305 of Regulation S-K). Reliance on public capitalization also means that financial institutions are acutely sensitive to their public share price, particularly if compensation of traders and their supervisors is tied to short-term stock performance rather than the risk horizon for their product markets. INST. OF INT'L FIN., FINAL REPORT OF THE IIF COMMITTEE ON MARKET BEST PRACTICES: PRINCIPLES OF CONDUCT AND BEST PRACTICE RECOMMENDATIONS 58–61 (2008) [hereinafter IIF REPORT].

58. Commercial banks have long relied on the ability to finance long-term loans with short-term deposits; crucial to the success of this "carry trade" is the ability to guarantee a profitable spread between the rates charged to borrowers and the rates paid to depositors. *See* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 192–93 (2009). The elimination of restrictions on the interest rate payable in savings accounts, as well as the development of strategies to circumvent restrictions on the payment

to permit regulated entities and their affiliates to branch into the jurisdiction of other regulators, often without judicial resistance, accelerated the deregulatory process;[61] indeed, commercial banks and broker/dealers clashed over the proper

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of interest in checking accounts under § 19i of the Federal Reserve Act, 12 U.S.C. § 371a (2006), and Regulation Q thereunder, 12 C.F.R. § 225.3 (2009), through money market funds and negotiated orders of withdrawal, has created greater pressure on banks to tighten this spread. *See, e.g.*, Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1327–30 (1995) (arguing that competition among banks to offer higher interest rates "spurred high-risk loans" and the savings and loan crisis of the late 1980s); Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 S.M.U. L. REV. 505, 569 (1998) (observing competition from mutual funds and other investment vehicles providing traditional check-cashing and retail banking services). Specialized electronic trading platforms enable corporations with a high credit rating seeking short-term financing to bypass financial institutions in favor of direct access to commercial paper markets. SEC. INDUS. & FIN. MKTS. ASS'N, ECOMMERCE IN THE FIXED-INCOME MARKETS: THE 2006 REVIEW OF ELECTRONIC TRANSACTION SYSTEMS 4–16 (2006) (surveying electronic platforms for various sectors—including commercial paper—by trading method, participants, and availability of pretrade prices and posttrade information), *available at* http://www.sifma.org/research/pdf/2006eCommerceSurveyFinal120606.pdf.

59. The profitability of the traditional brokerage, dealing, and underwriting activities of investment banks has also come under pressure from deregulation and advances in technology. *See* MORRISON & WILHELM, *supra* note 55, at 231–38, 240–42, 245–49. The abolition of fixed-commission schedules for brokerage transactions, as well as the entry of commercial banks into "discount" brokerage, spurred competition in brokerage compensation. SELIGMAN, *supra* note 41, at 473–86. Competition from electronic trading platforms, together with pressure from antitrust regulators and the SEC to abandon anticompetitive market-making practices, has reduced profit margins for exchange specialists and market makers. Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 386–87 (2002); Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. CORP. L. 865, 887–911 (2008). The availability of shelf registration for offerings of equity and debt securities under the Securities Act may have reduced the underwriters' spread on securities offerings by eligible issuers. David S. Kidwell, M. Wayne Marr & G. Rodney Thompson, *Shelf Registration: Competition and Market Flexibility*, 30 J.L. & ECON. 181, 205–06 (1987); Pouncy, *supra* note 58, at 570–71.

60. Jon Hilsenrath, *Markets Police Themselves Poorly, but Regulation Has Its Flaws*, WALL ST. J., July 21, 2008, at A2. At least one commentator has suggested that it is no longer justifiable to bundle routine account services for bank depositors with the high-risk activities of commercial banks, particularly in light of the broad range of mutual funds and other financial institutions that can perform this risk-taking function for investors. Oz Shy & Rune Stenbacka, *Rethinking the Roles of Banks: A Call for Narrow Banking*, ECONOMIST'S VOICE, June 2008, at 4, *available at* http://www.bepress.com/cgi/viewcontent.cgi?article=1271&context=ev.

61. *See, e.g.*, Bd. of Trade of Chi. v. SEC, 187 F.3d 713 (7th Cir. 1999) (concluding, over the SEC's objection, that futures contracts could be listed on the Dow Jones Utilities and Transportation Averages, because they reflected the market performance of industries that themselves represented a substantial segment of the market); Bd. of Trade of Chi. v. SEC, 923 F.2d 1270 (7th Cir. 1991) (upholding SEC's order to permit a proprietary trading system for options on government securities operated by Delta Government Options Corporation not to register as an "exchange" under § 6 of the Exchange Act, over the

scope of activities permitted under their respective statutory regimes.[62] Moreover, unregulated entities, such as hedge funds[63] and structured investment vehicles,[64]

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objections of rival CFTC-registered commodity exchanges trading Treasury futures); Chi. Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989) (holding that "index participations" were both securities and futures contracts, but that the CFTC's exclusive jurisdiction over futures contracts precluded SEC action with respect to such instruments).

62. For example, the Commission attempted to check the incremental expansion of securities activities by national- and state-chartered banks—in the face of judicial acquiescence to such activities within the Glass-Steagall framework—in its Rule 3b-9. 17 C.F.R. § 240.3b-9 (2007), *repealed by* Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Exchange Act Release No. 56,501, 72 Fed. Reg. 56,514, 56,566 (2007). *See, e.g.*, Sec. Indus. Ass'n v. Bd. of Governors, 468 U.S. 207 (1984) (upholding FRB order permitting nonbanking subsidiaries of a bank holding company to operate a discount brokerage business for bank customers); Sec. Indus. Ass'n v. Bd. of Governors, 807 F.2d 1052 (D.C. Cir. 1986) (upholding FRB order permitting state-chartered commercial bank to place commercial paper issued by third party); Sec. Indus. Ass'n v. Office of the Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), *aff'd*, 758 F.2d 739 (D.C. Cir. 1985) (per curiam), *aff'd in part and rev'd in part*, Clarke v. Sec. Indus. Ass'n, 479 U.S. 388 (1986).

Rule 3b-9 subjected to Commission regulation any bank that earned "transaction-related compensation" from brokerage services, whether as an accommodation for existing banking customers or resulting from public solicitation. 17 C.F.R. § 240.3b-9 (2007). The Commission deemed banks (or bank subsidiaries) providing such services to be excluded from the definition of "bank" under the Act, 15 U.S.C. § 78c(a)(6), and thus subject to regulation as brokers and dealers. The Court of Appeals for the D.C. Circuit vacated Rule 3b-9 in *American Bankers Ass'n v. Securities and Exchange Commission*, 804 F.2d 739 (D.C. Cir. 1986). Noting that Congress was aware of the various securities-related activities in which banks had traditionally engaged, *id.* at 746, the court observed that the regulatory structure established by Congress was designed to avoid duplicative regulation of financial institutions. *Id.* at 747 (noting the exemption for banks from the definitions of "broker," "dealer," "investment company," and "investment adviser"). The Court particularly noted that the term "bank" was defined "in terms of the government agencies that regulated them," rather than the specific functions they performed (i.e., deposit-taking). *Id.* The exclusion of banks from registration as brokers and dealers was thus "but one part of a consistent congressional policy of keeping oversight of the banking system separate from the SEC's oversight of the securities trading and investment industries." *Id.*

63. The nature of securities and derivatives trading, to a degree, limits the competitive impact of such entities. To obtain access to trading markets without revealing their trading strategies, for example, hedge funds and other entities typically must employ the services of a prime broker. Danforth Townley, *Davis Polk & Wardwell Memorandum Re: Negotiations of Prime Brokerage Arrangements*, *in* HEDGE FUNDS 2008, at 165, 167 (PLI Corp. Law & Practice, Course Handbook Series No. 14,014, 2008) (setting forth the basic terms of a prime brokerage agreement, including description of margin and collateral requirements); Letter from Brandon Becker, Director, Division of Market Regulation, Securities and Exchange Commission, to Jeffrey C. Bernstein, Prime Broker Committee (Jan. 25, 1994), *reprinted in* Townley, *supra* at 172–73 (setting forth interpretation of Commission and FRB rules for collection of margin and valuation of collateral from hedge fund customers pursuant to Regulation T). As a result, such funds remain subject to each investment bank's prudential limitations on customer borrowing or leverage.

Moreover, the individually tailored terms of swap agreements and the need for opacity ensures that most over-the-counter derivatives will be written through "swap dealers" rather than in principal-to-principal transactions. Hu, *supra* note 56, at 354–56.

profited from trading and arbitrage activities that commercial and investment banks performed;[65] these activities also raised concerns about systemic risk.[66] In an effort to compete with such entities, financial institutions began to sponsor their own off-balance-sheet investment vehicles through their investment advisory affiliates.[67]

Unlike bank holding companies, which became subject to significant restrictions on their activities and affirmative obligations with respect to their subsidiaries much earlier,[68] investment banks were not generally subject to prudential or other regulatory restrictions on financial activities performed through affiliates.[69] The

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64. *See, e.g.*, Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1777–78 (2004) (arguing that "[s]ecured lending runs the risk of becoming the poor cousin of securitization, not because securitization offers greater efficiency, but because it facilitates regulatory evasions and creates economic distortions").

65. Such vehicles do not perform traditional deposit-taking or broker/dealer services and rely on private capital raising, although some have sought to compete with financial companies and investment banking groups in the provision of certain financial services to third parties, such as writing commercial loans. Paredes, *supra* note 23, at 1001 n.101.

66. Because the books and records of such entities are not subject to regulatory oversight, regulators can only piece together the concentration risk to such hedge funds from any reports or compliance inspections of the financial intermediaries with whom they deal. STAFF OF THE SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 79 (2003) [hereinafter 2003 HEDGE FUND REPORT] ("The Commission may indirectly view certain limited aspects of hedge fund trading activities through its supervision of other market participants, *i.e.*, broker-dealers, SROs, etc. These avenues, however, present a fragmented view of the overall trading activity of hedge funds.").

67. Of course, to the extent that the proprietary funds are backed by the reputation of the sponsoring firm, an expectation may be created that the firm will guarantee obligations of the sponsored fund if it defaults. *See, e.g.*, David Enrich, *Inside Citi, a Hedge-Fund Push Blows Up; Brokers' Pitch to Investors Was One of Low Risk; Now, a Suit and a Move to Compensate for Big Losses*, WALL ST. J., Apr. 29, 2008, at C1 (reporting Citigroup's consideration whether to cover some losses in its Falcon and ASTA/MAT hedge funds); *see also infra* note 143.

68. The Bank Holding Company Act of 1956 gives the FRB the authority to regulate holding companies that have one or more operating subsidiaries that are depository institutions. *See, e.g.*, 3 MALLOY, *supra* note 19, § 8.2.1 (reciting history of the Bank Holding Company Act). The Act gave the Board the authority to permit bank holding companies (BHCs) to engage in certain activities "closely related to banking," 12 U.S.C. § 1843(c)(8) (2006); 12 C.F.R. § 225.28(b) (2009) (Regulation Y), to examine such affiliates, § 1844(c); § 225.5, and to require the BHC to terminate the activity or to terminate control of the subsidiary if the Board reasonably believed that such activity or control, inter alia, "constitute[d] a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank," § 1843(e); § 225.4. *See* 1 EDWARD F. GREENE, ALAN L. BELLER, EDWARD J. ROSEN, LESLIE N. SILVERMAN, DANIEL A. BRAVERMAN & SEBASTIAN R. SPERBER, U.S. REGULATION OF INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 13.04[3] (9th ed. 2009). A series of legislative and regulatory initiatives steadily increased the obligations of BHCs vis-à-vis their bank subsidiaries. *See, e.g.*, John C. Deal, Bob F. Thompson & Bennett L. Ross, *Capital Punishment: The Death of Limited Liability for Shareholders of Federally Regulated Financial Institutions*, 24 CAP. U. L. REV. 67, 75 (1995); Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 510–11 (1994).

69. Both NYSE and NASD rules, however, required approval of all control affiliates of a broker/dealer as well as subsequent changes in control. *See, e.g.*, NYSE Rule 304(e), 2

failure of Drexel Burnham Lambert and other firms in the high-yield securities market, however, reinforced SEC concerns that creditors of a broker/dealer affiliate might come to rely on the creditworthiness of the broker/dealer, in the expectation that the parent would shift capital from the broker/dealer as necessary to meet an affiliate's obligations.[70] Legislation thus authorized the Commission to request information regarding the activities of "material associated persons" of broker/dealers in order to obtain a better picture of the holding company's total exposure.[71]

Holding company structures also permitted a degree of regulatory arbitrage. Major investment banks, for example, moved their over-the-counter (OTC) derivatives dealing businesses into unregulated affiliates, often offshore,[72] to avoid the application of U.S. broker/dealer law and financial responsibility requirements;[73] in the process, holding companies diverted capital to such affiliates

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N.Y.S.E. Guide (CCH) ¶ 2304 (Mar. 8, 2006) (requiring Exchange approval of "[a]ny person who controls a member or member organization, . . . but is not a member or allied member or employee of a member organization"); NASD Rule 1017(a), FINRA Manual (FINRA), at 16,131 (June 26, 2008) (requiring members to file an application for approval of certain changes to its "ownership, control, or business operations").

70. S. REP. NO. 101-300, at 50–58 (1990); *see also* Jackson, *supra* note 68, at 564–68 (citing empirical evidence opposing this "hungry wolf" hypothesis); Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 481 (1992) (contrasting FIRREA cross-guarantees and other FDIC insolvency powers with traditional powers of trustee in bankruptcy); *cf.* 12 U.S.C. § 1815(e) (2006) (FIRREA cross-guarantee provision).

71. Market Reform Act of 1990, Pub. L. No. 101-432, § 4, 104 Stat. 963, 966–73 (codified at 15 U.S.C. § 78q(h) (2006)); *see also* 15 U.S.C. § 78o-5(b)(2) (2006) (authorizing the Secretary of the Treasury to promulgate recordkeeping and reporting requirements for risk assessment for holding companies of government securities brokers and dealers). Prior to such authority, the Commission had adopted rules imposing a deduction from net worth when computing net capital for intercompany transactions with affiliates whose books and records were not available for examination, ostensibly to detect embezzlement or fraudulent transactions. Financial Responsibility Rules, Exchange Act Release No. 24,553, 52 Fed. Reg. 22,295 (June 11, 1987). The Commission also amended the net capital rule to impose restrictions on the withdrawal of capital, Net Capital Rule, Exchange Act Release No. 28,927, 56 Fed. Reg. 9124 (Mar. 5, 1991), and promulgated additional early warning rules to provide the Commission staff with earlier notice of such withdrawals, 17 C.F.R. § 240.17a-11 (2009).

72. *See, e.g.*, Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Keynote Address at the FDIC's Forum on Mortgage Lending for Low and Moderate Income Households: Financial Regulation and Financial Stability (July 8, 2008) (noting the difficulty of adopting liquidation rules for holding companies of investment banks, inter alia, because they book a large share of their assets at offshore affiliates subject to foreign bankruptcy laws).

73. *See, e.g.*, PRESIDENT'S WORKING GROUP ON FIN. MKTS., OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 34–35 (1999), *available at* http://www.ustreas.gov/press/releases/docs/otcact.pdf (noting the use of unregulated investment bank holding company affiliates to house OTC derivatives dealing); Darringer, *supra* note 33, at 330–31 (asserting that "setting inappropriate capital requirements" for swaps, among other consequences, "will drive certain business from the regulated sector to the unregulated sector"). The lack of legal certainty afforded to OTC derivatives is also alleged to have played a role in the expatriation of the OTC derivatives business. PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* at 1. Congress eventually

(and away from the broker/dealer) to provide derivatives affiliates with greater credit support.[74] Following a concept release to solicit advice on reforming its financial responsibility rules, the Commission took gradual steps to modernize net capital computation[75] and repatriate derivatives business conducted through such affiliates.[76] As discussed below, these efforts culminated in its 2004 rule making designed to permit broker/dealers that are part of consolidated supervised entities (CSEs) to calculate net capital on a consolidated basis.[77]

D. The Aftermath of the Repeal of Glass-Steagall

In 1999, the enactment of the Gramm-Leach-Bliley Act permitted bank holding companies to engage in a broader variety of financial activities[78] through affiliates, subject to the functional regulation of each affiliate by its designated regulator.[79]

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accommodated such contracts in the Commodity Futures Modernization Act of 2000. Pub. L. No. 106-554 app. E, § 105, 114 Stat. 2763A-365, 2763A-379 (codified as amended at 7 U.S.C. § 2(g) (2006)) (excluding from the Commodity Exchange Act's prohibition on off-board trading of futures contracts any swap transaction on a nonagricultural commodity entered into by "eligible contract participants" that are "subject to individual negotiation by the parties" and "not executed or traded on a trading facility").

74. *See, e.g.*, OTC Derivatives Dealers, Exchange Act Release No. 40,594, 63 Fed. Reg. 59,362, 59,363 nn.7–9 (Nov. 3, 1998) (describing, for example, the desirability of uniform treatment with respect to OTC derivatives that are securities—such as options on securities—and OTC derivatives that are not securities); Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863, 898 (1992); Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 63 (1996); Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 AM. U. L. REV. 1023, 1050 (1994) (describing the development of derivative product companies by major investment banks whose debt had recently been downgraded in order to obtain AAA status). By contrast, U.S. banks engaged in swaps activity pursuant to guidance from and prudential oversight of bank regulators. Exchange Act Release No. 40,594, 63 Fed. Reg. at 59,363 nn.7–9 (describing differential regulation of swaps and derivatives by federal securities and banking regulators).

75. Net Capital Rule, Exchange Act Release No. 38,248, 62 Fed. Reg. 6474 (Feb. 12, 1997) (permitting use of theoretical option pricing models for listed options and related hedges).

76. Exchange Act Release No. 40,594, 63 Fed. Reg. at 59,362 (adopting final rules that created a separate regulatory regime to entice repatriation of broker/dealer affiliates dealing in derivatives). The Commission's rules exempted such "OTC derivatives dealers" in certain "eligible OTC derivatives instruments" under Rule 3b-13 from many aspects of broker/dealer regulation and permitted OTC derivatives dealers to use Value at Risk models (VaR) to compute net capital, subject to appropriate internal controls and Commission supervision. 17 C.F.R. § 240.15c3-1f (2009).

77. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004).

78. *Compare* 12 U.S.C. § 1843(k)(1)(A)–(B) (2006) (permitting FHC activities "financial in nature or incidental to such financial activity," or "complementary to a financial activity and [which do] not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally"), *with id.* § 1843(c)(8) (permitting BHC activities "so closely related to banking as to be a proper incident thereto").

79. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999).

Such "financial holding companies" were to be subject to the "umbrella" authority of the FRB.[80] To ensure that U.S. investment banks received "equivalent" treatment with U.S. bank holding companies and universal banks under non-U.S. law, Congress simultaneously mandated that the Commission establish a program of voluntary supervision of investment bank holding companies, along the lines of the Basel Accords.[81] The Commission's 2004 rule making for supervised investment bank holding companies (SIBHCs),[82] taken together with its rule making for CSEs promulgated the same day,[83] created a regulatory system for investment banks that, for most purposes, effectively mirrored Gramm-Leach-Bliley's system of oversight for financial holding companies.

The Commission, in supervising CSEs, simplified its task by permitting consolidated regulation by the FRB of the broker/dealer affiliates of commercial banks, while focusing its own resources on ultimate holding companies of financial services conglomerates that are not financial holding companies (FHCs) or similarly supervised entities. First, the use of internal modeling was limited to highly capitalized firms[84] that were subject to regulation on a firm-wide basis. Second, firms wishing to escape the onerous, strategy-based computations of the historic net capital rule were required either to demonstrate that their ultimate holding company was regulated by the FRB or to submit to consolidated regulation by the SEC.[85] Because only a handful of firms ever qualified as CSEs that were not

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The Act repealed former sections 20 and 32 of the Glass-Steagall Act, which barred national banks and state member banks from being affiliated with, or having certain personnel relationships with, entities in certain securities activities. *Id.* BHCs that elect not to be regulated as FHCs remain subject to essentially the same requirements applicable under former section 20. *See* 1 GREENE ET AL., *supra* note 68, § 13.03[1], at 13–14 & n.36.

80. *See, e.g.*, 12 U.S.C. § 1844(c)(2)(B)–(E), (3), (4) (2006) (limiting the Board's power to examine, regulate, and set capital adequacy requirements for certain regulated affiliates of an FHC).

81. 15 U.S.C. § 78q(i) (2006); Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831, 69 Fed. Reg. 34,472 (June 21, 2004); *see also Regulation of Investment Banks: Hearing Before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008) (LexisNexis Congressional) (statement of Erik Sirri, Director, Division of Trading and Markets, SEC) (describing impetus for the CSE program).

82. Supervised Investment Bank Holding Companies, Exchange Act Release No. 49,831, 69 Fed. Reg. 34,472 (June 21, 2004) (adopting release).

83. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004) (adopting release).

84. Eligibility for supervision on a consolidated basis is conditioned, inter alia, upon the broker/dealer maintaining $1 billion in "tentative net capital" (i.e., net capital before certain adjustments for market and credit risk) and $500 million in "net capital" at all times and notifying the Commission if its "tentative net capital" falls below $5 billion. 17 C.F.R. § 240.15c3-1(a)(7) (2009).

85. As discussed below, for the largest "bulge-bracket" firms, the formal computations of the SEC's net capital requirement have been supplanted by more principles-based holding company regulation. *Cf.* 17 C.F.R. § 240.15c3-1e (2009) (capital requirements for broker/dealer subsidiaries of unregulated holding companies subject to voluntary SEC oversight); *id.* § 240.15c3-1g (capital requirements for unregulated holding companies of broker/dealers that voluntarily undertake compliance with SEC supervision).

regulated by the FRB at the holding company level—namely, Goldman Sachs, Morgan Stanley, Lehman Brothers, Merrill Lynch, and Bear Stearns[86]—the SEC believed it could use its limited staff resources to conduct reviews with a respectable level of periodicity, even if it was unable to supervise continuously.[87]

The SEC's efforts at regulating CSEs were hobbled, however, by the lack of a credible deterrent threat—even if the program were more than voluntary. First, the SEC does not enjoy the same level of political independence as the FRB, which renders it unduly susceptible to political pressure from Wall Street.[88] Second, prudential supervision, which requires iterative application of principles and standards to a firm's internal controls, entails substantial ex post compliance efforts,[89] which in turn require a dedicated stream of revenue—something the SEC does not have.[90] As a result, the SEC has an incentive to focus precious resources on those areas most likely to generate immediate reputational or psychic benefits for the agency and its staff,[91] rather than litigation or administrative action against large investment banks. Third, the SEC may be hesitant to trigger a financial crisis by suspending the activities of a major investment bank without the power to facilitate an orderly resolution of the claims of the broker/dealer's affiliates.[92]

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86. OFFICE OF AUDITS, OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM 1 n.16 (2008), *available at* http://finance.senate.gov/press/Gpress/2008/prg092608i.pdf [hereinafter OIG REPORT].

87. *See id.* at 37–38. *See generally id.* (detailing the Commission's oversight deficiencies with regard to the collapse of Bear Stearns).

88. The five-year terms of service of SEC commissioners, the relative concentration of power in the chairman to set the agency's agenda, the perceived revolving door between the industry and the Commission's senior staff, and the agency's dependence on Congressional funding that varies from year to year all contribute to a risk of extreme political sensitivity—if not regulatory capture—by Wall Street firms wielding influence on Capitol Hill. 15 U.S.C. § 78d (2006); *see, e.g.*, Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L.R. 1591, 1597–98 (2006) (chairman, senior officers rotate out); Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233, 253–58 (2004) (describing the appropriations process for the SEC and the desirability of self-funding). The FRB, by contrast, consists of governors who enjoy longer terms and funds itself through assessments on member banks and profits from its proprietary trading activities. 12 U.S.C. §§ 243, 244 (2006); *see also* Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 525 (2000).

89. *Cf.* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 267 (2007) (discussing regulatory budget for depository institutions).

90. *See* Seligman, *supra* note 88, at 253–58 (advocating self-funding for the SEC).

91. *See* Langevoort, *supra* note 88, at 1619–23 (describing the SEC enforcement process and the incentives of agency litigators as distinct from rule makers); *see, e.g.*, U.S. SEC. & EXCH. COMM'N, 2007 PERFORMANCE AND ACCOUNTABILITY REPORT 27 (2007), *available at* http://www.sec.gov/about/secpar2007.shtml (reporting, among other performance measures, "distribution of cases across core enforcement areas," "enforcement cases successfully resolved," and "percentage of first enforcement cases filed within two years").

92. In particular, the inability to oversee the liquidation of foreign affiliates would

These structural infirmities may, at least in part, have been responsible for the SEC's inability to manage the collapse of Bear Stearns and Lehman Brothers. Officially, the SEC Chairman maintained that the collapse of Bear Stearns was due to a "crisis of confidence" that denied the firm the short-term liquidity it needed despite the fact that it was well capitalized and possessed liquid collateral.[93] The SEC's Office of the Inspector General, in its report on the CSE program in the wake of the collapse of Bear Stearns,[94] noted, among other factors, that the Commission's Division of Trading and Markets was aware that Bear Stearns had significant concentrations of market risk in mortgage-backed securities;[95] that the firm's risk-management personnel lacked the necessary expertise, staffing, and independence from traders;[96] and that Bear Stearns was not "compliant with the spirit of certain Basel II standards" and failed to update its internal models to reflect the risks posed by its business.[97]

The Inspector General attributed the inability of the Division staff to address these "red flags" in part to a lack of staffing,[98] a lack of an effective process for tracking material issues to ensure that they were resolved,[99] and a lack of coordination with other divisions and other regulators.[100] It is not clear, however, what steps the Division staff or other personnel at the Commission could have taken to address these deficiencies, at least after the Commission had permitted Bear Stearns to participate in the CSE program.[101] Moreover, given the rash of near failures by bank holding companies not subject to consolidated regulation by the SEC, the Inspector General's additional findings about the SEC's failure to impose specific leverage limitations on CSEs (as with non-CSE broker/dealers)[102] or the inadequacy of its capital or liquidity metrics point to a larger failure of meaningful tools for regulatory oversight, as discussed in the next section.

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complicate resolution of an investment bank. *See supra* note 72. As a means to overcome such difficulties, the Geithner Bill would require certain financial holding companies to report periodically to the FRB on a plan for "rapid and orderly resolution in the event of severe financial distress." U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE II: CONSOLIDATED SUPERVISION AND REGULATION OF LARGE, INTERCONNECTED FINANCIAL FIRMS, § 204(d), at 11–14 (2009), *available at* http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf [hereinafter GEITHNER BILL, TITLE II] (proposing an amendment to the Bank Holding Company Act of 1956 § 6(d), 12 U.S.C. § 1845(d) (2006)).

93. *Turmoil in the U.S. Credit Markets*, *supra* note 1 (testimony of Christopher Cox, Chairman, SEC).

94. OIG REPORT, *supra* note 86.

95. *Id*. at 17–18.

96. *Id*. at 20–23.

97. *Id*. at 24–33.

98. *Id*. at 49–50.

99. *Id*. at 37–38.

100. *Id*. at 41–44.

101. The Commission may rightly be faulted, of course, for approving Bear Stearns' participation before it had completed its inspection process. *See id*. at 40–41.

102. *Id*. at 10–20.

II. THE ENDS AND MEANS OF INVESTMENT BANK REGULATION

Systemic risk,[103] as described in the context of bank regulation, invokes a parade of horribles that disrupt the operation of the U.S. banking system. The failure of one or more banks may trigger "runs" on other (solvent) banks, and the cascading chain of failures would result in the collapse of the payments system, a dearth of credit for individuals and businesses (as surviving banks scale back their lending activity), and the potential loss of deposits (absent deposit insurance).[104] These risks have long been used to justify both the rigorous supervision and examination of banks and the extensive powers of the FDIC and FRB to manage the affairs of troubled banks and bank holding companies to avoid the prospect of a bankruptcy proceeding.[105]

In the context of investment banking, the systemic risks are of a slightly different nature. The failure of an investment bank should not disrupt the securities accounts of retail brokerage customers, so long as the firm has otherwise segregated sufficient funds and securities in accordance with the SEC's customer protection rule.[106] Nor would it necessarily unduly impact counterparties to

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103. The term "systemic risk" is frequently used to refer to a risk of a series of sudden, adverse consequences buried within the legal or economic structure of the financial market that may be precipitated by one or more events. Professor Schwarcz defines the term as:

> [T]he risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.

Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008); *see also* Jonathan R. Macey, *Derivative Instruments: Lessons for the Regulatory State*, 21 J. CORP. L. 69, 82 (1995) (distinguishing systemic risk from the "localized" risk of an individual firm's default). "Systemic risk" is also increasingly invoked as a goal of federal banking or derivatives legislation, without precise definition. *See* 7 U.S.C. § 5(b) (2006) (stating, among the purposes of the Commodity Exchange Act, "to ensure the financial integrity of all transactions subject [to the Act] and the avoidance of systemic risk"); 12 U.S.C. § 4401 (2006) (finding that procedures for netting obligations among financial institutions "would reduce the systemic risk within the banking system and financial markets"); *id.* § 1823(c)(4)(G) (subparagraph entitled "Systemic Risk," permitting FDIC, upon determination of the Treasury Secretary and the concurrence of the FDIC Board and the FRB, to take "other action or provide assistance . . . as necessary to avoid or mitigate [adverse effects on economic conditions or financial stability]"); *see also* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-366 (enumerating among the purposes of the act, "(6) . . . to reduce systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions" and "(7) to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations").

104. Fischel et al., *supra* note 18, at 307–13 (summarizing economic theory concerning the reason for bank runs and their macroeconomic consequences).

105. *See* 1 MALLOY, *supra* note 19, § 1.3.3, 1.69–1.116 (describing the evolution of the FDIC).

106. 17 C.F.R. § 240.15c3-3 (2009) (requiring broker/dealers to "maintain the physical

derivatives transactions or other credit exposure to the extent that such counterparties have obtained an adequate quantity (and quality) of collateral.[107] Rather, systemic risk in this context refers to the chain of consequences for other participants in securities and derivatives markets in the event that a major firm was forced into bankruptcy.[108]

Some of the consequences of excessive "interconnectedness" might include:

- Devaluation of publicly traded securities resulting from the "fire sale" liquidation of a bankrupt firm's portfolio of securities assets;
- Devaluation of publicly traded securities resulting from the simultaneous "closeout" and liquidation of collateral used to support outstanding derivative transactions;
- Exposure to unsecured claims against the bankrupt firm, such as short-term commercial paper and undercollateralized securities or derivatives transactions;
- The loss of hedging transactions (e.g., swaps, forwards, options) with the bankrupt firm to offset market and credit risks, which might be difficult or extremely costly to replace as a result of changed market conditions;
- Exposure on credit insurance (e.g., credit default swaps) written on the debt securities of the bankrupt firm;
- Reduced lending, underwriting, and dealing activity as commercial and investment banks retrench to conserve capital.[109]

The simultaneity of such events might have consequences similar to those of traditional bank failures. For example, institutional investors may seek to unwind transactions with and restrict short-term lending to financial firms that might appear troubled;[110] this in turn could cause money market funds and other short-term funds on which individual investors rely for immediate liquidity to lose value.[111]

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possession or control of all fully-paid securities and excess margin securities" and "[e]xcess of total credits . . . over total debits" in customer accounts as computed under 17 C.F.R. § 240.15c3-3(a)). As described above, SIPC may advance funds for the prompt payment and satisfaction of net equity claims of customers (not to exceed $500,000 per customer, and for cash claims, $100,000 per customer). 15 U.S.C. § 78fff-3 (2006); *see supra* note 45.

107. For some transactions, the quantity and quality of permitted collateral is established by regulation. *See, e.g.*, 17 C.F.R. § 240.15c3-3(b)(3) (2009) (collateral required for loans of securities from customers of a broker/dealer); Class Exemption to Permit Certain Loans of Securities by Employee Benefit Plans, Prohibited Transaction Exemption 81-6, 46 Fed. Reg. 7527 (Jan. 23, 1981) (collateral required for loans of securities from an ERISA plan).

108. *See, e.g.*, Okamoto, *supra* note 58, at 194–203 (describing how the meltdowns of Long-Term Capital Management, Bear Stearns, Lehman Brothers, and AIG parallel bank runs).

109. *See, e.g.*, *Turmoil in the U.S. Credit Markets*, *supra* note 1 (testimony of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System).

110. *Cf.* BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS 23–25 (2008) (describing pressure on short-term and long-term funding markets and the increased collateralization requirements for loans secured by securities collateral other than Treasury securities, which precipitated the FRB's unprecedented decision to open its discount window to primary dealers).

111. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., NINETY-FIFTH ANNUAL REPORT

Moreover, the significant interconnectedness of commercial banks and other financial services conglomerates in securities and derivatives markets could lead to contagion in the commercial banking sector.

A. Regulatory Ends

The appropriate level of financial responsibility regulation turns, to some degree, on how the problem is framed. Efficiency—that is, the reduction of transaction costs and agency costs in the provision of financial services—is often held out to be the paramount goal of financial services regulation.[112] Access to short- and long-term capital and opportunities to fine-tune business risks are important drivers of economic growth, and an inefficient financial sector indirectly affects the performance of all other industries.[113] Regulation of financial responsibility, like other activities, should thus be assessed, at least in part, by the appropriate balancing of the ex ante costs imposed by regulation against the ex post consequences of a failure to regulate.

If we view investment bank regulation as the "localized" problem of protecting customers, creditors, and counterparties of firms approaching financial difficulty, a cost-benefit analysis might suggest that the current level of SEC regulation of investment banks is sufficient (if not itself excessively onerous).[114] SEC regulation already provides a measure of protection for customers, directly (under the customer protection rule) and indirectly (under the net capital rule). Major creditors

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5–13 (2008), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/annual08/pdf/AR08.pdf (describing impact of the failure of Lehman Brothers on the commercial paper market).

112. *See* Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 752–53 (2000) (arguing that regulation of markets is appropriate because market crashes are "allocatively inefficient" and that financial instability affects "real economic performance"); Hu, *supra* note 56, at 367 (arguing that regulation of systemic risk is important because the "'externalities' from failure are higher than those arising from the failure of a typical industrial enterprise"); Macey, *supra* note 103, at 82 (arguing that "regulation of derivatives activity is more likely to have the unintended consequence of forcing trading activity into less efficient (but economically equivalent) channels, rather than curbing or preventing such activity"); Schwarcz, *supra* note 103, at 205–07 (asserting that "efficiency should be a central goal in regulating systemic risk," but that it "should not be the only goal" because "[f]ailure of the financial system can generate social costs in the form of widespread poverty and unemployment, which in turn can destroy lives and foster crime").

113. Moreover, even those cynical of regulators' commitment to maximizing efficiency should agree that it is in regulators' self-interest to ensure that financial markets function somewhat efficiently, if only to preserve the expectation of steady increases in staff, budgets, and eventual employment opportunities after government service. *See* Langevoort, *supra* note 88, at 1603–06 (noting propensity of senior SEC officials to use superior expertise accumulated while at the Commission to seek comparative advantage upon reentry into private sector).

114. *Cf.* Darringer, *supra* note 33, at 330 (discussing the adverse effects of excessive capital requirements, including "misallocation of capital resources," "distortions in bank pricing and business decisions," causation of a "global credit crunch," "increase [in] portfolio risk [or acquisition of] the riskiest assets within each asset classification," and migration of business "from the regulated sector to the unregulated sector").

of investment banks, much like other public companies, are able to set the terms of credit at arm's length, based on their appraisal of the firm's assets and management.[115] Counterparties to various securities and derivatives transactions, moreover, may bargain for a degree of protection against counterparty credit exposure through a variety of devices.[116] Counterparty credit exposures, thus, may well be a risk endemic to the investment banking business *that can be internalized like any other risk* if adequate information is disclosed. Firms dealing with investment banks as counterparties must either adopt reasonable internal controls against such risk or bear the consequences.[117] Occasional market crises, while painful, may serve to rearrange financial relationships—rewarding perspicacious firms and well-designed products and dismantling poorly managed firms and ill-conceived products—in a socially beneficial way.[118]

Other approaches to the problem of systemic risk take a macroeconomic perspective, justifying intervention to promote the additional social goals of maintaining stability and fairness.[119] Under this view, the broader consequences of instability for the marketplace—unemployment, financial insecurity, political unrest—require regulatory intervention, even if long-term social welfare is marginally reduced.[120] A procrustean limitation on leverage may be deemed inefficient, from an economic perspective,[121] but it nevertheless provides some assurance that incidents of marketplace instability resulting from the failure of major financial intermediaries will be less frequent.[122] Fairness and investor

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115. *See, e.g.*, BASEL II FRAMEWORK, *supra* note 13, ¶ 809, at 175 (setting forth the aim of Pillar III to "encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution"). *But see infra* note 213 (critiquing the free-market perspective).

116. *Cf.* 7 U.S.C. § 1a(12) (2006) (defining "eligible contract participants" who may enter into exempt swap agreements under the Commodity Exchange Act); 15 U.S.C. § 80a-3(c)(7) (2006) (defining "qualified purchasers"); 17 C.F.R. § 240.15c3-3(c)(3) (2009) (establishing minimum collateral requirements for securities loans).

117. *See* Macey, *supra* note 103, at 84–89 (arguing that many of the risks associated with derivative trading that have been identified as "systematic risks" posing negative "externalities" by academics who favor regulation may in fact be internalized).

118. *See id.*

119. *See* Pouncy, *supra* note 58, at 590 (arguing that, from a "heterodox" perspective, "welfare enhancements resulting from productive financial innovation [should] be distributed between wages and profits not only to promote efficiency," by "correcting perceived market imperfections that, for example, raise cost, lower transacting freedom, or otherwise produce socially undesirable results," but that they should seek to promote "equity as well"); *see also* MARK CASSELL, HOW GOVERNMENTS PRIVATIZE 35–42 (2002) (discussing the Resolution Trust Corporation's mandate, in liquidating the assets of failed savings and loan associations, to ensure participation by minority- and women-owned businesses, to promote affordable housing, and to protect local financial and real estate markets).

120. *See* Schwarcz, *supra* note 103, at 207.

121. *See* Erik F. Gerding, *Laws Against Bubbles: An Experimental-Asset-Market Approach to Analyzing Financial Regulation*, 2007 WIS. L. REV. 977, 1007 (providing typology of antibubble laws).

122. *Cf.* Schwarcz, *supra* note 103, at 211–13.

protection—both in the availability and suitability of financial services—are both additional goals that might be deemed to improve efficiency.[123]

An intermediate approach might view systemic risk primarily as a collective action problem. To assert that certain firms are "too big" or "too interconnected" to fail implies that the constituents of the firm are collectively likely to prefer an outcome that preserves existing contractual and other relationships over the belated and uncertain rearrangement of those relationships in bankruptcy. The difficulty lies in developing a mechanism to share the cost of preserving those relationships, if any, so that no individual creditor or counterparty finds it advantageous to force the firm into insolvency. At one end of the spectrum, a major derivatives counterparty might prefer to buy a defaulting firm's entire portfolio rather than incur the costs of recovering its claims in bankruptcy. At the other end, individual customers or depositors may find it difficult to orchestrate or finance a bailout, merger, or prompt liquidation without regulatory intervention.

Under this approach, the goal of regulation should be to determine whether, on the basis of available information, the impact of insolvency on a firm's major counterparties would have a sufficiently significant impact that it is in their collective interest to entertain a negotiated alternative. In such situations, federal authorities can effectively address or compensate for the lack of traditional financing, fear of violating capital or concentration thresholds, lack of information, or other transaction costs that restrain counterparties and creditors from privately negotiating a transaction. Concerted action—under the oversight of a regulator or central banker—may be possible with the injection of additional resources.

B. Regulatory Means

While financial regulators have a wide range of administrative and enforcement tools at their disposal, devising the correct set of rules, standards, and principles poses several challenges.[124] First, regulators must consider what resources they have at their disposal and how much of the cost of regulation can be shifted to private industry or to third parties without a loss of quality.[125] Regulators must consider how the intensity of regulatory activity or the application of regulation should be ramped up to deal with market conditions that may portend a crisis.

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123. Because systemic risk entails consequences primarily for the counterparties eligible to participate in the markets for exotic financial instruments, the argument for regulating systemic risk under this rubric is somewhat attenuated. *See* Paredes, *supra* note 23, at 998–1004; *see also* 2003 HEDGE FUND REPORT, *supra* note 66, at 79 (arguing that the Commission's concern about the opacity of hedge funds is based "both on the possible loss of customer assets held by broker-dealers, which the Commission has a mandate to protect in conjunction with [SIPC], and the systemic risk implications for the broader financial system, should a large broker-dealer fail due to exposure to a hedge fund"). Indeed, a regulatory system designed to protect sophisticated contract participants from their own failure to monitor for local and counterparty risk might exacerbate the "moral hazard." *See* Hu, *supra* note 56, at 367–69.

124. *See* M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1396–97 (2004).

125. *See* Sidney A. Shapiro, *Outsourcing Government Regulation*, 53 DUKE L.J. 389, 390 (2003).

Moreover, regulators must consider what measures to take in the aftermath of a crisis, and the signal those actions send to regulated entities.

1. Prophylaxis: Balancing Rules and Principles

Regulators struggle with prophylactic regulation of the financial services industry because of the constant development of new products and services. Financial innovation both improves the efficiency of financial markets and increases the potential for latent risk to individual firms and to the financial system.[126] The evolution of financial instruments is driven by many factors. Some allow their users to shift or diversify risks posed by other assets or transactions. Securitization diversifies risk emanating from debt instruments with variable cash flows, such as pools of mortgages, bonds, receivables and other assets,[127] while swaps and over-the-counter derivative contracts allow contract participants to exchange the market risk or credit risk in underlying instruments for the credit risk of counterparty performance.[128] Others, such as synthetic securities,[129] money market mutual funds,[130] and repurchase agreements,[131] were tailored to circumvent particular legal or regulatory obstacles.[132]

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126. As the processes of financial innovation have become more standardized, a literature has developed in legal academia analyzing these processes and the manner in which financial regulators cope with changes in the financial system. *See* Hu, *supra* note 56**,** at 337–38 (describing change in process of innovation); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1632 (2008); Pouncy, *supra* note 58, at 513–38 (defining financial innovation, chronology of financial instruments). *See generally* Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Law*, 69 TEX. L. REV. 1273 (1991).

127. *See* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1063 (1996) (noting benefits of securitization). In doing so, it reduces the risk premium required to underwrite the underlying instruments, and thus reduces borrowing rates for homeowners, issuers, and other borrowers.

128. *See* JOHN C. HULL, OPTIONS, FUTURES, AND OTHER DERIVATIVES 132 (3d ed. 1997) (discussing credit risk of swaps).

129. Synthetic positions in various securities were developed throughout the 1990s to avoid regulation by the SEC and the CFTC. *See* Pouncy, *supra* note 58, at 585.

130. Money market mutual funds were developed in part to offer customers checking and related bank services without bank regulation. *See* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 748–49 (1985).

131. *See, e.g.*, SEC v. Miller, 495 F. Supp. 465, 467 (S.D.N.Y. 1980) (noting that entities may structure loans secured by securities as a "repurchase agreement," among other reasons, because of "a desire to circumvent the U.C.C. requirements and other legal obstacles to using ordinary collateralized loans"). An argument may be made, for example, that securities "sold" under a repurchase agreement, unlike securities "pledged" to a financing counterparty, are not subject to the automatic stay in bankruptcy. *See In re* Bevill, Bresler & Schulman Asset Mgmt. Corp., 67 B.R. 557, 596–98 (D.N.J. 1986). The legal uncertainty created by such arguments ultimately led Congress to exclude repurchase agreements from the automatic stay under the so-called "closeout" provisions of the Bankruptcy Code. 11 U.S.C. § 546(f) (2006) (limiting bankruptcy trustee's ability to avoid transfers in connection with "repurchase agreements"); *id.* § 559 (providing that "exercise of a contractual right of a

Financial products require their sponsors—be they investment banks, commercial bank holding companies, or other regulated or unregulated entities—to consider a variety of risks. Among the "known" risks that the regulatory system for financial products today requires firms to quantify for purposes of computing capital requirements are market risk from changes in the value of underlying instruments,[133] credit risk of issuers of securities,[134] and operational risks,[135] including both legal risks and agency costs arising from inadequate controls or complex legal structures.[136] As important, if less quantifiable, are the liquidity risks resulting from the depth and breadth of the market (if any) in which the instrument

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repo participant . . . to cause the liquidation . . . of a repurchase agreement" in the event of insolvency or bankruptcy "shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title"); *see* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, tit. III, sec. 391, § 101, 98 Stat. 333, 364 (adding provisions governing "repurchase agreements").

132. *See* Pouncy, *supra* note 58, at 548.

133. *See* BASEL II FRAMEWORK, *supra* note 13, ¶¶ 683–718, at 157–203. Historical information may provide some basis for modeling market risks. *See* Hu, *supra* note 56, at 345; *see also* IIF REPORT, *supra* note 57, at 47–50.

134. *See* BASEL II FRAMEWORK, *supra* note 13, ¶¶ 50–643, at 19–143.

135. *See id.* ¶¶ 644–83, at 144–57 (described as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events").

136. *See id.* at 144 n.97 (described as "exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements"). Agency costs are also a vital consideration in assessing a regulatory program. New instruments continuously strain the legal and regulatory framework for risk management. *See* Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1492 (1993); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1031 (2007). Complex legal and accounting structures exacerbate the cost of monitoring or insuring against the failure of intermediaries in the production chain. *See* IIF REPORT, *supra* note 57, at 49–50 (describing the agency cost problems inherent in the "originate-to-distribute" model of mortgage underwriting); Robert C. Pozen, *How to Revive Securitization Markets*, WALL ST. J., Apr. 29, 2008, at A11 (arguing for better disclosure of sponsor obligations and greater independent governance power with respect to securitization trusts).

Complex instruments, moreover, may result in increased agency costs if senior managers and directors are unable to supervise or implement a supervisory structure over the conduct of traders and product designers. *Cf.* Hugo Dixon, *Give Bank Boards a Spine: Directors Who Can Weigh Risk Would Also Maintain a Better Grip on CEOs*, WALL ST. J., May 27, 2008, at C12; Henry Kaufman, *Who's Watching the Big Banks?*, WALL ST. J., Nov. 13, 2007, at A25; Alistair MacDonald, *U.K. Panel Warns of Tighter Banking Regulation*, WALL ST. J., Mar. 3, 2008, at A2. Senior executives and directors may also be unfamiliar with the vast array of financial products under development, Hu, *supra* note 56, at 369–70 (quoting Michael Hiltzik, *Banks Enter New World of High Risk*, L.A. TIMES, Oct. 27, 1985, at A1), while younger traders and managers may possess technical expertise without practical experience, *see, e.g.*, Andrew Ross Sorkin, *A Wish List for Fixing Wall Street*, N.Y. TIMES, May 13, 2008, at C1 (interview with Kenneth C. Griffin, Founder of Citadel Investment Group). The rush of competitors to offer a product generating above-average returns may blind them to the need to obtain appropriate expertise or establish internal controls. *See* Pouncy, *supra* note 58, at 579; Schwarcz, *supra* note 57, at 14–15.

trades,[137] as well as risks posed by excessive concentration of positions in correlated assets or the counterparty credit risk of excessive concentration of transactions directly or indirectly with certain counterparties.[138] Indeed, to the extent that correlations among asset prices become apparent only in hindsight, it is difficult for regulators to marshal the consensus necessary to require such correlations to be taken into account in computing regulatory capital or taking other prophylactic measures.[139]

When supervising the risk-management functions of investment banks and other financial institutions, for example, policy makers must determine whether to prescribe an ex ante rule, a standard applied ex post in administrative or judicial proceedings, or a more abstract principle or objective to be elaborated by formal interpretation and informal consultation with the relevant regulators.[140] In some

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137. *See* JEAN DESROCHERS & JACQUES PRÉFONTAINE, BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION 15–16 (2008).

138. *See* BASEL II FRAMEWORK, *supra* note 13, ¶¶ 770–78, at 214–17; *see also* Jamroz, *supra* note 74, at n.219 (describing the dual impact of the implosion of several firms specializing in the high-yield securities market in the late 1980s: a decline in the market for high yield debt and illiquidity in the secondary market); Partnoy & Skeel, *supra* note 136 (anticipating underestimation of correlation risk with respect to instruments held in CDOs and other structured instruments).

139. *See* Rachel McTague, *Sirri Explains Lessons Learned So Far from Sub-Prime Securities Market Crisis*, BNA SEC. L. DAILY, Mar. 21, 2008 (summarizing remarks of Erik Sirri, Director, Division of Trading & Markets, SEC before the Investment Advisers Association to the effect that firm valuation models misestimated the correlation risk among mortgages and overestimated the liquidity of CDOs in determining concentration levels); *see also* Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 172–75 (2009).

140. *See* Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 73 (1983) (framing the question of optimal precision of rules in terms of the cost of ensuring compliance, over- and under-inclusiveness, and the cost of rule making); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 621–24 (1992) (contrasting the ex ante costs of developing rules with the ex post costs of applying and enforcing standards); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 961–68 (1995) (contrasting, inter alia, the strengths and weaknesses of rules, standards, and principles as sources of law). For example, banks that use the "standardised measurement method" for market risk developed under the original rule-based framework of the Basel Accords are generally subject to an 8% charge to net capital for the "specific risk" of holding a position in an individual equity security, and an 8% charge for the "general market risk" of holding a long or short position in the market as a whole. BASEL II FRAMEWORK, *supra* note 13, ¶ 718(xix)(i), at 176–77. Regulatory approval for the use of internal models to measure market risk under the standard-based approached envisioned by the Basel II Framework, for example, depends upon an assessment that, inter alia, "[t]he bank's models have in the supervisory authority's judgement a *proven* track record of *reasonable* accuracy in measuring risk[.]" *Id.* ¶ 718(lxxi), at 191 (emphasis added). An example of an even more abstract principle for risk-based regulation might be 12 U.S.C. § 1844(e)(1) (2006), which authorizes the FRB to require an FHC to terminate a subsidiary's activity (or its ownership or control of the subsidiary) "whenever it has reasonable cause to believe that the . . . activity

circumstances, simple disclosure of risks might be sufficient, as long as counterparties or customers possess the expertise or have access to the information necessary to assess performance independently.[141] Because of the substantial "public" business commercial and investment banks perform, they have become subject to significant substantive regulation of their risk-management and operational functions.[142] Implementing such objectives in the context of regulating financial responsibility poses significant challenges.

The broad objectives of regulation include assuring that firms use reliable internal controls for assessing business risks, maintain adequate capital and liquid assets available to weather foreseeable risks, and maintain adequate documentation of the foregoing for purposes of regulatory oversight.[143] Detailed recordkeeping and reporting rules, for example, are almost universally used for financial firms in order to simplify regulatory oversight.[144] Inducing firms to improve internal controls for greater compliance, however, is a more delicate task, particularly once the initial hurdle of registration or licensure has passed; while operational standards are preferable, because they can be tailored to individual firms' internal organization, the "iterative" process of improving compliance with standards could become futile unless the regulatory agency routinely (if not continuously) exercises its supervisory and examination powers.[145]

. . . constitutes a serious risk to the financial safety, soundness, or stability of a . . . subsidiary bank and is inconsistent with sound banking principles or with the purposes of this chapter." *Id.*

141. *See* Hu, *supra* note 136, at 1496 (advocating incremental disclosure requirements, in light of regulators' limited understanding); Schwarcz, *supra* note 57, at 4–7 (arguing that the mix of bankruptcy, tax, securities law, commercial law, accounting, and finance considerations entailed in designing financial products make disclosing the proper amount of information difficult). The recent subprime lending crisis revealed, for example, both a lack of accountability in underwriting standards for assets underlying structured instruments and the failure to anticipate the impact of concentrated defaults on valuation of such instruments. Because of the assumptions upon which these instruments were designed, originators of the special purpose vehicles failed to ensure that someone in the creation and distribution chain internalized the latent risks of uncreditworthiness and illiquidity these instruments posed. *See* Kettering, *supra* note 126, at 1632.

142. *Cf.* Jackson, *supra* note 68, at 564.

143. *See* Hu, *supra* note 56, at 380, 385 (noting that depository institutions rely primarily, if not exclusively, on capital requirements to deal with the risks posed by swap instruments and other financial derivatives); Schwarcz, *supra* note 103, at 210–13 (discussing "historical approaches" to regulating systemic risks of banks, hedge funds, and other entities whose activity may affect financial markets); *see also* Stephen Joyce, *N.Y. Fed President Outlines Reform of Nation's Financial Regulatory System*, BNA BANKING DAILY, June 10, 2008.

144. *See, e.g.*, 31 C.F.R. § 103.120 (2009) (requiring financial institutions regulated by a Federal functional regulator or a self-regulatory organization—including banking institutions, securities broker-dealers, FCMs and introducing brokers—to comply with anti-money laundering program requirements); BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 35–37 & n.2 (1997) (describing informational requirements of banks and non-bank financial institutions that provide services similar to those of banks), *available at* http:// www.bis.org/publ/bcbs30a.pdf.

145. *Cf.* Jackson, *supra* note 89, at 267 (noting that regulation of depository institutions constituted an estimated 45.1% of the total budget and required an estimated 42.7% of the total staff for U.S. financial regulation in 2004).

The choice of prophylactic measures also turns significantly on how the regulator perceives its mission. Depositors lend banks the use of their money in exchange for a fee (or banking services), whereas securities accountholders typically view broker/dealers as custodians absent express permission to use their securities.[146] The former lends itself to a system of standards for assessing the quality of lending and underwriting practices (since deposits are the source of funds for such activity), while the latter might thus lend itself to a system of rules designed to prohibit commingling.[147]

The size of modern commercial and investment banks and their highly automated trading activity makes it difficult to rely on antiquated calculations to determine the risk exposure of a firm. Hardwired rules are difficult to change, particularly if an agency's ability for rapid market intervention is limited by its statutory authority.[148] Statistical models based on analyses of scenarios representative of historical movements have thus been developed to gradually replace rule-based "haircuts" on market and credit risks.[149] New risk-management

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146. Willa E. Gibson, *Banks Reign Supreme Under Revised Article 9 Deposit Account Rules*, 30 DEL. J. CORP. L. 819, 852–53 (2005) (describing the differences between deposit accounts and securities accounts); *see supra* text accompanying notes 45–48 (discussing broker/dealer's use of customer credit balances).

147. Regulators may engage in discrimination based on size, even if regulatory philosophies may differ; those with quantitatively greater or unusual risks may be subject to more prudential supervision, while smaller firms may be subject to hard-wired rules and liquidated or sold off once they approach financial difficulty. Conversely, a regulator strapped for enforcement resources might prefer to focus on small firms—against whom they are likely to rack up more sanctions—rather than devote significant resources to large firms with a strong reputational interest in setting and abiding by industry best practice.

148. *See, e.g.*, Net Capital Rule, Exchange Act Release No. 28,927, 56 Fed. Reg. 9124, 9130–31 (Mar. 5, 1991) (Fleischman, Comm'r, dissenting) (challenging the SEC's authority to promulgate a rule empowering it to issue orders preventing the withdrawal of capital absent express statutory authority to proceed by order).

149. *See* Darringer, *supra* note 33, at 261–65 (critiquing the Basel I product-based approach to capital computation). The Basel II Framework, for example, allows banks to "use risk measures derived from their own internal risk management models" for determining market risk in lieu of the standardized "building-block" approach of the original Basel Accords, subject to:

- certain general criteria concerning the adequacy of the risk management system;
- qualitative standards for internal oversight of the use of models, notably by management;
- guidelines for specifying an appropriate set of market risk factors (i.e., the market rates and prices that affect the value of banks' positions);
- quantitative standards setting out the use of common minimum statistical parameters for measuring risk;
- guidelines for stress testing;
- validation procedures for external oversight of the use of models; and
- rules for banks which use a mixture of models and the standardised approach.

technologies employ backtesting of risk-management systems in order to detect and address emerging risks, rather than requiring regulatory review and approval of higher haircuts or margins.[150] Such measures, of course, are handicapped by firms' and regulators' inability to foresee the particular risks for which firms must establish internal controls. Without proper understanding of the limitations of risk-management systems, moreover, senior executives and managers may well abdicate authority to subordinates to make risk assessments for the firm.[151]

2. Manipulating Regulatory Levers as Market Conditions Change

Unlike commercial banks, investment banks do not rely on customer deposits to finance their day-to-day activities. Investment banking is, nevertheless, a business that can come to rely significantly on sources of short-term liquidity.[152] Investment banks may finance operations with a variety of short-term instruments, including commercial paper, repurchase agreements, and letters of credit.[153] As pressures mount to extract higher profits from underwriting, market making, derivatives dealing, and other business lines requiring cash or cash equivalents, relatively cheaper short-term financing may become significantly more attractive than long-

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BASEL II FRAMEWORK, *supra* note 13, ¶ 701(ii), at 162–63. The Basel II Framework also permits regulated entities to use an "internal risk based approach" for assessing credit risk, *id*. ¶ 211, at 52, and an "advanced measurement approach" for operational risk, *id*. ¶ 655, at 147, but only if they have received supervisory approval from their respective national bank supervisory authorities. After much debate, U.S. federal bank regulators agreed to require only certain large, internationally active banking organizations (with at least $250 billion in total assets or at least $10 billion in foreign exposure) to transition to such "advanced approaches" for credit and operational risk. Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 79 Fed. Reg. 69,288 (Dec. 7, 2007) (joint rule making by Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury).

150. *See, e.g.*, 17 C.F.R. § 240.15c3-1e(d)(1)(iii) (2009) (requiring backtesting and reconfiguration of VaR models to reflect the number of incidents in which net capital losses exceeded the VaR calculation of one-day market risk during a specified time period). Regulators must nevertheless choose (by necessity) time periods or confidence levels for the calibration of internal risk models, as well as formulae for converting projected negative movements under those models into adjustments to net capital. *See, e.g.*, *id.* § 240.15c3-1e(b)(1), (3) (2009); *see also id.* § 240.15c3-1e(c) (requiring computation of "counterparty exposure charge[s]" and "concentration charge by counterparty" using formulae applying multipliers determined by the counterparty's credit rating). Such regulatory decisions may appear "overprotective" to firms that are willing to tolerate greater market or credit risk. *See, e.g.*, Darringer, *supra* note 33, at 325–26.

151. *Cf.* Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 821–23 (2000).

152. *See* Molinari & Kibler, *supra* note 11, at 22 (describing broker/dealers' need for liquid assets).

153. *See* John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 747–48 & n.109 (2009) (describing Drexel Burnham Lambert Group's reliance on commercial paper financing); Molinari & Kibler, *supra* note 11, 25–33 (describing broker/dealer's special liquidity needs and the use of repurchase agreements and letters of credit).

term liabilities or capital.[154] These sources of liquidity, like any other, can dry up rather quickly in the event of credit concerns or a market panic.

Because the creditors in such short-term financing arrangements are typically financial intermediaries and institutional investors,[155] a capped deposit insurance scheme like the FDIC or an investor protection scheme like the SIPC may not be enough to assure investors that their financial position is secured. Risk-management protocols thus typically require firms to monitor a variety of "early warning indicators," such as:

- rapid asset growth;
- growing concentrations in certain asset classes or liabilities;
- repeated incidents of approaching or breaching internal limits;
- widening credit-default-swap spreads;
- requests for additional collateral, decrease in credit lines;
- difficulty in arranging short-term financing; or
- other potential signs of reputational concern.[156]

While market crises might be staved off through ex post regulatory intervention, there is considerably less agreement as to how regulators know when intervention is warranted, and how to intervene. In circumstances where one or more institutions approach financial difficulty, regulators may have the power to put such firms under more intense scrutiny or require them to limit their activities until they are healthier or can be sold or liquidated.[157] In the context of systemic risk, however, it is generally nonlocalized, market-wide activity that threatens market stability.[158] In an ideal world, regulators would identify overhyped or misunderstood products or contracts and curtail their use until the market has a chance to develop appropriate protocols for managing their risks.

Unfortunately, regulators do not possess such prescience, and they may well be loath to check the growth of new products through regulatory intervention simply because the rate of growth in a particular product line accelerates.[159] In the absence

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154. *Cf.* ROBERT J. BARBERA, THE COST OF CAPITALISM: UNDERSTANDING MARKET MAYHEM AND STABILIZING OUR ECONOMIC FUTURE 40–43 (2009) (summarizing Hyman Minsky's "Financial Instability Hypothesis"—which describes, inter alia, how periods of economic expansion can induce businesses and individuals to become perilously reliant on short-term financing—and its application in the recent financial crisis).

155. According to the Federal Reserve Board, money market funds and financial institutions are among the largest holders of commercial paper and counterparties to repurchase agreements. *See* FEDERAL RESERVE BOARD, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, tbls.L.207 & L.208, at 88 (Dec. 10, 2009) (identifying holdings of "federal funds and security repurchase agreements" and "open market paper"—consisting of commercial paper and bankers' acceptances—by sector).

156. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION 15–16 (2008).

157. *See supra* note 71 (SEC early warning requirements); *infra* note 163 (FDIC powers to take "prompt corrective action").

158. *See* PAULSON BLUEPRINT, *supra* note 10, at 143–46.

159. *See* Kettering, *supra* note 126, at 1645–55 (suggesting that regulators' "natural inclination to avoid market shocks is apt to lead them to support market expectations with

of independent knowledge of market practice, regulators are likely to adopt standards for new products based on the information selectively provided by the firm or industry trade associations; while these standards may reflect best practices at any given time, further refinement of standards will lag behind because of the information gap.[160] In some cases, market pressure causes legislators or regulators to remove prophylactic regulation that may be deemed to call into question the legality or regulatory treatment of the new product.[161] Even within individual firms, moreover, the innovative use of financial products by traders may exceed the ability of in-house compliance counsel to assess risks and develop appropriate internal controls.[162]

Keeping capital ratios low and margin levels high may provide greater assurance that firms will be solvent in a crisis, but they stifle growth.[163] Some academic commentators have suggested that agencies or self-regulatory organizations with margin-setting authority, such as securities and commodity exchanges, could raise margins as a means to curb trading.[164] Exchanges, however, may be loath to use

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respect to the legal characteristics of a sufficiently well-established product").

160. *See* Hu, *supra* note 56, at 405–06.

161. *See* Kettering, *supra* note 126, at 1632–55 (describing the manner in which repurchase agreements achieved legal certainty in judicial proceedings and with the blessing of regulators and legislators as a result of being "too big to fail").

162. Private incentives to prevent risks from erupting into crises may not suffice either. Financial institutions with a strong, long-term reputational interest, for example, might seek to reduce leverage and amass liquidity in ebullient markets, in order to invest more cheaply in failing firms during a market downturn. This long-term incentive, however, may be undercut by short-term interests driven by compensation structures or pressure from shareholders to maximize earnings.

163. A self-regulatory organization such as a stock exchange may, of course, require that a firm that is nearing its maximum capital ratio scale back its activity to a more reasonable level as a condition of maintaining or expanding its current level of business. *See, e.g.*, NYSE Rule 325(a), (b), 2 N.Y.S.E. Guide (CCH) ¶ 2325 (Dec. 10, 2008) (requiring firms carrying customer accounts to refrain from expanding or to reduce business if net capital falls below certain levels). *But see* 15 U.S.C. § 78iii(e) (2006) (requiring SIPC to "consult and cooperate" with SROs to "develop[] and carr[y] into effect procedures reasonably designed to detect approaching financial difficulty").

By contrast, the Federal Deposit Insurance Corporation Improvement Act of 1991 significantly expanded the FDIC's authority to take "prompt corrective action" in the event an insured depository institution encounters difficulty, subject to a least cost analysis. 12 U.S.C. § 1831o (2006) (specifying corrective action to be taken by FDIC or appropriate banking agency if an insured depository institution is "undercapitalized," "significantly undercapitalized," or "critically undercapitalized"); *id.* § 1843(*l*)(1)(A) (requiring as a condition of eligibility to be regulated as a "financial holding company" that "all of the depository institution subsidiaries of the bank holding company [be] well capitalized"). Some commentators have questioned whether the FDIC's special powers with respect to insolvent banks are warranted. *See* Swire, *supra* note 70, at 488, discussed *infra* text accompanying note 231.

164. *See* Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission Is Appropriate?*, 80 NOTRE DAME L. REV. 909, 947–48 (2005) (criticizing SEC and FRB for failure to use regulatory tools); Gerding, *supra* note 121, at 1030 (discussing the limited effectiveness of margin rules).

that authority in a manner that might decrease liquidity during periods of price volatility;[165] indeed, increased competition may signal greater liquidity, which in turn may prompt further deregulation.[166] Imposing credit limits or heightened margin or capital requirements on one class of assets in the midst of a rising market, moreover, could well trigger a collapse in asset prices while speculative activity migrates to another asset class to compensate.[167] Likewise, in lieu of closing down insolvent firms immediately, regulators (either because they lack such power or fear repercussions for other firms) may attempt to keep the firm on life support by attempting to prevent market forces from taking their course.[168]

3. Allocating the Cost of Failures

Law and regulation dictate how and to what extent the cost of failures are allocated to individual market participants (counterparties and creditors), industry peers, and the public (whether in the form of a taxpayer-funded bailout or a recovery fueled by quantitative easing). At the level of individual market participants, law makers and policy makers may create or support ex ante incentives for such entities to protect themselves against the domino effect of multiple failures caused by a single irresponsible firm. At the level of the industry, law makers and regulators might seek to apportion responsibility based on the ability to pay (for example, a tax, fee, or insurance premium based the size of one's balance sheet), rather than individual culpability. When such measures are

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165. Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, 83–84, 142 (1991) (discussing and critiquing exchanges' arguments for not raising margins).

166. *See, e.g.*, Securities Credit Transactions, 61 Fed. Reg. 20,399, 20,400 (May 6, 1996) (proposed FRB rule making to deregulate extensions of credit against debt and other "non-equity securities" held by a U.S. broker/dealer for the account of a customer, on the grounds that banks, foreign broker/dealers and other foreign lenders, "with whom U.S. broker dealers increasingly compete worldwide," are "generally . . . unconstrained" in extending credit against such securities).

167. *Cf.* Hu, *supra* note 151, at 797–98 (stating that the Fed has limited tools, and that market pressure makes it difficult to use them in times of crisis). One of the great innovations of the late twentieth century was the credit default swap (CDS). In theory, CDSs could be highly useful tools in managing risk; the problem with CDSs, however, is that they substitute the credit risk of the insurer for the credit risk of the reference entity. If insurers are not diligent in controlling risk, and insureds fail to protect themselves against the possibility of the insurers' default, their utility as risk-management tools is illusory. *See, e.g.*, TETT, *supra* note 3, at 125–28; Brian J.M. Quinn, *The Failure of Private Ordering and the Financial Crisis of 2008*, 5 N.Y.U. J. L. & BUS. 549, 592–93 (2009).

168. For example, the SEC may allege manipulation if firms participate in the unwinding or transfer of client contracts from a failed entity or share information with their own clients who may have dealings with the failing entity. *See* Kate Kelly & Susanne Craig, *Goldman Is Queried About Bear's Fall—Manipulation Talk Worried Schwartz; Lehman Also Calls*, WALL ST. J., July 16, 2008, at C1 (describing the SEC investigation of Citadel's and Goldman Sachs' trading activity in the credit-swap market—in which Citadel and Goldman allegedly unwound swaps with Bear, and Goldman may have taken on swap positions that clients unwound at Bear—on the heels of rumors about Bear Stearns' solvency).

insufficient, use of fiscal or monetary policy, together with statutory or regulatory authority to resolve firms, might be appropriate.

Individual firms can best protect themselves against counterparty credit risk,[169] be it with respect to a derivative contract or credit extended against financial assets, by requiring adequate collateral to meet daily (or more frequent) variations in credit exposure, which may then be liquidated by the firm in the event its counterparty is unable to meet calls for additional collateral or otherwise triggers an event of default.[170] Moreover, firms may seek to net all of their contracts with a counterparty under one or more master agreements. The U.S. Bankruptcy Code strongly supports these approaches by granting counterparties the ability to terminate, net, and "closeout" such transactions outside of any bankruptcy proceeding.[171] While such measures may serve the interests of individual firms in "localized" failures, the preferential treatment of closeout rights to other secured and unsecured claims of an insolvent financial institution may further weaken a destabilized firm and leave less on the table for its other creditors.[172]

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169. Firms may also seek to insure against credit or counterparty risks or obtain a "put" option on financially innovative products. *See* Hu, *supra* note 56, at 418 (suggesting requirement that firms purchase swap insurance for "non-designated" swaps that can't be addressed by rules); *see also In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 113 (Del. Ch. 2009) (describing "liquidity put" that "allowed the purchasers of [Citigroup's collateralized debt obligations] to sell them back to Citigroup at original value" and the contribution of such options for Citigroup's exposure to subprime mortgage risk). *But see supra* note 167 (discussing insurance risk).

170. *See, e.g.*, HULL, *supra* note 128, at 534.

171. The Code permits, inter alia, enforcement of ipso facto clauses providing for termination of qualified transactions upon bankruptcy, 11 U.S.C. §§ 555, 556, 559, 560 (2006), netting of exposures resulting from such transactions and the liquidation of collateral supporting such transactions outside the automatic stay ("closeout"), *id.* § 362(b)(6), (7), (17), and restricts avoidance of transfers constituting margin or settlement payments, *id.* §§ 546(e), (f), (g). *See* Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1525–32, 1534–37 (2005) (discussing the Code provisions).

172. Kettering, *supra* note 126, at 1651 (discussing, in the context of the LTCM bailout, the consequences of exercising closeout rights); Schwarcz, *supra* note 103, at 201 (describing impact of simultaneous closeout of open derivatives contracts); *see also* Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout* 20 (Fed. Reserve Bank of Chi. Working Paper Series, Paper No. 2005-03, 2005), *available at* http://ssrn.com/abstract=730648 (asserting that, while netting and closeout provisions are routinely justified because of their role in reducing systemic risk, closeout rights potentially contribute to systemic risk "by making it more difficult to manage the distress or insolvency of a major dealer" and netting and collateral protections "do little to ameliorate the disruptions to markets that would ensue from abrupt termination of a large number of contracts with attendant fire-sale losses from liquidating collateral and the need to reestablish hedges with new counterparties"); Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 114–16 (2005) (arguing that differential treatment of derivatives contracts in bankruptcy may be justified on the grounds that the automatic stay does little to enhance their value, unlike firm-specific assets whose value might be impaired if the firm ceased to be a going concern).

More comprehensive mechanisms entail a combination of industry initiative and regulatory effort to overcome collective action problems.[173] Clearinghouses and guarantee funds, much like insurance companies, mutualize the risk of localized defaults among all members or contributors.[174] Clearinghouses may additionally facilitate multilateral netting of exposures among their brokers and dealer members to reduce each member's net exposure to the financial system.[175] Often the obligations of defaulting members of such clearinghouses will also be backed by a guarantee fund into which members must contribute. To the extent that a firm's contribution to a guarantee fund, or pro rata share of loss in a clearinghouse, is not linked to the extent or riskiness of its dealings with a defaulting firm, however, clearinghouses may lessen the incentive for firms to make the ex ante expenditure necessary to monitor risk.[176]

Some regulators have taken steps to enhance the responsibility of the financial industry in containing systemic risk through better clearance and settlement systems for derivatives and other new financial products.[177] Like traditional

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173. For example, the clearance and settlement of securities was consolidated by the Securities Acts Amendments of 1975. 15 U.S.C. § 78q-1 (2006). Through the SEC's persistence in fulfilling this mandate, clearance and settlement of transactions in most publicly-traded securities is now effected through various subsidiaries of the Depository Trust & Clearing Corporation (DTCC). PAULSON BLUEPRINT, *supra* note 10, at 211. All options listed on U.S. stock and options exchanges are cleared and traded through the Options Clearing Corporation. HARRIS, *supra* note 17, at 50. By contrast, clearinghouses for futures and related transactions remain unlinked. PAULSON BLUEPRINT, *supra* note 10, at 51.

174. *See* HARRIS, *supra* note 17, at 46; *supra* note 153.

175. *See, e.g.*, Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps, Securities Act Release No. 8999, Exchange Act Release No. 59,246, 74 Fed. Reg. 3967 (Jan. 22, 2009) (to be codified at 17 C.F.R. pts. 230, 240, 260) (adopting interim final temporary rules providing exemptions under federal securities law to facilitate the operation of one or more central counterparties for those credit default swaps); *DTCC and the Clearing Corporation Announce Credit Default Swap Clearing Facility*, DTCC CORP. NEWSL. (Depository Trust & Clearing Corp.), June 2008, at 6, *available at* http://www.dtcc.com/news/newsletters/dtcc/2008/jun/june@dtcc.pdf (describing arrangements to facilitate central clearing for OTC derivatives dealers through a central clearing counterparty).

176. *Cf.* Romano, *supra* note 74, at 81.

177. For example, Treasury Secretary Timothy Geithner has delivered proposed legislation for "financial regulatory reform" to Congress, which includes a proposal to require clearing of all over-the-counter derivatives through a registered derivatives clearing organization. *See* U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE VII: IMPROVEMENTS TO REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS, § 713, at 15–30 (2009), *available at* http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf [hereinafter GEITHNER BILL, TITLE VII]; *see also* Press Release, Fed. Reserve Bank of New York, Statement Regarding June 9 Meeting on Over-the-Counter Derivatives (June 9, 2008), *available at* http://www.newyorkfed.org/newsevents/news/markets/2008/ma080609.html (describing meeting of "17 major financial institutions" to discuss ways to improve processing, centralization, and infrastructure of over-the-counter derivatives); Michael M. Grynbaum, *Derivatives Trading Is Scrutinized*, N.Y. TIMES, June 10, 2008, at C1; *Regulators Agree Central Counterparty for Derivatives Market Would Lower Risks*, BNA SEC. L. DAILY, July 10, 2008 (discussing the support of Pat Parkinson,

clearinghouses for transactions in equity and debt securities and exchange-traded derivatives, a central clearinghouse for over-the-counter derivatives would reduce each individual member's exposure to a defaulting counterparty to a financial contract in two ways: first, by netting transactions so as to reduce the total number and size of outstanding transactions with a defaulting counterparty, and second, by guaranteeing each defaulting member's net obligation through a guarantee fund.[178] The key obstacle here is that any guarantee fund designed to satisfy member obligations in full might entail a significantly increased commitment of liquid capital beyond current levels.[179] As a result, central clearing and settlement might help reduce net exposures and provide some guarantee for specific products but should not be expected to contain a major crisis.

The last resort in any crisis of systemic proportions is a federally orchestrated bailout or liquidation.[180] In the context of commercial banks and other insured depository institutions, routine liquidation transactions have historically taken a

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deputy director in the Federal Reserve's Division of Research and Statistics, for proposed CCP for credit derivatives).

178. Ancillary to such a system is the need for mechanisms to capture trade information electronically and contemporaneously with the execution of such transactions, as well as procedures to ensure that the common terms of such transactions are adequately documented in master agreements. Both regulators and industry participants have become increasingly concerned, in recent years, about the lack of adequate documentation underlying their derivatives activity. COUNTERPARTY RISK MGMT. POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 11 (2005) [hereinafter TOWARD GREATER FINANCIAL STABILITY] (presenting recommendations and guiding principles, classified as (i) "actions that individual institutions can and should take at their own initiative," (ii) "actions which can be taken only by institutions collectively in collaboration with industry trade groups," and (iii) "actions which require complementary and/or cooperative actions by the official sector"); *Lawmakers Seek GAO Report on Tech Woes in Derivatives Market*, 38 Sec. Reg. & L. Rep. (BNA) No. 24, at 1008 (June 9, 2006) (requesting that GAO determine the adequacy of the legal, technological, and paperwork-handling infrastructure of credit derivatives markets).

179. *See, e.g.*, DEPOSITORY TRUST & CLEARING CORP., ANNUAL REPORT 54 (2008), *available at* http://www.dtcc.com/downloads/annuals/2008/2008_report.pdf (reporting participant deposits of approximately $47 billion as of December 31, 2008); OPTIONS CLEARING CORP., ANNUAL REPORT 19 (2008), *available at* http://www.optionsclearing.com/about/ann_rep/ann_rep_pdf/annual_rep_08.pdf (reporting a $5.5 billion clearing fund as of December 31, 2008); SEC. INVESTOR PROT. CORP., ANNUAL REPORT 16 (2008), *available at* http://www.sipc.org/pdf/SIPC Annual Report 2008 FINAL.pdf (reporting net assets of approximately $1.7 billion as of December 31, 2008, prior to the satisfaction of $1.4 billion in "estimated costs to complete customer protection proceedings" relating to the Madoff scheme and others).

180. While nationalization of banks is not openly mentioned as an option in the United States, the FDIC and other bank regulators have maintained dominant interests in or operated banks while in receivership for significant periods of time. *See, e.g.*, Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 BROOK. L. REV. 1295, 1296, 1327–36 (1995) ("By the end of President Reagan's second term in office, the advocates of free-market capitalism were quietly relying on massive government interventions and a policy of financial bailout to safeguard the entire monetary payment system."); *cf. End of Illusions*, ECONOMIST, July 19, 2008, at 81 (dubbing potential "conservatorship" of government sponsored enterprises a "fancy word for nationalization").

variety of forms, including open monetary assistance to keep troubled banks afloat, negotiated "purchase-and-assumption" transactions, auctioning of the bank's assets, and outright payments to insured depositors.[181] For more systemic crises, the use of fiscal or monetary policy may be appropriate to provide liquidity to the marketplace on a temporary basis.[182] To avoid undue "moral hazard," central bankers and other federal interveners must of course maintain a degree of "constructive ambiguity" as to whether a given entity or crisis will warrant intervention.[183] Beyond mere moral hazard, however, government intervention may well dole out benefits and costs unfairly among market participants if federal officials are motivated by political pressure, rather than the obligation to seek out the best outcome.[184]

III. ALTERNATIVE STRATEGIES TO REGULATING INVESTMENT BANKS

While the SEC's program for supervision of CSEs and SIBHCs has been suspended,[185] it is far from settled as to how federal regulators will regulate holding companies of financial service providers other than bank holding companies. Federal policy makers have proposed broad oversight of all financial service providers, as discussed in greater detail in Part IV below, but differ substantially as to the regulatory responsibilities and appropriate regulatory authorities for holding companies of regulated broker/dealers and other categories of financial intermediaries. Critical to resolving this issue is a determination as to (i) which additional categories of financial services conglomerate must be subject to federal oversight for financial responsibility and (ii) which categories of financial services conglomerate will be eligible for voluntary federal oversight (for example, as a

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181. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1172–1193 (1988). The Resolution Trust Corporation (RTC), a federally chartered corporation, handled nearly $460 billion in assets owned by approximately 750 ailing thrift institutions over a six-year period (1989–1995): as conservator of ailing thrifts, RTC either sold off them or their insured deposits to private buyers (making up the difference) or shut them down and paid insured deposits directly; RTC also acted as receiver of unsold assets. *See* CASSELL, *supra* note 119, at 28–32. To avoid openly impacting the federal budget (by law, any new expenditures had to be offset by tax increases or cuts in existing expenditures), RTC's operations were funded in substantial part by the Resolution Funding Corporation (REFCORP), a quasi-governmental corporation that raised approximately $30 billion by issuing long-term bonds underwritten by private investment bankers (at a premium to Treasury securities). *Id.* at 148–49.

182. *See infra* Part IV.C.

183. Partnoy, *supra* note 112, at 757, 783 (suggesting that central bank should maintain "constructive ambiguity" as to whether it will bail out failing financial firms); *cf.* Hu, *supra* note 151, at 875 (arguing that the Federal Reserve and Treasury's power to clean-up should be curtailed as a signal to the market that there is no safety net).

184. *See, e.g.*, Hu, *supra* note 151, at 870 (suggesting that Warren Buffett was willing to bail out LTCM).

185. Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), *available at* http://www.sec.gov/news/press/2008/2008-230.htm.

condition for exemption from regulation in other jurisdictions where they do business).

Among the new categories of financial service provider that are likely to become subject to some enhanced federal oversight regime are holding companies of insurance companies. Several proposals contemplate a federal regulatory scheme for some systemically significant insurance companies,[186] in light of the near failure of AIG due to the derivatives activity of its unregulated affiliates.[187] Investigations into the conduct of AIG have already identified that the regulation of AIG's insurance companies by the New York State Insurance Department did not ensure adequate oversight of AIG's affiliated financial-products divisions, even though such affiliates handled a significant volume of exchange-traded and over-the-counter derivatives.[188] With federal regulation of insurance companies, regulation of insurance holding companies is a likely further step.[189]

In addition to insurance companies, there is a growing consensus that hedge funds and other private funds are likely to come under increased regulatory scrutiny. The Obama administration has resurrected proposals to subject hedge fund advisers to registration under the Investment Advisers Act of 1940.[190] Meanwhile, European Union regulators have publicly discussed subjecting such private funds to a degree of regulatory oversight,[191] in which case U.S. funds participating in European or international markets may seek a domestic regulatory regime—much like the SIBHC and CSE regulatory regimes—to take advantage of any available exemptions based on reciprocity or home country regulation.

186. *See* U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE V: OFFICE OF NATIONAL INSURANCE, § 313, at 1–2 (2009), *available at* http://www.financialstability.gov/docs/regulatoryreform/title V ofc Natl Ins 7-22-2009 fnl.pdf (proposing to create an Office of Insurance within the Treasury Department that would have the authority, among other functions, "to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system"); GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 8 (2009), *available at* http://www.group30.org/pubs/reformreport.pdf [hereinafter G30 REPORT].

187. *See, e.g.*, William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009) (describing how AIG exploited the CFMA to engage in derivatives activity at the holding company level).

188. *But cf. American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearings Before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 6–8 (2009) (testimony of Eric Dinallo, Superintendent, New York State Insurance Department) (defending the New York State Insurance Department).

189. *See* PAULSON BLUEPRINT, *supra* note 10, at 126–36.

190. *See* U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE IV: REGISTRATION OF ADVISERS TO PRIVATE FUNDS (2009), *available at* http://www.treas.gov/press/releases/reports/title iv reg advisers priv funds 7 15 09 fnl.pdf (requiring registration of advisers to private funds) [hereinafter GEITHNER BILL, TITLE IV].

191. *See Commission Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers*, at 2–4, COM (2009) 207 final (Apr. 30, 2009) (proposing to require hedge funds and private equity funds that meet certain thresholds for assets under management to obtain authorization from their home country regulators and to meet certain requirements, including minimum capital requirements).

Moreover, the FDIC has unveiled rules that would require heightened capital cushions, continuity of ownership, and regulatory scrutiny for private equity firms that seek to acquire depositary institutions, but without designating them as a "source of strength" for their depositors like traditional bank holding companies.[192] For such private funds, regulators might well consider regulation as an investment bank holding company as a means of discouraging creeping regulation by banking regulators.

A third possibility is that existing bank and nonbank holding companies may wish to spin off financial services businesses, either to remove troubled assets or to qualify for access to federal assistance in the event of a systemic failure.[193] Separating the "good bank" from the "bad bank" would allow the good bank to seek private infusions of capital based upon its stronger portfolio of assets.[194] The holding company and its nonbank subsidiaries would thus continue to operate as a going concern or wind down in an orderly manner.[195] Regulation of such entities as a broker/dealer holding company or similar nonbank holding company might entitle them to the benefits of exemptive relief for financial institutions engaged in derivative transactions under federal securities, commodities, and bankruptcy law.

The common theme is that financial services conglomerates that are not bank holding companies should be subject to some regulation for systemic risk, but not to the same degree as federally insured depository institutions or their holding companies. Regulators would therefore be responsible for monitoring such firms for liquidity and capital adequacy—and possibly for intervening to resolve a failing institution in the event of financial stress—but without the same commitment to rescue such firms as depository institutions. To the extent that the allocation of authority to or among regulators sets the tone for any subsequent regulatory

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192. Final Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440, 45,448 (Sept. 2, 2009).

193. Among nonbank companies, for example, General Motors spun off its financial services arm, GMAC, in 2006 as part of an internal reorganization. *See* GMAC Financial Services, Who We Are, http://www.gmacfs.com/us/en/about/who/index.html. GMAC subsequently sought and obtained approval from the FRB as a bank holding company in 2008. *Id.* General Electric, meanwhile, has lobbied Congress to avoid becoming subject to regulation as a bank holding company, despite calls from the Treasury to regulate its financial services arm, GE Capital, as a bank holding company. *See, e.g.*, Peter Eavis, *Defining Road Rules for GE Capital*, WALL ST. J., Aug. 10, 2009, at C10.

194. *See* Editorial, *Making Failure an Option*, WALL ST. J., June 9, 2009, at A18 (advocating breakup and resolution of Citigroup); Katharina Bart, *UBS Banks on Low-Risk Future*, WALL ST. J., Feb. 11, 2009, at C3 (describing UBS's decision to require investment banking units to fund themselves at market rates instead of relying on cheaper central funding).

195. *See, e.g.*, John Coates & David Scharfstein, *Lowering the Cost of Bank Recapitalization*, 26 YALE J. ON REG. 373, 381–82 (2009) (describing the process by which the assets of a BHC bank subisidiary might be removed to a bridge bank, owned and guaranteed by the FDIC, without attempting to recapitalize the BHC and its nonbank subsidiaries); Rob Cox, *Citibank in 2011—Hypothetically*, N.Y. TIMES.COM, Jan 24, 2010, *available at* http://www.nytimes.com/2010/01/25/business/25views.html (satirically describing the possible "creation of Toxia, America's biggest nonbank financial institution," to contain the most underperforming assets of GE Money and Citi Financial).

framework, the alternatives frequently discussed are (i) consolidation of authority in the FRB, (ii) functional regulation of investment banks and other nonbank financial services conglomerates by a regulator such as the SEC, FDIC, or newly formed regulator, and (iii) industry initiatives.

A. Consolidate Authority in the FRB

Perhaps the most forcefully advocated alternative to the current system of financial regulation is to consolidate oversight of all holding companies of all financial services providers in the Federal Reserve Board. The premise of this argument is that ex post central bank relief must be tied to ex ante central bank regulation, for only the prospect of access to central bank liquidity in times of crisis can induce market participants to comply with ex ante efforts to monitor and counteract systemic risk.[196] Accordingly, all entities that might seek an entitlement to, or face the prospect of, an intervention by the FRB by virtue of their extended network of counterparty relationships would become subject to central bank oversight.[197] At a minimum, such regulation would consist of additional information gathering by the FRB from individual firms subject to regulation, as well as the authority to alert firms of potential risks to their business resulting from their own or their counterparties' activities.[198] It would also seek to grant broad discretionary powers to the FRB to limit the activities of, or liquidate, firms that threaten market stability.[199]

Centralization of regulatory authority over financial services, whether in a central bank or other financial services agency, has many adherents.[200] First, centralization would eliminate gaps and coordinate regulation of all financial intermediaries. While holding companies for banks and brokerage firms are ostensibly subject to the same regulatory capital requirements, the potential for

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196. *See* Timothy Geithner, Op-Ed, *We Can Reduce Risk in the Financial System*, FIN. TIMES, June 8, 2008, at 9.

197. *See* PAULSON BLUEPRINT, *supra* note 10, at 146–48.

198. *See id.* at 148–51.

199. *See id.* at 151–52.

200. *See* Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1 (2005) (arguing for consolidation of banking regulators); John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 473–81 (1995) (arguing for consolidation of SEC and CFTC); Pouncy, *supra* note 58, at 587. Smaller countries may prefer a single financial regulator because of the significant benefits from economies of scale. For larger countries, policy makers must consider both pros and cons of consolidated regulation: A single regulator may improve the consistency and comparability of regulation of different financial products, avoid "regulatory gaps" when regulating new products, and be reputationally responsible for success of the system. Martin Čihàk & Richard Podpiera, Are More Integrated Prudential Supervision Agencies Characterized by Better Regulation and Supervision? 8–9 (July 5, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=998624. On the other hand, a single regulator that is too large, whose objectives are ill defined, or that performs multiple roles (such as a central bank) may not be as effective. *Id*. at 9–10.

inconsistent interpretive guidance across regulators can create opportunities for preferential treatment. Disparities in the regulation of sales practices and margins taken by bank, securities, and commodity regulators—even when such disparities are created by express statutory mandate—have long been the subject of industry complaints.[201] Regulators loath to resolve such debates may often be tempted to yield to the lowest common denominator, rather than risk alienating one constituency.

Centralization of regulatory authority in the FRB would also carry with it the benefits of depoliticization and ease of global coordination. A centralized regulatory authority, such as the FRB, is typically constituted as a central bank insulated from political pressure and thus able to focus its regulatory efforts on long-term market stability.[202] To the extent that, in many non-U.S. markets, commercial and investment banking is conducted in "universal" banking enterprises under a single financial regulator,[203] centralizing authority in the FRB would allow U.S. financial regulation to speak with one voice in international or global fora and to coordinate regulatory responses with other central bankers more rapidly.[204]

Critics note that conferring exclusive authority on a single panoptic regulator to regulate financial markets has significant drawbacks as well. A central bank with broad discretionary authority may be inclined to favor depository institutions over other regulated entities—or bank holding companies over investment banking groups, in a systemic crisis—either by relying on nonbanks as a "source of strength" for depository institutions within a holding company or favoring relief to depository institutions over other market participants.[205] It is also not clear that a

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201. *See* PAULSON BLUEPRINT, *supra* note 10, at 106–09; Coffee, *supra* note 200, at 473–81 (arguing for consolidation of SEC and CFTC).

202. *Cf.* Ramirez, *supra* note 88, at 503–04.

203. *See* Eilis Ferran, *Do Financial Supermarkets Need Super Regulators? Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 BROOK. J. INT'L L. 257 (2003); Joseph Silvia, *Efficiency and Effectiveness in Securities Regulation: Comparative Analysis of the United States's Competitive Regulatory Structure and the United Kingdom's Single-Regulator Model*, 6 DEPAUL BUS. & COM. L.J. 247 (2008).

204. *Cf.* IIF REPORT, *supra* note 57, at 126–41 (recommending that central banks institutionalize mechanisms for injecting liquidity).

205. Bank regulators have long sought to reach the assets of affiliates of a troubled institution in order to avoid commitment of public funds. For example, the FDIC has sought to require commonly controlled banks and trusts to cross-guarantee losses of an insured depository institution. Jackson, *supra* note 68, at 533–35; *see also* 12 U.S.C. § 1815(e) (2006) (granting the FDIC power to assess any loss it incurs due to the failure of one insured depository institution against commonly controlled banks and trusts, but not nonbanking affiliates).

The FRB has taken the position that BHCs must similarly serve as a "source of strength" to their subsidiary institutions, 12 C.F.R. § 225.4 (2009), and has asserted the policy view that "a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity." Policy Statement, Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707, 15,708 (Apr. 30, 1987) (noting further that "[a] bank holding company's failure to meet its obligation to serve as a source of strength to regulator with plenary authority over systemic risk will seek to use its authority to countermand heightened business conduct or prudential regulation—in the name of market stability—during the run-up to a market crisis.[206]

Unified regulation may also undermine the ability of a central regulator to distinguish the degree of federal oversight or remedial intervention accorded to different products or services. To the extent that it may be highly undesirable that investment banking and securities trading generally receive the same level of federal protection as the banking system, the identity of the regulator charged with oversight of specific affiliates or product lines is an important signal to the public—for example, SIPC versus FDIC protection—to make such divisions clear.[207] A single regulator would reinforce the implicit expectation that all regulated financial

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its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe and unsound banking practice [subject to a cease-and-desist order under § 1818(b)] or a violation of Regulation Y, or both"); Jackson, *supra* note 68, at 528–39. The Fifth Circuit rejected this view in *MCorp Financial, Inc. v. Board of Governors Federal Reserve System*, 900 F.2d 852, 863 (5th Cir. 1990) (concluding that "the Board's determination that the holding company's failure to transfer its assets to a troubled subsidiary was an 'unsafe or unsound practice' . . . is an unreasonable and impermissible interpretation of that term"), *aff'd in part and rev'd in part on other grounds*, 502 U.S. 32 (1991).

The Gramm-Leach-Bliley Act of 1999 subsequently limited the FRB's ability to seek funds or assets from a regulated securities or insurance affiliate of a troubled depository institution without the consent of such affiliate's regulator. 12 U.S.C. § 1844(g) (2006). *But see* Supervisory Letter SR 00-13 from the Bd. of Governors of the Fed. Reserve Sys. to the Officer in Charge of Supervision and Appropriate Supervisory Staff at Each Fed. Reserve Bank and to Financial Holding Companies (Aug. 15, 2000), *available at* http://www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0013.HTM (noting that the Board "is responsible for assessing consolidated capital adequacy for FHCs with the ultimate objective of protecting the insured depository subsidiaries from the effects of disruptions in the nonbank portions of the organization").

206. *See* 12 U.S.C. § 1639(*l*)(2) (2006) (providing the FRB with discretionary regulatory authority to "prohibit acts or practices in connection with . . . (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of [statutory disclosure requirements for certain mortgages]; and (B) refinancing of mortgage loans that the Board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower"); Alan S. Blinder, *Two Bubbles, Two Paths*, N.Y. TIMES, June 15, 2008, at BU6 (distinguishing central bank's role in bubbles caused by unsafe or unsound banking practices from those caused by exogenous factors); Allan H. Meltzer, *Keep the Fed Away From Investment Banks*, WALL ST. J., July 16, 2008, at A17; *see, e.g.*, Editorial, *A Crisis Long Foretold*, N.Y. TIMES, Dec. 19, 2007, at A36 (asserting that the Fed neglected its obligation to regulate "unfair" and "deceptive" mortgage lending under Home Ownership Equity and Protection Act of 1994).

207. One study has suggested, for example, that investors are generally unable to distinguish the type of services provided by, or appreciate the conflicts of interest that permeate, a web of interconnected financial intermediaries. ANGELA A. HUNG, NOREEN CLANCY, JEFF DOMINITZ, ERIC TALLEY, CLAUDE BERREBI & FARRUKH SUVANKULOV, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS, at xix (2008), *available at* http://www.rand.org/pubs/technical_reports/2008/RAND_TR556.pdf (finding that "[i]nvestors had difficulty distinguishing among industry professionals and perceiving the web of relationships among service providers").

institutions would benefit from the federal government's largesse, thus exacerbating moral hazard.

Most importantly, however, commentators have described the pressure on the FRB to avoid intervening during periods of market exuberance (when its efforts "take away the punchbowl")[208] if it has the power to remediate ex post.[209] Indeed, the FRB has rolled out a number of financing facilities in recent months to create some semblance of stability in financial markets,[210] while doing little as yet to exercise the enormous economic leverage it possesses over the financial industry to increase its prophylactic authority.[211] This may be partly a result of its twin role in the U.S. financial system, as both a regulator and market participant.[212] As a

208. "The job of the Federal Reserve is to take away the punchbowl just when the party gets going." GEORGE COOPER, THE ORIGIN OF FINANCIAL CRISES: CENTRAL BANKS, CREDIT BUBBLES AND THE EFFICIENT MARKET FALLACY 138 (2008) (attributing quotation to William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve between 1951 and 1970).

209. *See, e.g.*, COOPER, *supra* note 208, at 24 ("[T]he Fed's monetary policy can be characterised as one in which policy is used aggressively to prevent or reverse credit contraction or asset price deflation, but is not used to prevent credit expansion or asset inflation."); Amitai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 25 YALE J. ON REG. 1, 26–27 (2008) (describing pressures on FRB monetary policy); Ramirez, *supra* note 88, 538–554 (chronicling the FRB's ability to exercise political independence in exercising monetary policy); *see also* ALAN GREENSPAN, THE AGE OF TURBULENCE 178 (2007) ("If we raised rates and gave as a reason that we wanted to rein in the stock market, it would have provoked a political firestorm. We'd have been accused of hurting the little investor, sabotaging people's retirements. I could imagine the grilling I'd get in the next congressional oversight hearing.").

210. In addition to direct lending to financial institutions via its discount window, the FRB has created (i) a Term Auction Facility, through which depository institutions may bid for use of funds of 28-day or 84-day maturity, (ii) a Primary Dealer Credit Facility, which lends funds to the FRB's primary dealers overnight at fixed rate and secured using variety of collateral, and (iii) a Term Securities Lending Facility, which permits firms to borrow U.S. Treasury securities against riskier forms of collateral for a one-month period. Bd. of Governors of the Fed. Reserve Sys., Credit and Liquidity Programs and the Balance Sheet: Lending to Depository Institutions (Jan. 13, 2010), http://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm; Bd. of Governors of the Fed. Reserve Sys., Credit and Liquidity Programs and the Balance Sheet: Lending to Primary Dealers (Jan. 13, 2010), http://www.federalreserve.gov/monetarypolicy/bst_lendingprimary.htm. Notably, each of these tools is designed to provide short-term financing as a means to address concerns about scarcity of liquidity.

211. *See* Stephen Joyce & Aaron Lorenzo, *Borrowing Facilities Achieve Success but Market Stubbornness Frustrates Fed*, BNA BANKING DAILY, May 13, 2008.

212. *Cf.* Alfred C. Aman Jr., *Bargaining for Justice: An Examination of the Use and Limits of Conditions by the Federal Reserve Board*, 74 IOWA L. REV. 837, 892–98 (1989) (raising concerns about the FRB's use of conditions and voluntary commitments from bank holding companies under the Bank Holding Company Act in lieu of administrative rule making). In a related context, the Federal Reserve Board has encountered similar issues with designing its program for "primary dealers," the commercial and investment banks that assist the FRBNY in implementing monetary policy through participation in periodic Treasury auctions and the FRBNY's Open Market Operations, as well as supplying information about market conditions. HARRIS, *supra* note 17, at 58. Critical to the success of the primary dealer

regulator, the FRB has in recent years expressed a commitment to regulation by market forces, rather than altering (or stating an intention to alter) margin requirements or monetary policy or increasing regulation in the face of market practices.[213] As a market participant, however, it has a mixed record in exploiting its leverage as lender of last resort to extract either commitments to improve risk management or concessions from ailing firms to deter other supplicants for relief.[214] Other bank regulators, who do not enjoy the luxury of the FRB's unlimited balance sheet, have taken a firmer stand.[215]

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program, as with any underwriting or selling syndicate, is some assurance about (and corresponding due diligence into) the reputational integrity and creditworthiness of participating firms. Acknowledging the "public impression" that primary dealers were regulated by or held special status with the Federal Reserve System, however, the FRBNY amended its procedures to replace its discretionary selection procedures with more standardized criteria regarding capital adequacy and creditworthiness and a focus on "market," rather than "dealer," surveillance. Fed. Reserve Bank of N.Y., Administration of Relationships with Primary Dealers (Jan 22, 1992), http://www.ny.frb.org/markets/pridealers_policies.html.

213. COOPER, *supra* note 208, at 34–36 (criticizing the FRB's "internally inconsistent" philosophy of deferring to the doctrine of market efficiency while asset prices rise and credit expands, while adopting the "Keynes/Minsky perspective" of government intervention through fiscal and monetary policy when the economy contracts); MARTIN MAYER, THE FED: THE INSIDE STORY OF HOW THE WORLD'S MOST POWERFUL FINANCIAL INSTITUTION DRIVES THE MARKETS 282–83 (2001) (noting that "Greenspan's fear of ordering participants in a private market to follow imposed standards has limited the Fed's role in risk reduction" and arguing that the FRBNY should have taken a more aggressive approach to "stress test[ing]" bank's financial models); Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A1 (describing the FRB's deregulatory policy under Chairman Greenspan and its role in thwarting efforts to regulate derivatives in accordance with free market principles); *see also The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov. Reform*, 110th Cong. (Oct. 23, 2008) (testimony of Alan Greenspan), *available at* http://oversight.house.gov/images/stories/documents/20081023100438.pdf ("[T]hose of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief.").

214. *Compare* PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, at 12–14 (1999), *available at* http://www.treas.gov/press/releases/reports/hedgfund.pdf [hereinafter LTCM REPORT] (describing the FRBNY's role in creating a consortium of LTCM's trading partners to take on the "responsibility and burden of resolving LTCM's difficulties" by investing $3.6 billion in new equity), *and* Davidoff & Zaring, *supra* note 16, at 479–80 (describing Treasury Secretary Paulson's effort to push "JPMorgan to offer as low a price as possible" to Bear Stearns' shareholders as part of its FRB-backed acquisition of Bear Stearns "in order to again prevent future moral hazard by financial institutions"), *with* Louise Story & Gretchen Morgenson, *A Rift at the Fed over the Bailout of A.I.G.*, N.Y. TIMES, Jan. 22, 2010 at B1 (describing internal divisions at the FRB over the decision "to pay A.I.G.'s trading partners in full on tens of billions of dollars in contracts" in lieu of negotiating for a fraction of that amount).

215. The FDIC may not exercise its authority "to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured depository institution" or to take certain other remedial measures unless (i) "necessary" to provide insurance coverage for the insured deposits and (ii) the total amount

B. Coordinated Oversight of Investment Bank Holding Companies

Another set of initiatives to improve regulation of the investment-banking sector would entail greater cooperation among existing regulators, such as the SEC, while preserving multiple regulators with different portfolios. Proposals have been made to give the SEC increased oversight authority over holding company affiliates of broker/dealers, in lieu of the now-defunct voluntary supervisory program.[216] At least one commentator has suggested greater collaboration among risk-management specialists at each agency to assess the health of the financial system and make appropriate recommendations.[217] Others have suggested giving the SEC the power to take corrective action or force resolution of investment banks,[218] or giving the FDIC itself the power to resolve investment banks.[219] As capital requirements and

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of the expenditures and obligations incurred is the "least costly to the Deposit Insurance Fund of all possible methods for meeting the Corporation's obligation." 12 U.S.C. § 1823(c) (2006). An exception exists when the Treasury Secretary, upon the written recommendation of the FDIC Board and the Federal Reserve Board, after a supermajority vote of each, determines that failure to do so, inter alia, "would have serious adverse effects on economic conditions or financial stability." *Id.*; *see also* Thecla Fabian, *FDIC Prepares for Failure of Larger Banks; Bear Stearns Continues to Raise Questions*, 40 Sec. Reg. & L. Rep. (BNA) No. 23, at 895 (June 9, 2008). Commentators have already suggested, for example, that the FRB (or any other prudential regulator of investment banking activities) should follow a "least cost" approach to assessing alternatives in the face of distress and to create an audit trail for subsequent review by another branch of government. Robert C. Pozen, Op-Ed, *Think First, Bail Out Later*, N.Y. TIMES, June 15, 2008, at WK13 (criticizing the Fed's bailout of Bear Stearns). *But see* Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the FDIC's Forum on Mortgage Lending for Low and Moderate Income Households (July 8, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080708a.htm ("Designing analogous rules for the prompt and orderly resolution of securities firms is not straightforward, as these firms differ significantly from most commercial banks in their financing, business models, and in other ways," such as "book[ing] a large share of their assets at [offshore] affiliates . . . subject to foreign bankruptcy laws.").

216. Malini Manickavasagam, *SEC's Sirri Asks Congress for Legislation to Strengthen Investment Bank Regulation*, 40 Sec. Reg. & L. Rep. (BNA) No. 19, at 737 (May 12, 2008).

217. *See, e.g.*, Harvey L. Pitt, *"For Want of a Nail": ERM for the Regulators*, COMPLIANCE WK., Apr. 29, 2008, http://www.complianceweek.com/article/4100 (calling for creation of a Risk Management Committee on the PWG for the purpose of "making an annual, top-down, risk-based assessment of the U.S. financial system"). Since the market crash of 1987, the executive branch has convened a Working Group on Financial Markets, composed of the four principal federal financial regulators, to give recommendations with a view to "enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and maintaining investor confidence." Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

218. *See* Meltzer, *supra* note 206 (arguing that the SEC should have the same authority with respect to investment banks as federal bank regulators have with commercial banks, in lieu of granting the FRB discretionary oversight); *see also infra* text accompanying notes 274–279 (describing the resolution authority for investment bank holding companies in the *Geithner Bill, Title XII*). Of course, national securities exchanges and self-regulatory organizations already possess this power. *See supra* note 163.

219. *Regulating and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 7–10 (2009)

business practices are standardized across retail financial services, regulatory conflicts or gaps may be reduced or addressed through joint rule-making exercises or formal interagency agreements.[220]

There is an argument that legislators should consider fragmenting regulation of investment banks by regulatory objective. The Paulson Blueprint, for example, refers to the distinction between regulation of the "localized" risk of individual firm failures versus "systemic" risk to the financial market.[221] Under such a scheme, a prudential regulator would be responsible for handling firm-specific events, while a systemic regulator would handle marketwide events.[222] The difficulty here is that much of the information gathering and analysis by a systemic risk regulator and prudential regulator would be duplicative. Moreover, to the extent that a systemic risk regulator must assume the functions of a prudential regulator when investment bank failures might signal instability,[223] the prudential regulator's power would be effectively neutralized over entities considered too big to fail.

For such fragmented regulation to have a significant impact, the prudential regulator for investment banks would have to have the power to take corrective action, including the power to require the investment bank to scale down its operations, sell off key assets, and, in extreme circumstances, to liquidate. The FDIC, for example, has sought to exercise such authority with respect to the holding companies of FDIC-insured commercial banks.[224] It is questionable whether regulators could exercise such powers effectively with respect to a holding company for investment banks or other nondepositary institutions if its principal creditors are institutions and sophisticated counterparties, rather than depositors. A regulator who seeks to take such action runs the risk of impairing claims on the firm, particularly if it intervenes too late or cannot realize the full value of the firm's assets in liquidation,[225] and its statutory mandate is designed to limit creditor claims to the value of the insolvent firm.[226]

[hereinafter *Regulating and Resolving*] (testimony of Sheila M. Bair, Chairman, FDIC).

220. *See, e.g.*, Memorandum of Understanding Between the U.S. Sec. & Exch. Comm'n and the Bd. of Governors of the Fed. Reserve Sys. Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008), *available at* http://www.sec.gov/news/press/2008/2008-134_mou.pdf.

221. PAULSON BLUEPRINT, *supra* note 10, at 143–46.

222. *Id.*

223. *See, e.g.*, *id.* at 152 (noting that a broad grant of authority to the FRB to impose corrective actions "clearly could impact and potentially undercut PFRA's authority and to some extent CBRA's authority" and suggesting checks on the ability of the FRB to initiate such actions without seeking approval from the Secretary of the Treasury and, in the case of PFRA-regulated entities such as depository institutions, the head of the PFRA).

224. *See* Resolution Reform Act of 2009, S. 1540, 111th Cong. §2 (2009) (granting the FDIC the authority "to resolve the holding companies, affiliates, and subsidiaries of failed or failing insured depository institutions"); *Regulating and Resolving*, *supra* note 219, at 7–10 (testimony of Sheila M. Bair, Chairman, FDIC); *infra* text accompanying notes 274–279 (describing the resolution authority for investment bank holding companies in the *Geithner Bill, Title XII*).

225. *Cf.* Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 155 (2007) (noting that "banking law places an emphasis on minimizing immediate losses to the FDIC and depositors through prompt initiation of legal closure and resolution primarily through

Moreover, legislators would have to decide which agency would be responsible for exercising such authority. To the extent that authority would be conferred upon the SEC, the critical question is how to justify the allocation of SEC staff resources to maintain a rigorous enforcement program for the handful of investment banks that qualify for it, when economies of scale would suggest that the Federal Reserve Board is better suited to incorporate such oversight into its supervisory activities. Even if second-tier broker/dealers or affiliates of existing FHCs were to seek CSE status, further mergers among investment banks, acquisitions by FHCs, or failures could rapidly thin the ranks.[227] Moreover, even with dedicated funding for the program,[228] turnover among the handful of economists or other staff persons assigned to CSE oversight could drastically affect the quality of the program and the consistency of the supervision required by Basel II for the successful implementation of the Framework.[229]

The argument for giving the FDIC the power to take corrective action with respect to faltering investment banks is simply that it is the federal agency with the most experience in handling the resolution of financial institutions.[230] It is not clear whether there is an adequate policy basis for granting the FDIC the powers associated with regulation of insured institutions without any corresponding federal obligation (as opposed to discretion) to insure their customers and counterparties against default. SIPC already insures securities accounts against default. None of the other rationales for granting the FDIC special insolvency powers—such as the fear of insider abuse or mismanagement of monies deposited by public customers and the federal policy of restricting ownership in and heavily regulating the acquisition of depository institutions—appears compelling in the case of the purely proprietary trading and dealing activities of investment banks.[231]

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liquidation; while corporate bankruptcy is more likely to weigh perceived long-term going-concern value").

226. *See infra* text accompanying notes 289–90.

227. *See* MORRISON & WILHELM, *supra* note 55, at 298 (illustrating through a timeline the formation of FHCs and SIBHCs through the processes of merger and acquisition).

228. *See Fiscal 2009 Appropriations: Financial Services and General Government: Before the Financial Servs. and General Government Subcomm. of the H. Appropriations Comm.*, 111th Cong. (2008) (testimony of Christopher Cox, Chairman, SEC) (observing that "[w]hile the CSE program is at present voluntary, and receives no dedicated funding from Congress, . . . Congress may be acting to fill this gap").

229. By contrast, the Commission is ideally suited to ensure compliance by both FHCs and SIBHCs with the Third Pillar of the Basel II Framework to the extent that there is a compelling need to ensure that the disclosure framework contemplated thereunder dovetails with mandatory disclosure requirements applicable to FHCs and SIBHCs under federal securities law. BASEL II FRAMEWORK, *supra* note 13, ¶¶ 813–16, at 227.

230. *Regulating and Resolving*, *supra* note 219, at 20 (testimony of Sheila M. Bair, Chairman, FDIC) (noting that "[w]hile no existing government agency, including the FDIC, has experience with resolving systemically important entities, probably no agency other than the FDIC currently has the kinds of skill sets necessary to perform resolution activities of this nature").

231. *Cf.* Macey & Miller, *supra* note 181, at 1215–23 (discussing impediments to changes in control of depository institutions); Swire, *supra* note 70, at 506 (discussing "insider abuse").

C. Promote Industry Initiatives

Because competitors of failing enterprises bear the primary brunt of systemic risk, they have some incentive both to prevent systemic risk from arising and to mitigate the consequences of a systemic event. The calibration of such models to compute capital requirements or other internal restrictions on transactions or products is a matter of discretion, however, and regulators (rightly or wrongly) have reason to fear that banks will not fully internalize the potential risks they bring to the financial system.[232] Furthermore, the ex ante probability of a systemic crisis is sufficiently insubstantial that even the most trivial prophylactic efforts to reduce operational risk—such as ensuring adequate documentation of derivative contracts—may be left unaddressed or uncompleted until markets reach crisis unless failure to comply carries the possibility of regulatory sanction, or worse, inability to document one's claims in an insolvency proceeding.

Many efforts have been made to adopt standards or "best practices" for risk management. Firms routinely suggest the development of more "robust and pervasive" risk cultures, including formalization of the role of risk-management officers, internal controls for risk, and greater board awareness of firm risks.[233] A number of discrete working groups have also been created to address specific components of the regulatory framework, such as reducing the operational risks entailed in OTC derivative transactions or improving the monitoring of counterparty credit risk.[234] As discussed above, however, procedures developed in the wake of a crisis may be sacrificed or modified if viewed as an impediment to competition.[235] Moreover, participation of the entities most vulnerable in a crisis (such as unregulated funds) cannot be assured.

Enhanced disclosure is also routinely suggested by both regulators and industry in the wake of a crisis.[236] Voluntary information-sharing agreements among firms would in theory allow individual intermediaries to make better formed assessments about latent concentration or indirect counterparty credit risks.[237] Determining who should have access to what information presents the regulatory challenge. Disclosing proprietary information to a regulator, particularly on a voluntary basis, runs the risk of freedom-of-information requests or misappropriation by regulatory officials.[238] Disclosing proprietary information to counterparties risks revealing

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232. *See supra* notes 76, 150 (discussing VaR models).

233. IIF REPORT, *supra* note 57, at 31–38.

234. *See, e.g.*, LTCM REPORT, *supra* note 214, at F-1 to -6.

235. *See, e.g.*, *Confessions of a Risk Manager*, ECONOMIST, Aug. 9, 2008, at 73 (giving a first-person account by an anonymous risk manager) ("At the root of it all, however, was—and still is—a deeply ingrained flaw in the [risk management] decision-making process. In contrast to the law, where two sides make an equal-and-opposite argument that is fairly judged, in banks there is always a bias towards one side of the argument.").

236. *See* G30 REPORT, *supra* note 186, at 12; Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Address to the Security Traders 12th Annual Washington Conference (May 7, 2008), *available at* http://www.sec.gov/news/speech/2008/spch050708cc.htm (pressuring greater disclosure of liquidity risk by major investment banks).

237. *See* IIF REPORT, *supra* note 57, at 107–09 (suggesting the formation of a Market Monitoring Group).

238. Hu, *supra* note 56, at 410 (discussing Freedom of Information Act (FOIA) issues

trading strategies, or worse, could prompt a "run" if its financial situation is perceived as deteriorating;[239] because these entail the disclosure of proprietary information, third-party verification (usually in the form of a regulator) is necessary to ensure completeness. Client information is even more sensitive, since clients have the ability to break up activity across firms to avoid revealing their strategy to any single firm, thus complicating risk management.

Ex post initiatives, moreover, may tend toward self-preservation or cherry-picking of failed firms' assets.[240] Healthy firms in a position to acquire ailing firms, for example, may delay in order to avoid straining their own balance sheets with additional debt or to profit from further reductions in public share prices.[241] The time and effort to undertake due diligence during a market crisis, moreover, poses an additional impediment to self-correction. Government involvement may, to a degree, address collective-action problems in order to arrive at an expeditious solution, as long as such efforts focus on those firms that have the most incentive to bail out a troubled firm.[242]

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related to seeking information from industry).

239. OCC, FRB, FDIC, and OTS regulations provide that:

> [E]xcept in very limited circumstances, banks, savings associations, and other financial institutions may not disclose a report of examination or any portion of the report, nor make any representations concerning the report or the report's findings without the prior written permission of the appropriate federal banking agency. The circumstances for release of nonpublic supervisory information may include disclosure to a parent holding company, director, officer, attorney, auditor, or other specified third party, as indicated in the regulations of the appropriate federal banking agency. Any person who discloses or uses nonpublic information except as expressly permitted by one of the appropriate federal banking agencies or as provided by the agency's regulations may be subject to the criminal penalties provided in 18 USC 641.

Press Release, Bd. of Governors of the Fed. Reserve Sys., FDIC, Office of the Comptroller of the Currency, Office of Thrift Supervision, Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information (Feb. 28, 2005), *available at* http://www.fdic.gov/news/news/press/2005/pr1805a.html.

240. For example, the Master Liquidity Enhancement Conduit—which was to have been created by several major banks to purchase assets from structured investment vehicles invested in subprime mortgages—failed to materialize. Karen Krebsbach, *Street Still Cool to Super SIV Fund*, U.S. BANKER, Jan. 2008, at 16; *see also* Floyd Norris, *3 Major Banks Offer Plan to Calm Debts in Housing*, N.Y. TIMES, Oct. 16, 2007, at A1 (describing the Master Liquidity Enhancement Conduit concept); Gillian Tett, Krishna Guha & David Wighton, *Banks Agree $75bn Mortgage Debt Fund*, FT.COM, Oct. 14, 2007.

241. *See, e.g.*, *Under the Hammer*, ECONOMIST, July 12, 2008, at 81–82 (reporting rumors of long-anticipated, but as yet unconsummated, acquisitions of certain investment banks and commercial banks).

242. For example, the FRBNY organized a $3.6 billion bailout of Long-Term Capital Management (LTCM) by its major creditors, including Bankers Trust, Barclays, Chase, Credit Suisse First Boston, Deutsche Bank, Goldman Sachs, Merrill Lynch, J.P. Morgan, Morgan Stanley, Salomon Smith Barney, UBS, Société Générale, Lehman Brothers, and Paribas. LTCM REPORT, *supra* note 214, at 12–14; Anita Raghavan & Mitchell Pacelle, *To the Rescue? A Hedge Fund Falters, So the Fed Persuades Big Banks to Ante Up*, WALL ST. J., Sept. 24, 1998, at A1. Bear Stearns, however, notably declined to participate despite its significant exposure to LTCM. LTCM REPORT, *supra* note 214, at 17–20 (describing Bear

IV. THE DIFFICULTIES OF ACHIEVING POLITICAL CONSENSUS

While the basic tools and institutional structures for regulating financial services conglomerates are fairly well established, regulatory reform has stalled even as policy makers have resisted calls to contemplate more sweeping changes to the structure of financial regulation.[243] Some radical approaches may have little chance of being implemented in practice—such as a complete ban on intervention by the FRB or the Treasury[244] or using antitrust law or similar concepts to bar firms from becoming too large or interconnected to fail.[245] Other approaches may require a reconfiguration of congressional oversight, and a corresponding augmentation or diminution in the power of the committee chairs and ranking members, whose regulatory agencies are eliminated, merged, or diminished.[246] Finally, the considerable wealth and influence of the financial services industry all but ensures that changes in the regulatory landscape will be incremental.[247] As a result, the proposals that have been put forward tend to coalesce around "two to five" models.[248]

Stearns' exposure to LTCM as its prime broker).

An industry bailout may also take the form of participation in a "firm commitment" underwriting. *See, e.g.*, Patrick Hosking & Christine Seib, *FSA Puts Pressure on Top Five Banks to Support Bradford & Bingley Rights Issue*, TIMES (London), June 10, 2008, at 43 (discussing Financial Services Authority's "unprecedented step" of pressuring U.K. banks to sub-underwrite £20M of a proposed £258M rights offering by a U.K. financial services firm).

243. *See, e.g.*, *Why Wall Street Reforms Have Stalled*, N.Y. TIMES.COM, Sept. 11, 2009, http://roomfordebate.blogs.nytimes.com/2009/09/11/why-wall-street-reforms-have-stalled (presenting the views of several academic, industry, and government commentators on the reasons why efforts to change the culture of, and risks in, the financial industry have not been successful in the wake of the current crisis).

244. *Cf.* Curtis J. Milhaupt, *Japan's Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design?*, 77 WASH. U. L.Q. 399, 406–07, 430–31 (1999) (arguing that "[e]mpirical observation . . . discredits the view that a world without deposit insurance is a world of market discipline for banks" because market participants will assume the existence of implicit deposit protection and that, based on the Japanese experience, well-designed explicit government guarantees "may be the starting point for the development of effective private mechanisms to control bank risk and promote bank stability").

245. *Cf.* David Cho, *Banks 'Too Big to Fail' Have Grown Even Bigger*, WASH. POST, Aug. 29, 2009, at A1 (noting that a "series of federally arranged mergers safely landed troubled banks on the decks of more stable firms" but created even bigger banks likely to have government backing in the event of a crisis).

246. For example, the bifurcation of regulatory authority over securities and derivatives between the SEC and CFTC has survived in part because the two agencies are overseen by different House committees. *See* Coffee, *supra* note 200, at 450–51 (describing role of the House Agriculture Committee in protecting CFTC's jurisdiction).

247. *See, e.g.*, Gretchen Morgenson & Don van Natta Jr., *In Crisis, Banks Dig in for Fight Against Rules*, N.Y. TIMES, June 1, 2009, at A1 (describing Wall Street's lobbying effort against efforts to regulate derivatives).

248. *See* Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009).

In this Part, I compare the recommendations with respect to the problem of regulating financial services conglomerates of a set of five representative views in the political process:

- The *Paulson Blueprint*, which represents the policy recommendations of the Treasury Department under Henry Paulson;
- The legislation recently proposed by the Treasury Department under Timothy Geithner (the *Geithner Bill*);[249]
- The report of the Thirty (the *G30 Report*), a "private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia," chaired by Paul Volcker;[250]
- The Report of the Committee on Capital Markets Regulation (the *CCMR Report*), a committee composed of "twenty-five leaders from the investor community, business, finance, law, accounting, and academia";[251] and
- The plan proposed by the Republican members of the U.S. House Financial Services Committee (the "House Republican Bill").[252]

I have structured this Part based on their approaches as to (i) how to define "systemic risk" or "systemically significant" institutions, (ii) who has the power to take "corrective action," and in what form, to counter concerns about excessive risk, and (iii) how broadly the FRB or another regulator can take remedial action in the wake of a crisis.

A. Defining Systemic Risk

One key question that most of the proposals address is whether to identify certain financial services conglomerates as "systemically significant," and if so, whether the appropriate process is to identify them as such through legislation, rule making, or a discretionary process. With respect to the first question, for example, the House Republican Bill appears to reject the idea of identifying systemically significant institutions.[253] Designating institutions as such constitutes, in the view of the bill's sponsors, an express government guarantee of a bailout in the case of financial stress and creates undue moral hazard.[254] Moreover, special designation puts such firms at a significant advantage when raising funds in capital markets or attracting depositors or clients; this could result in a cartelization of the financial

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249. *See supra* note 177.

250. G30 REPORT, *supra* note 186.

251. COMM. ON CAPITAL MKTS. REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (2009), *available at* http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_(5-26-09).pdf [hereinafter CCMR REPORT].

252. Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Cong. (2009).

253. *See* Press Release, House Comm. on Fin. Servs. Republicans, Republicans Introduce Comprehensive Financial Regulatory Reform Legislation (July 23, 2009), *available at* http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=692&Itemid=43 (describing philosophy of House Republican Bill).

254. *See id.*

services industry as larger, government-backed market participants crowd out smaller firms that do not enjoy such a guarantee.[255] The *CCMR Report* likewise concedes that higher capital requirements may be appropriate for "large" institutions, but it cautions against a special designation or a special resolution regime for systemically significant institutions because of the moral hazards entailed.[256]

By contrast, the *Geithner Bill* and the *G30 Report* attempt to define more clearly which firms pose a systemic risk to financial markets. The apparent purpose of such identification would be to ensure that regulators subject such firms to heightened regulation ex ante and some sort of orderly resolution ex post. The *G30 Report*, for example, recommends appropriate prudential regulation not only for BHCs, but also for "large, internationally active insurance companies" and "large investment banks and broker/dealers" not otherwise organized as bank holding companies; it further suggests that prudential regulation might be appropriate for private pools of capital for "funds above a size judged to be potentially systemically significant."[257] The *Geithner Bill* would expressly define as Tier 1 FHCs those financial firms whose combination of size, leverage, and interconnectedness could "pose a threat to global or United States financial stability" if it failed.[258] The FRB would be responsible, pursuant to statutory criteria and in consultation with the Secretary of the Treasury and a newly formed Financial Services Oversight Council (consisting of all federal financial regulators), for developing rules to define those firms that pose such risks to the financial system.[259]

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255. *See* Peter J. Wallison, *Congress is the Real Systemic Risk*, WALL ST. J., Mar. 17, 2009, at A15 ("Financial institutions that not are large enough to be designated as systemically significant will gradually lose out in the marketplace to the larger companies that are perceived to have government backing . . . ."); William Poole, Former St. Louis Fed. Reserve President, Remarks to the CFA Society of San Francisco (May 6, 2009), *available at* http://www.sustainablewealth.org/bailouts-an-affront-to-the-market-and-to-democracy (arguing that "market[s] will allocate too much capital to firms" in the top ten to twenty positions if government guarantees are expected).

256. CCMR REPORT, *supra* note 251, at 69–71 (offering, as "a starting point," the idea of a progressive capital surcharge for "core" U.S. banks with more than $250 billion in assets); *id.* at 113 (supporting an ad hoc determination of systemic risk); *id.* at 207–08 (noting possible disadvantages inherent in the designation of certain institutions as "systemically significant").

257. G30 REPORT, *supra* note 186, at 8–9.

258. GEITHNER BILL, TITLE II, *supra* note 92, § 204, at 3–4.

259. *See* U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE I: FINANCIAL SERVICES OVERSIGHT COUNCIL, § 102, at 1–3 (2009), *available at* http://www.financialstability.gov/docs/regulatoryreform/07222009/titleI.pdf [hereinafter GEITHNER BILL, TITLE I]. The bill provides that the FRB would establish rules, in consultation with the Department of the Treasury, to guide the identification of Tier 1 FHCs, GEITHNER BILL, TITLE II, *supra* note 92, § 204(a), at 3–4, but provides that the new Financial Services Oversight Council, among other bodies, "may recommend financial firms to the Board of Governors of the Federal Reserve System for designation as Tier 1 financial holding companies," GEITHNER BILL, TITLE I, *supra* § 103(a), at 3–4.

Other approaches might leave such determinations to the FRB, the Treasury, or another market stability regulator on an ad hoc basis. The *Paulson Blueprint*, for example, identifies a broad range of institutions that may pose a macro-prudential risk—including bank holding companies and other financial services conglomerates as well as private pools of capital—and gives its "market stability" regulator broad authority to access or compel disclosure of information from such institutions, to publish aggregate financial information about overall market risk, and to consult and provide input into rule making by individual financial regulators.[260] Under this framework, the market stability regulator would appear to have broad, unchecked power to decide whether particular institutions are "systemically significant" and to take appropriate action.

Most of the reform proposals contemplate retaining the FRB as the market stability regulator for all financial holding companies, but as suggested by the discussion in Part III, the proposals differ with respect to how prudential oversight of financial firms will be allocated. With the exception of the House Republican Bill, each proposal contemplates broad authority for the FRB to collect information from systemically significant financial institutions (and in some cases, private pools of equity). Several of the proposals nevertheless contemplate granting concurrent power to individual prudential regulators or to a council thereof.[261] Only the House Republican Bill, in an effort to focus the FRB's mission on monetary policy, proposes to confer exclusive authority on a Market Stability and Capital Adequacy Board (which would include outside experts as well as regulators) to monitor interactions among various sectors of the financial system, identify risks, and report its findings to Congress.[262]

To the extent that most of the proposals grant broad authority to the FRB to define and oversee systemically significant financial services conglomerates, the debate focuses on the degree to which it is possible to check the FRB's authority through the individual or collective action of other federal regulators.[263] One flaw

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260. PAULSON BLUEPRINT, *supra* note 10, at 148–51.

261. *See, e.g.*, CCMR REPORT, *supra* note 251, at 206–10 (expressing ambivalence as to how to allocate supervisory authority between the FRB and any newly created financial services authority); G30 REPORT, *supra* note 186, at 10–11; GEITHNER BILL, TITLE II, *supra* note 92, § 204, at 13–14 (proposing an amendment to the Bank Holding Company Act of 1956 § 6(d)(3), 12 U.S.C. § 1845(d)(3) (2006)) (providing the FDIC with backstop examination authority); PAULSON BLUEPRINT, *supra* note 10, at 152 (proposing a "Market Stability Council" composed of the Secretary of the Treasury, the Chair of the FRB, and the head of the Prudential Financial Regulatory Agency (PFRA)).

262. Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Cong. § 201 (2009) (proposing an eleven-member Market Stability and Capital Adequacy Board comprising the chairs of six federal financial regulators and five private members appointed by the President who are "specially qualified to serve . . . by virtue of their education, training, and experience").

263. *See* H.R. 3310 § 102 (proposing a ten-day period, extendible by an additional thirty days, during which the functional regulator and Market Stability and Capital Adequacy Board may consult with creditors of a "non-bank financial institution" prior to the filing of an involuntary petition for bankruptcy); CCMR REPORT, *supra* note 251, at 206–10 (expressing ambivalence as to how to allocate supervisory authority between the FRB and any newly created financial services authority); GEITHNER BILL, TITLE I, *supra* note 259, §

in this strategy is that the FRB has historically enjoyed political independence, whereas other financial regulators, such as the Treasury and the SEC, are susceptible to greater political pressure.[264] Rather than combat the cyclicality of markets, such a regulatory structure could exacerbate it, to the extent that politically accountable regulators are likely to resist oversight during boom markets. Moreover, the effectiveness of such a council or advisory board would be diminished if its ranks are expanded to include assorted political appointees and state banking and securities regulators, as some have proposed.[265]

B. Taking Corrective Action

The proposals also differ as to whether the concept of "prompt corrective action" should be extended to nonbank financial services conglomerates and, if so, whether such powers should be exercised by a designated prudential regulator or the FRB. The Republican Plan, for example, expresses a preference for handling the resolution of nonbank financial services conglomerates through the bankruptcy process,[266] whereas the other proposals express a preference for some resolution

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103(a), at 3–4 (empowering a new Financial Services Oversight Council to "recommend financial firms to the Board of Governors of the Federal Reserve System for designation as Tier 1 financial holding companies"); PAULSON BLUEPRINT, *supra* note 10, at 152 (proposing a "Market Stability Council" comprised of the Secretary of the Treasury, the Chair of the FRB, and the head of the Prudential Financial Regulatory Agency (PFRA) to approve FRB-initiated corrective action with respect to insured depository institutions); *see also* H.R. 3310 § 403 (requiring the discontinuance of any actions taken by the FRB using emergency powers in response to a joint resolution of the Senate and House expressing disapproval of the action); G30 REPORT, *supra* note 186, at 11 (recommending that any systemic support provided by a central bank under exigent circumstances be subsequently approved by an appropriate governmental entity "with the consequent risk transfer to that entity"); U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE XIII: ADDITIONAL IMPROVEMENTS FOR FINANCIAL CRISIS MANAGEMENT, § 1301, at 1 (2009), *available at* http://www.financialstability.gov/docs/regulatoryreform/07222009/titleXIII.pdf [hereinafter GEITHNER BILL, TITLE XIII] (proposing an amendment to the Federal Reserve Act § 13, 12 U.S.C. § 343, to limit the FRB's power to extend credit to persons other than banks by requiring the prior written approval of the Secretary of the Treasury).

264. *See* Kettering, *supra* note 126, at 1646–47 & n.308 (discussing the relative independence of financial regulatory agencies such as the SEC, OCC, and FDIC); Ramirez, *supra* note 88, at 532–35 (contrasting the FRB's political independence with that of the SEC).

265. *See, e.g.*, Letter from Timothy J. Karsky, Chairman, Conferences of State Bank Supervisors, Roger Sevigny, President, Nat'l Ass'n of Ins. Comm'rs & Fred J. Joseph, President, N. Am. Sec. Adm'rs Ass'n, to Sen. Christopher J. Dodd, Chairman, Senate Comm. on Banking, Hous. & Urban Affairs, Sen. Richard Shelby, Ranking Member, Senate Comm. on Banking, Hous. & Urban Affairs, Rep. Barney Frank, Chairman, House Comm. on Fin. Servs. & Rep. Spencer Bachus, Ranking Member, Hous. Comm. on Fin. Servs. (May 18, 2009), *available at* www.nasaa.org/content/Files/JointSystemicRiskCouncil_letter.pdf (seeking representation by state financial regulators in any systemic risk council).

266. H.R. 3310 § 102 (proposing a ten-day period, extendible by an additional thirty days, during which the functional regulator and Market Stability and Capital Adequacy Board may consult with creditors of a "non-bank financial institution" prior to the filing of an involuntary petition for bankruptcy).

mechanism for nonbank financial services conglomerates. The *G30 Report*, for example, would apply a resolution mechanism "only to those few organizations whose failure might reasonably be considered to pose a threat to the financial system," to be undertaken by a regulator with powers "comparable" to the resolution authority for deposit-taking institutions.[267] By contrast, the *CCMR Report* (consistent with its preference to avoid the systemically significant designation) recommends a Financial Company Resolution Act, applicable to all financial institutions, which would draw upon existing resolution rules applicable to broker/dealers, banks, and other entities under the Bankruptcy Code.[268]

The *Paulson Blueprint* and the *Geithner Bill* each take a similar approach but provide more detail as to how resolution authority would be allocated and exercised. The *Paulson Blueprint* vests authority in the FRB to coordinate systemic risk regulation and to initiate corrective action affecting the entire financial landscape.[269] Under the *Paulson Blueprint*, the FRB would have the authority to require firms to take corrective actions—such as limiting risk exposures to certain assets or counterparties or bolstering their liquidity or capital positions—as necessary to eliminate threats to market stability.[270] The *Paulson Blueprint* recognizes that some checks on the FRB's corrective authority might be appropriate. For example, the FRB might be required to seek the approval of a Market Stability Council for firms regulated by the Prudential Financial Regulatory Agency (PFRA) and the Secretary of the Treasury for all other financial services charter firms.[271]

Under the *Geithner Bill*, all Tier 1 FHCs and bank holding companies would be subject to a regime of prompt corrective action similar to that exercised by the FDIC under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) with respect to insured depository institutions.[272] Firms would also be subject to enhanced public disclosures about their risk profile, capital adequacy, and risk-management capabilities, and each firm would be required to report periodically to the FRB on its plan for "rapid and orderly resolution in the event of severe financial distress."[273] The proposal further contemplates a special resolution regime, in which the Treasury would be able to make a determination as to whether corrective action should be taken with respect to a Tier 1 FHC,[274] with the FDIC or SEC generally appointed to act as conservator or receiver of investment bank

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267. G30 REPORT, *supra* note 186, at 16.

268. CCMR REPORT, *supra* note 251, at 124–27.

269. *See* PAULSON BLUEPRINT, *supra* note 10, at 147.

270. PAULSON BLUEPRINT, *supra* note 10, at 151–52.

271. *Id.* The Market Stability Council, as conceived in the *Paulson Report*, might consist of the Secretary of the Treasury, the Chairman of the FRB, and the head of the PFRA. *Id.* at 152. As a result, the FRB would need to obtain the concurrence of either the Secretary of the Treasury or the head of the PFRA if it sought to require corrective action. *Id.*

272. U.S. DEP'T OF THE TREAS., PROPOSED LEGISLATION: TITLE XII: ENHANCED RESOLUTION AUTHORITY, §§ 1201–10 (2009), *available at* http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf [hereinafter GEITHNER BILL, TITLE XII].

273. GEITHNER BILL, TITLE II, *supra* note 92, § 204(d), at 11–14 (proposing an amendment to the Bank Holding Company Act of 1956 § 6(d), 12 U.S.C. § 1845(d) (2006)).

274. GEITHNER BILL, TITLE XII, *supra* note 272, § 1203(b), at 5.

holding companies outside of the operation of the Bankruptcy Code.[275] The conservator or receiver would also have broad authority to control a firm's operations, sell or transfer all or part of its assets (including a portfolio of the firm's qualified financial contracts), determine creditors' claims pursuant to rule making, and renegotiate or repudiate contracts with employees and third parties.[276]

The *Geithner Bill*'s prescriptions for managing the failure of a Tier 1 FHC, while an important step in addressing systemic failures, do not fully address the risks posed by investment banks. First, the plan appears to fragment authority over the resolution of investment bank holding companies among three agencies. The Secretary of the Treasury would have the authority to invoke the special resolution regime for a Tier 1 FHC, based on specified criteria,[277] but only upon the written recommendation of two-thirds of the members of the FRB or two-thirds of the commissioners of the SEC.[278] Such overlapping authorizations could create significant problems without achieving the intended result. To the extent that the Treasury and the SEC are generally regarded as susceptible to political influence, the task would ironically fall to the FRB to act as a check on the deployment of the U.S. government's fiscal resources.

Second, while the *Geithner Bill* contemplates that the FRB will have consolidated oversight over both domestic and foreign subsidiaries of a Tier 1 FHC, it is not clear how the SEC or any other financial regulator could oversee the orderly resolution of a Tier 1 FHC's non-U.S. subsidiaries. While SIPC would continue to handle the disposition of the assets of the customers of a Tier 1 FHC's broker/dealer subsidiary in accordance with the provisions of the Securities Investor Protection Act, the SEC must rely on the FRB or the Treasury to finance resolution of the firm's proprietary obligations. The proposal at most contemplates that the SEC or another financial regulator responsible for liquidation should "coordinate with the appropriate foreign financial authorities regarding the resolution of subsidiaries of . . . covered bank holding compan[ies]" located in foreign jurisdictions.[279]

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275. *Id.* § 1202(1)(B), at 1–2 (providing that the SEC shall be the "Appropriate Federal Regulatory Agency" of a covered holding company "if the largest subsidiary . . . is a broker or dealer"); *id.* § 1204(b), at 7–8 (providing that the Secretary of the Treasury may appoint "one of the Appropriate Federal Regulatory Agencies" as conservator or receiver of a covered holding company); *id.* § 1207, at 9 (requiring termination and exclusion of actions under the Bankruptcy Code and state insolvency law against covered holding companies).

276. *Id.* § 1209 (describing the powers and duties of the FDIC and SEC when acting as conservator or receiver).

277. *See id.* § 1203(b), at 5 (requiring the Secretary of the Treasury to determine that (1) the firm is in default or "in danger of default"; (2) the failure of the firm and its resolution under otherwise applicable law would have "serious adverse effects" on the financial system or the economy; and (3) use by the government of the special resolution regime would "avoid or mitigate" these adverse effects).

278. *Id.* § 1203(a)(1), at 2.

279. *Id.* § 1209(a)(1)(M), at 77–78; *see also* CCMR REPORT, *supra* note 251, at 122, 127 (recommending consolidation or coordination of cross-border insolvency proceedings for multi-entity financial companies).

C. Providing Remedial Relief

The proposals also differ on the political accountability of the FRB when using monetary policy to effect a bailout. While the use of fiscal policy—such as the Troubled Asset Relief Program (TARP)—is subject to ad hoc congressional authorization and direct congressional and executive oversight, the FRB's authority under Section 13(3) of the Federal Reserve Act to extend credit to nonbank entities in "unusual and exigent circumstances" is limited only by the Act's requirement of a supermajority vote.[280] Because of the difficulties of maintaining constructive ambiguity in the face of a systemic crisis, the various proposals (with the exception of the *CCMR Report*) seek ways publicly to limit the discretion of the FRB to use monetary policy.

The *Geithner Bill*, for example, contemplates further limiting the FRB's power to extend credit to persons other than banks by requiring the prior written approval of the Secretary of the Treasury.[281] To the extent that political appointees are likely to favor a bailout in a time of market distress, it is not clear how effective a check this will be. The *Geithner Report* would also authorize the Treasury, as with the current TARP program, to use fiscal tools—such as providing loans, purchasing assets, guaranteeing liabilities, or making equity investments in the firm—in addition to the FRB's emergency lending authority.[282] To the extent that fiscal policy is subject to greater discipline and political risk than monetary policy, it is unclear whether a Treasury Secretary would be willing to limit monetary policy during periods of market stress.

More ambitious proposals create disincentives for political actors to participate in a central-bank initiated bailout. The *G30 Report* argues for the preservation of central bank emergency lending for "highly unusual and exigent circumstances," but seeks to ensure political cover for lending to nonbank financial institutions, whether "by law or practice."[283] The report further recommends that fiscal policy, rather than central bank liquidity, be used when purchasing or lending against high-risk assets or providing long-term direct or indirect capital support.[284] Any systemic support provided by the FRB under exigent circumstances, moreover, would be subsequently approved by an appropriate governmental entity "with the consequent risk transfer to that entity."[285] The House Republican Bill would further constrain the FRB's authority. For example, in addition to requiring the Treasury Department to approve all actions taken by the FRB under section 13(3), the Plan suggests that Congress should have the right to block any FRB action by congressional

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280. 12 U.S.C. § 343 (2006) (permitting the FRB, "[i]n unusual and exigent circumstances, . . . by the affirmative vote of not less than five members, [to] authorize any Federal reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange").

281. GEITHNER BILL, TITLE XIII, *supra* note 263, § 1301, at 1 (proposing an amendment to the Federal Reserve Act § 13, 12 U.S.C. § 343 (2006)).

282. *See* GEITHNER REPORT, *supra* note 10, at 77–78.

283. G30 REPORT, *supra* note 186, at 11.

284. *Id.*

285. *Id.*

resolution and that the FRB's discretion to bail out individual institutions (as opposed to creating broadly available liquidity facilities) should be eliminated.[286]

It is unlikely that such checks on the FRB's remedial powers are more than window dressing. There is no suggestion that the FRB has not enjoyed the full backing of the Secretary of the Treasury during the current crisis. In addition, while certain members of Congress have taken the Chairman of the FRB to task for the dramatic expansion of the FRB's balance sheet during the current crisis,[287] there is little reason to believe that Congress would not accede to a politically palatable rescue package. By contrast, there is every reason to believe that a politically popular president might, in defiance of a reluctant Congress, assert executive authority to use fiscal funds to stave off a crisis until the requisite political support could be marshaled for FRB relief, regardless of possible constitutional challenges.[288] As a result, the consultation requirements may be helpful for purposes of encouraging coordinated action, but are unlikely to present serious obstacles to intervention in the face of political pressure.

The *Geithner Bill* further provides, along the lines of the *G30 Report*, that federal regulators use fiscal policy to backstop the resolution authority of the FDIC and the SEC. On the one hand, the bill purports to limit the resolving authority's maximum liability to claims for the amount it would have received if no corrective action had been taken and the firm had been liquidated under the Bankruptcy Code or state insolvency law.[289] On the other, the bill provides that the FDIC may provide emergency assistance to a covered holding company, and that the FDIC and SEC, when acting as conservator or receiver, may make additional payments or credit additional amounts to claimants, to "prevent or mitigate serious adverse effects to financial stability or the United States economy."[290] To fund such payments, the FDIC and SEC would draw upon a "bank holding company fund" financed by borrowing from the Treasury, which in turn would be financed through public borrowing, the outlays of which would be recouped by risk-based assessments on holding companies.[291] Whether Congress would authorize such an

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286. Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Cong. § 403 (2009) (requiring the discontinuance of any actions taken by the FRB using emergency powers in response to a joint resolution of the Senate and House expressing disapproval of the action).

287. *See, e.g.*, Brian Blackstone & Patricia Yoest, *The Financial Crisis: Bailouts Turn Up Heat on Fed Chief—Both Sides of Hill Increase Criticism of Bernanke Moves*, WALL ST. J., Sept. 19, 2008, at A2; Neil Irwin, *A Growing Chorus on the Hill Questions the Fed's Decisions; Lawmakers Could Delay Expansion of Bank's Powers*, WASH. POST, Mar. 26, 2009, at D1; Damian Paletta, *Fed Documents Fuel Concerns About Expanding Central Bank's Role*, WALL ST. J., June 27, 2009, at A4.

288. Jeffrey Rosen, *TARP Heels*, NEW REPUBLIC, Mar. 18, 2009, at 5, *available at* http://www.tnr.com/article/tarp-heels (describing potential constitutional challenges by libertarian organizations to the TARP program); *cf.* ROBERT E. RUBIN, IN AN UNCERTAIN WORLD 168–76 (2003) (describing former Treasury Secretary Rubin's use of unorthodox measures to avert defaulting on the federal debt in the face of Republican opposition to raising the debt ceiling).

289. GEITHNER BILL, TITLE XII, *supra* note 272, § 1209(d)(2).

290. *Id.* § 1209(d)(3).

291. *Id.* § 1209(n).

open-ended commitment remains to be seen in light of the resistance that industry participants may bring to bear against the use of such levying authority.[292]

V. A SELF-REGULATORY FRAMEWORK FOR SYSTEMIC CRISES

My proposed framework for regulating investment banks and other financial services conglomerates would draw upon the tools for regulation outlined in Part II and the institutions described in Part III, but would depart dramatically from the traditional shuffling of regulatory responsibilities of the type described in Part IV. The proposal would essentially consist of a cost-sharing mechanism organized on the model of the modern self-regulatory organization (SRO), the membership of which would include those financial conglomerates "too interconnected to fail." Requiring major participants to have some "skin in the game" would not only cause them to consider more carefully the credit and operational risks of dealing with particular counterparties but also, by extension, to internalize at least part of the cost of the anticipated clean-up of markets after a crash.[293] Substantive regulation might consist primarily of risk-management principles, overseen by a prudential regulator with superior expertise in information gathering and analysis, while industry rules, incrementally developed during ebullient times under the oversight of a business conduct regulator, would establish a clear, ex ante baseline level of responsibility.

A. The Proposal

The goal would be to transform the way in which the FRB and the Treasury intervene in the wake of a financial crisis. Rather than leaving regulators to attempt to broker deals among counterparties or cajole competitors to save an insolvent firm from bankruptcy, the proposal would create an industry organization committed to identifying firms in need of assistance and to participating in any government-orchestrated assistance. Unlike a clearinghouse, however, the participation of each firm would be determined by formulas that would serve as a starting point for any ex post negotiation. These formulas, moreover, would create

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292. *See, e.g.*, David Streitfeld, *The Bailout Bill Comes Due, Vexing Agencies*, N.Y. TIMES, Sept. 18, 2009, at B1 (discussing the FDIC's and FHA's concerns about tapping the Treasury or the industry to finance their activities and banks' opposition to special fees to replenish FDIC funds).

293. *Cf.* Alan S. Blinder, Op-Ed, *The Case for a Newer Deal*, N.Y. TIMES, May 4, 2008, at B20 (suggesting that originators of mortgages and sponsors of securitization vehicles should retain some interest or accountability for the creditworthiness of assets underlying asset-backed securities). Such a proposal could easily turn into a cost-defraying measure for the federal government, rather than a means of promoting financial stability and mitigating systemic risk, if federal authorities routinely call upon the self-regulatory organization to participate in bailouts. *See, e.g.*, Jackson, *supra* note 68, at 561–62 (observing that defraying federal costs is not a "regulatory justification" for imposing obligations on bank holding companies). As a matter of policy, therefore, it is probably safer to give the self-regulatory organization the initial obligation to make a determination whether remedial action is appropriate, rather than give the FRB or another federal regulator the formal ability to require the SRO to participate in a transaction.

ex ante incentives and disincentives for firms when dealing with counterparties in whose resolution the firms might be called upon to participate some day.

Legislation would establish the general purposes of the organization—for example, to share the costs of restoring stability to the financial system—and the organization itself would adopt rules for asset purchases, stock purchases, or financial assistance to troubled firms in situations where the FRB (or another systemic regulator) declares a crisis. An agency other than the FRB—be it the SEC or any successor regulator—would be responsible for approving the rules of the entity to ensure fair treatment of members. In the event of a crisis, the systemic regulator—when seeking industry participation in a bailout or acquisition—could either invoke the rules of the entity to finance the clean-up transaction or negotiate a less burdensome arrangement consistent with the privileges and obligations of participating members.

To avoid an open-ended commitment to bail out all financial firms, the success of an industry buyout financed by the FRB must depend on whether industry members have a vested interest in protecting a failing firm from bankruptcy. As a result, the final terms of a buyout will depend, among other considerations, on (i) the relative size and leverage of affected financial conglomerates, (ii) the degree to which such entities managed their concentration or counterparty risk, (iii) the degree to which products were marketed without due diligence or regard for latent risks, (iv) the impact on capital adequacy and liquidity of the assumption of risk with respect to the failing enterprise, and (v) the potential gain to participating firms if assumed positions recover value after the crisis has abated.

In the following three Subparts, I describe how such an organization might be constituted, how it would operate in advance of a systemic crisis, and how it would participate in a rescue operation for a failing firm during a systemic crisis.

1. Membership

As discussed above, one of the obstacles that policy makers face in crafting the contours of a "too big to fail" policy is that it is not in the regulators' interest to define which firms merit this treatment.[294] Rules may be designed to ensure that firms of a certain size or who are entrusted with functions vital to government interests, such as primary dealers, would qualify;[295] indeed, the FRB's enormous commercial power relative to its primary dealers and as lender of last resort, among other factors, has given it the clout to compel industry participation in many similar transactions. But smaller banks or brokerage houses, or even hedge funds, pose different issues: while reform proposals affirm that bailout authority for systemically significant institutions must be tied to an ex ante commitment to prudential supervision,[296] a systemic regulator would always have to decide ex post

294. *Cf.* Partnoy & Skeel, *supra* note 136, at 1036 ("Fourteen Families" resolve credit derivatives backlog); Kaufman, *supra* note 136 (noting combined assets).

295. *See, e.g.*, *supra* note 212 (discussing criteria for selecting primary dealers), *supra* note 84 (discussing criteria for consolidated supervision of CSEs), *supra* note 149 (discussing criteria for use of "advanced approaches" to assessing market risk by large, internationally active banking organizations).

296. *See, e.g.*, CCMR REPORT, *supra* note 251, at 70 ("Firms that are too big, too

whether the costs of bankruptcy to the broader economy exceed the cost of a bailout.

The proposed approach would give the FRB greater "constructive ambiguity" in the face of a systemic crisis by replacing the binary decision of *whether* to bail out a failing firm out with the decision to determine the *degree* to which it will participate in an industry initiative. The proposal would link a federal commitment to be bailed out with a commitment to participate in the bailout of other firms, if called upon by the FRB to do so or if approved by participating firms pursuant to ex ante rules. Membership in such an organization would thus be largely voluntary (for firms other than the largest banks and investment firms) and subject to a form of "credit" approval by other members. Such membership would also entail a commitment to share—both vertically, with federal regulators, and horizontally, with other members—certain categories of information necessary to determine direct and indirect interfirm concentration risk.[297]

Firms might be induced to seek membership through a variety of incentives. The most important incentive, of course, is the implicit credit support provided by the organization, which would reduce the firm's transaction costs when hypothecating assets or entering into derivative transactions involving credit exposure. Membership in the organization might also be required, for example, for firms that seek to compute capital or required margin in accordance with risk-based models, such as under the SEC's net capital rule and proposed SRO portfolio margining rules,[298] or under the Basel Framework.[299] Other privileges of membership might include the right to preferential treatment of derivatives and financing contracts currently available to financial institutions under federal bankruptcy law.[300]

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interconnected, or too complex to fail impose added costs to the government and, ultimately, the taxpayer in the form of the government assistance that might be needed to rescue large, distressed institutions. Given the concentration risks to the government, it is reasonable to question whether 'systemically important' firms should be held to a higher solvency standard."); G30 REPORT, *supra* note 186, at 27 ("[M]arkets are likely to presume that the largest regulated financial institutions will, to some extent, be protected against the full force of market discipline . . . . To compensate for this, and to keep the probability of potential failure of such institutions to acceptably low levels, existing regulatory standards and supervisory approaches will need to be upgraded."); PAULSON BLUEPRINT, *supra* note 10, at 156 (stating that "market stability discount window lending would have to be supported by Federal Reserve authority to collect information and conduct examinations of borrowing firms in order to protect the Federal Reserve (and thereby the taxpayer)").

297. Members and nonmembers would continue to be regulated by the SEC for compliance with the net capital rule and the customer protection rule. If, however, a systemic risk regulator were recognized as the "ultimate regulator" of an investment bank holding company, the SEC would presumably defer to its consolidated regulator for capital requirements.

298. Paredes, *supra* note 23, at 1027 n.18 (citing articles proposing SRO margining rules).

299. Phyllis Diamond, *Lawmakers Quiz SEC on Plans to Re-Assess CSE Liquidity Standards*, BNA SEC. L. DAILY, Apr. 4, 2008 (discussing capital and liquidity standards for the top five CSEs: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley).

300. *See* 11 U.S.C. § 101(22) (2006) (defining "financial institution," inter alia, for purposes of the closeout provisions applicable to securities and derivatives transactions under the Bankruptcy Act); *supra* note 171 (describing preferential treatment).

2. Operation

The FRB's role in the proposed framework would be to act as lead underwriter for any proposed rescue transaction. Like most reform proposals, this proposal would grant the FRB wide discretion to gather information from all regulated and unregulated financial firms in order to detect, prevent, and remediate market events. This proposal would also give the FRB broad discretion to fashion remedial relief, but within the framework established by SRO rules and only upon a formal request by the industry.[301]

The SRO would perform principally two functions: it would both define specific categories of aggregate information to be gathered from and shared by members on a routine basis and develop terms for sharing the costs and benefits of underwriting clean-up efforts when requested by the FRB. To ensure that such rules are administered fairly, the SEC would assist members of the proposed self-regulatory body in formulating equitable rules for the allocation of responsibilities (and privileges) in the event of a FRB-mandated bailout. While it would be unrealistic for the SEC and the SRO to develop a comprehensive framework for all possible market crises, adopting predictable rules would help focus negotiations in the wake of a crisis and help quantify potential exposures to systemic risk.

The information-sharing function of the SRO would be limited to those categories of information that can be aggregated sufficiently to avoid disclosure of proprietary or customer trading, and that are desirable to refine cost-sharing rules. As industry proposals have recognized, the quantity and quality of information a financial services conglomerate provides about its activities depends on the degree of confidentiality that counterparties are able to ensure.[302] Sharing of information among member firms—which might include information about aggregate transaction volumes in various financial products—would allow firms to identify specific areas of potential risk across firms and to readjust their own trading strategies to avoid undue concentration. Sharing information subject to an SRO mandate and under regulatory supervision would ensure standardization and some third-party verification of disclosures.

The cost sharing rules would essentially take the form of a syndication agreement, defining the terms under which responsibility would be apportioned among SRO members.[303] The rules, for example, might set maximum and minimum thresholds for financial commitment based on each member's respective net worth, as well as specific allocation targets based on each member's net exposure to particular asset classes or financial instruments deemed to have contributed to the crisis. The rules might also craft procedures for relieving financially troubled firms of an obligation to participate in an FRB-orchestrated transaction, as well as procedures for reallocating the shares of defaulting or troubled members to more solvent members. The rules might even specify the

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301. For a discussion of this framework, see *infra* Part V.A.3.

302. TOWARD GREATER FINANCIAL STABILITY, *supra* note 178, at 46–47.

303. *See, e.g.*, 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 500–04 (4th ed. 2006) (describing the formation and terms of the "agreement among underwriters").

terms under which individual members could bid for a failing firm if they are willing to improve upon the terms set by the SRO.

Rules might also be designed to protect members against excessive discriminatory treatment, such as by requiring a certain degree of participation based on line of business. For instance, it would be foolish to imagine that investment banks generally pose the same degree of moral hazard as commercial banks, given that bank depositors are far less able to evaluate the risk or severity of bank failures than institutional counterparties of investment banks. Nevertheless, to the extent that the framework for commercial bank regulation is far more sensitive to systemic risk—both in terms of the degree of supervision commercial banks receive as well as the availability of deposit insurance—there is a possibility that the FRB would use any industry sponsored organization as a means to prop up commercial banks at the expense of investment banks. To a degree, the sheer size of the largest bank holding companies relative to investment bank holding companies allays such concerns, since any major commercial bank bailout would far exceed the available resources of investment banks. Moreover, only bank holding companies would be in a position to acquire a defaulting commercial bank or its customer accounts.[304]

Legislation would grant certain protections to members participating in a FRB-orchestrated bailout. For example, legislation should generally preempt any action by shareholders to enjoin or set aside any FRB-orchestrated bailout conducted at the FRB's request and in accordance with SRO rules.[305] Legislation might also grant the SRO a right of first refusal to participate in any bailout involving the use of FRB financing (including bailouts of hedge funds, major corporations, or other unregulated entities), to the extent that the FRB might thereby convey (intentionally or unintentionally) prized assets or substantial equity exclusively to one or more commercial or investment banks. Conversely, the SRO may be entitled to seek bids for assets or affiliates of a failed institution (other than affiliates that are insured depository institutions) while under the conservatorship of a joint FRB-SRO vehicle. Finally, legislation should guarantee SRO members the right to a

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304. *Cf.* Macey & Miller, *supra* note 181, at 1188 (discussion of the FDIC's auction procedures for troubled banks). In particular, the inability of private equity investment firms to participate effectively in the financing of troubled bank holding companies because of restrictions on concentrated ownership under the Bank Holding Company Act, *see* 12 U.S.C. § 1841(a)(2) (2006) (defining "bank holding company" to include any company that owns twenty-five percent or more of the voting securities of any bank or any other bank holding company or, inter alia, "exercises a controlling influence over the management or policies of the bank or company"), has drawn considerable media attention. *See, e.g.*, Editorial, *The Banks and Private Equity*, N.Y. TIMES, Aug. 3, 2008, at 9.

305. Shareholders of failing firms should, of course, remain able to seek monetary damages for any breach of a board's fiduciary duties in the context of such a transaction, to the fullest extent permitted by state law. *See In re* Bear Stearns Cos., Inc. S'holder Litig., C.A. No. 3643-VCP, 2008 WL 959992 (Del. Ch. Apr. 9, 2008) (describing shareholder litigation in opposition to the acquisition of Bear Stearns pending in both Delaware and New York courts); *see also* Gretchen Morgenson, *Approve This Deal, or Else*, N.Y. TIMES, June 15, 2008, at BU1 (discussing shareholder criticism of the "sweet package" received by the Texas Pacific Group and other institutional investors as part of Washington Mutual's efforts to raise additional capital in the face of subprime mortgage losses).

supermajority vote before they are required to participate in the bailout of a nonmember firm.[306]

3. Structuring Relief

Because of the unpredictability of market events and the variety of approaches to effectuating remedial relief, the FRB must have broad discretion in fashioning any remedial measures. Moreover, since many such transactions must be negotiated within limited time windows, excessively elaborate protocols would discourage FRB reliance on any market-wide system of relief. Nevertheless, certain procedures would be necessary before the FRB is permitted to foist a particular transaction on a market SRO.

i. Determining if Federal Intervention Is Warranted

The first step the FRB would be required to take is to make a determination, based on the information at hand, whether multilateral relief is warranted in any given circumstance. To the extent that a failing firm's insolvency would disproportionately impact only a few firms, the appropriate recourse is to encourage the firms most affected to induce some form of pre-bankruptcy acquisition or settlement. In such circumstances, the FRB would communicate privately to the affected members that it would not initiate any industry-wide relief, absent a demonstration that such an obligation would trigger adverse consequences for the affected firms and their counterparties. Affected firms might also appeal to the industry SRO for a vote on whether, under the circumstances, to grant relief without federal assistance.

The purpose of such a requirement is to discourage federally financed relief in circumstances where the benefits would flow primarily to a handful of firms. While FRB participation in any transaction will be the subject of extensive (if time-pressured) negotiation, it would be a useful signal to the marketplace if the FRB were able to convey its views as to whether it would take the lead in executing a transaction, whether it would participate in a transaction led by the industry, or whether it would be opposed outright to participation.

ii. Scope of Relief

The second step the FRB would take is to determine the appropriate structure of the relief at issue. Much like the "least-cost" approach of the FDIC,[307] the FRB would be expected to structure relief in the form that would impose the least burden on the financial system as a whole, in terms of total obligations assumed (contingent or otherwise) and total liquidity to be committed. In some circumstances, this might entail underwriting the issuance of additional shares to raise capital or temporarily guaranteeing new obligations in an effort to preserve the entity. In others, remedial relief might consist of the purchase and orderly

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306. *See* 12 U.S.C. § 343 (2006) (requiring a supermajority vote for the FRB to take actions to address systemic risk).

307. *See supra* notes 163, 215.

liquidation of a narrowly limited portfolio of assets or contracts, such as through a special purpose vehicle, while allowing the remainder of the firm's assets to be liquidated in bankruptcy.[308] In yet others, acquisition of the firm as a whole might be desirable, with participating firms purchasing equity interests (for example, through a cash-out merger) in exchange for assumption of outstanding obligations.[309]

iii. Apportionment of Responsibility

The third step would be to allocate a share of the remedial efforts among the FRB and industry participants. The FRB would be given broad discretion, for example, to determine what percentage (if any) of remedial relief to assume itself. If, for example, a significant percentage of a defaulting firm's obligations were owed to nonmember firms (such as institutional investors or private vehicles), it may not be appropriate to burden industry members with a significant share of responsibility for the defaulting firm's conduct. By contrast, if a defaulting firm's transactions were largely conducted with other members, a stronger case would exist for limiting relief to industry members. The FRB would be authorized to selectively reveal information about the specific exposures of member firms to the SRO and its members in an effort to negotiate an appropriate distribution of shares.

The purpose of this step would be, essentially, to assess both the relative culpability of individual firms and the industry as a whole, as well as the capacity of individual firms to participate in any remedial relief. For truly extraordinary events (such as 9/11 or Hurricane Katrina), the FRB might consider financing the lion's share of a transaction if other firms were not able and willing to do so.[310] For crises precipitated by a chronic industry failure to monitor counterparty risks or agency costs (such as the Enron debacle and the subprime crisis), the FRB might scale back its role in any intervention. As a means to internalize the costs of risk taking, firms might also be required to structure executive compensation, or compensation for other highly remunerated employees, in such a manner as to deny or claw back compensation from those individuals who had direct or indirect responsibility for the products or services on the basis of which contribution is assessed.[311]

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308. *See supra* notes 163, 230–31 & 272–76 (discussing the FDIC's power to take "corrective action" of this type).

309. *See supra* notes 163, 230–31 & 272–76 (discussing the FDIC's power to take "corrective action" of this type).

310. *See, e.g.*, Jackson, *supra* note 68, at 601–02 (suggesting that, in some circumstances, the risk of systemic failure is sufficiently "uninsurable" that the federal government must act as insurer of last resort).

311. Some commentators have asserted that equity-based compensation, particularly in the financial services sector, may have contributed to higher risk taking and leveraging. *See* Carl R. Chen, Thomas L. Steiner & Ann Marie Whyte, *Does Stock Option-Based Executive Compensation Induce Risk-Taking? An Analysis of the Banking Industry*, 30 J. BANKING & FIN. 915, 943 (2006) (concluding that "the structure of executive compensation . . . induces risk-taking in the banking industry" and lending support to the view that "regulators need to consider a new paradigm that explicitly provides the appropriate incentives/disincentives for risk-taking within the compensation structure"); Anthony J. Crawford, John R. Ezzell &

iv. Duration of Relief

The fourth step would require the FRB to consider whether industry participation should be immediate or phased in over a period of time. The FRB could, for example, allocate responsibility to individual firms to purchase shares in a portfolio of assets, but finance a significant percentage of the purchase price to avoid imposing undue demands on marketplace liquidity. Such obligations could then be satisfied over a period of years (or decades) as markets recover. Amortizing industry obligations in this manner might also provide risk-management professionals with some basis for developing estimates of the anticipated cost of such crises over time, rather than treating them as onetime events.

James A. Miles, *Bank CEO Pay-Performance Relations and the Effects of Deregulation*, 68 J. BUS. 231, 232–33, 246–55 (1995) (discussing the extent to which increased pay-performance relations for CEOs after deregulation can be attributed to the hypothesis that banks seek to transfer wealth from the FDIC and taxpayers to the bank's shareholders by engaging in morally hazardous risk-taking); Kose John & Yiming Qian, *Incentive Features in CEO Compensation in the Banking Industry*, FRBNY ECON. POL'Y REV., Apr., 2003, at 109 (asserting that if top management of commercial banks is "very closely aligned with equity interests in banks, which are highly leveraged institutions, management will have strong incentives to undertake high-risk investments"); *see also* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 363–67 (2009) (arguing that the "the most significant policy issue" raised by the pay-for-performance compensation at major Wall Street firms "was the systemic risk that these particular high-powered incentives created for firms whose failure would ramify throughout the financial system as a whole"); Frederick Tung, *The Great Bailout of 2008-09*, 25 EMORY BANKR. DEV. J. 333, 340 (2009) (arguing that "[W]hen you pay managers of banks with equity, you increase their risk-taking incentives by giving them a direct equity stake in the upside payoff from taking big risks"). *But see* Elijah Brewer III, William Curt Hunter & William Jackson III, *Deregulation and the Relationship Between Bank CEO Compensation and Risk-Taking* 2 (Fed. Reserve Bank of Chi. Working Paper Series, Paper No. 2003-32, 2003), *available at* http://ssrn.com/abstract=486985 (concluding that "more levered banks do not have higher levels of equity-based CEO compensation").

One of the challenges of regulating the relationship between risk and compensation, however, is the difficulty of setting temporal parameters—whether through the use of vesting requirements or claw back periods—to determine when, and what percentage of, an employee's compensation is free and clear of any such encumbrance. *See* VIRAL V. ACHARYA & MATTHEW RICHARDSON, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 204–13 (2009). Tying such provisions to the duration of a firm's participation in a transaction under the proposal might conveniently avoid the problems of picking specific timeframes. *See, e.g.*, 31 C.F.R. § 30.2 (2009) (imposing restrictions on the compensation of employees of a recipient of assistance under TARP "during the period during which any obligation to the Federal government arising from financial assistance provided under the TARP remains outstanding"); *id.* § 30.8 (requiring, inter alia, that bonus payments for senior executive officers and the next 20 most highly compensated employees of a TARP Recipient be subject to clawbacks for "materially inaccurate financial statements . . . or any other materially inaccurate performance metric criteria").

B. Discussion and Analysis

In this section, I discuss some of the advantages of the proposed framework and the concerns it might raise for financial regulators and financial services conglomerates.

1. Advantages of the Proposed Framework

The advantages of this proposal are straightforward. First, to the extent that most of the reform proposals have been stymied because of concerns about regulators defining which entities will be deemed "systemically significant," a regulatory framework that actively involves the financial services industry in the decision-making process can both shield the process from political pressure and improve its accuracy. One of the battles that regulators must perennially fight is to gain some regulatory power with respect to hedge funds and other unregulated but systemically dangerous entities. It may be far easier, however, to induce hedge funds and other private pools of equity to participate in a self-regulatory body if their prime brokers or counterparties pressure them to do so for their own protection. To the extent that not all bank holding companies, other financial services conglomerates, or private pools of equity pose systemic risks, a self-regulatory organization is better suited to identifying the relevant criteria for determining which entities pose the greatest risks to the system and sparing the majority of such entities from enhanced regulation or disclosure.

Second, if industry participants have more insight than regulators into instruments that are likely to pose significant systemic risks, an industry-led body can better factor that insight into the self-regulatory organization's plan for allocating responsibility in the event of a crisis. Some firms may avoid novel products if they believe that their competitors are not adequately gauging the risk of their use.[312] Firms beset by such qualms, however, have no incentive to push the industry toward taking a harder look at their risk exposure. If the baseline assumption is that firms will participate in any industry-orchestrated bailout based on their share of exposure to a particular product or portfolio, firms that are averse to certain product lines or instruments will have an incentive to push for rules designed to cabin the risks from those product lines or instruments.

Third, industry participation in a bailout of a financial services conglomerate helps address one of the most critical problems faced by government-initiated remedial action: asset valuation. To the extent that the FRB and Treasury undertake to purchase (with a view to later sell) securities and other financial products, holders of dollar-denominated assets and taxpayers are rightly concerned that the government will buy too dear and sell too cheap. As a result, many government bailout programs—such as the Resolution Funding Corporation (REFCORP),[313] the Resolution Trust Corporation (RTC),[314] and the Treasury's recently announced

312. TETT, *supra* note 3, at 129–42 (describing JPMorgan Chase's decision not to expand its synthetic derivatives business in light of concerns about the residual risk of synthetic collateralized debt obligations).

313. *See supra* note 181.

314. *See supra* note 181.

"Public-Private Investment Program" (PPIP)[315]—view public-private partnerships as a useful means of letting private actors set prices for assets to be sold off from failing firms. Government agencies, however, must currently give private firms generous incentives to induce their voluntary participation in such partnerships. Creating a permanent role for industry alleviates that need.[316]

Fourth, formalizing the industry's role in a market crisis may hasten the incentives to develop better industry mechanisms. Often, financial crises can be the result of negligence in handling routine documentation of master agreements or confirmations, or in simple risk-reducing measures like netting and novation through a clearinghouse. A greater chance of collective liability for the mistakes of individual market participants may, all other things being equal, provide more incentive to take up such projects during periods of heightened market activity. An organization of the sort discussed thus far could, through a collective decision-making process, develop its own mechanisms for improving the stability of markets in times of crisis.[317] It also might be required to create a temporary liquidity facility—the size of which could, for example, be calibrated to the net capital requirement of its smallest member—to assist members or nonmembers to continue operations while they seek to raise additional capital.[318]

Finally, to the extent that bailouts can entail significant fees for the underwriters, advisers, lawyers, and other individuals who assemble the various transactions necessary to implement government assistance, it seems that giving major financial services conglomerates a stake in such transactions can save some expenditures

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315. *See* Press Release, Dep't of the Treas., Treasury Department Releases Details on Public Private Partnership Investment Program (Mar. 23, 2009), *available at* http://www.treas.gov/press/releases/tg65.htm.

316. While it may not entirely solve the problem—the industry might be too willing to low-ball when purchasing distressed assets—the price-setting process would remain insulated from government intervention.

317. *Cf.* Grynbaum, *supra* note 177 (quoting Timothy Geithner, President of the Federal Reserve Bank of New York, as stating that "[t]he major central banks should put in place a standing network of currency swaps, collateral policies and account arrangements that would make it easier to mobilize liquidity across borders quickly in crisis"); Kara Scannell, *SEC Role Is Scrutinized in Light of Bear Woes*, WALL ST. J., Mar. 27, 2008, at A6 (describing Chairman Cox's testimony); Letter from Christopher Cox, Chairman, SEC, to Nout Wellink, Chairman, Basel Committee on Banking Supervision (Mar. 20, 2008) (asserting that "[c]ounterparty withdrawals and credit denials, resulting in a loss of liquidity—not inadequate capital—caused Bear's demise"), *available at* http://www.sec.gov/news/press/2008/2008-48.htm.

318. SEC officials have advocated such a facility, even with the availability of funding by the Federal Reserve Board. *Regulation of Investment Banks: Hearing Before the Subcomm. on Secs., Ins. and Inv. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (May 7, 2008) (testimony of Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission) (noting that "[w]hile the Federal Reserve . . . forestalled a similar run-on-the-bank from playing out elsewhere, it nonetheless remains for Congress to determine whether to provide more predictable access to an external liquidity provider . . . similar to the framework in the Federal Deposit Insurance Improvement Act and the Federal Deposit Insurance Act for systemically important investment bank holding companies").

around the margins. Several financial services conglomerates are alleged to have profited significantly from the capital raising and restructuring transactions their troubled peers have undertaken to weather the current crisis.[319]

2. Concerns Raised by the Proposed Framework

As discussed above, many commentators look skeptically on proposals grounded in self-regulation, and a proposed regulatory framework for handling systemic crises that leans upon an industry body to take the lead in resolving them raises a host of issues. Among other issues, the framework must deal with the inevitable opportunity for firms to exploit such structures to profit at the expense of the taxpayer or to cartelize the provision of financial services. It may also be difficult to devise rules of governance or risk allocation for such an organization, and to induce firms to internalize the consequences of a bailout that is a low-risk, high magnitude event. From the perspective of the industry, moreover, there is a threat that, if ex ante incentives prove insufficient to stave off an eventual systemic crisis, solvent firms will be expected to commit themselves financially to a long-term bailout during market conditions in which their own financial position may be unstable.

First, it is important to recognize that our current ad hoc framework for addressing systemic crises creates many of the same problems, and in a manner that may result in greater inequities. For example, in the absence of a systematic way to address crises, government officials may induce some financial services conglomerates to accept significant short-term burdens while directly or indirectly conferring financial benefits on others. At the discretion of federal regulators, some firms may be encouraged—or, at worst, coerced—into bailing out a failing competitor to prevent a systemic failure,[320] while others might profit handsomely from the preservation of large counterparty positions without being asked to participate in the rescue of the defaulting firm.[321] This kind of discretion motivates

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319. *See, e.g.*, Liam Pleven & Aaron Lucchetti, *AIG Breakup Is Fee Bonanza: Wall Street Firms Could Collect Nearly $1 Billion for IPOs and Advice, Analysis Shows*, WALL ST. J., Aug. 7, 2009, at A1.

320. For example, in connection with Bank of America's acquisition of Merrill Lynch, Bank of America CEO Kenneth Lewis' testified that Bank of America had considered invoking a "material adverse change" clause to terminate the acquisition in light of the "staggering amount of deterioration" at Merrill Lynch, but that Treasury Secretary Henry Paulson had told him that "if Bank of America were to back out of the Merrill Lynch deal the government either could or would remove the Board and management." Letter from Andrew M. Cuomo, Att'y Gen., State of N.Y., to Sen. Christopher J. Dodd, Chairman, Senate Comm. on Banking, Hous. & Urban Affairs, Rep. Barney Frank, Chairman, House Fin. Servs. Comm., Mary L. Schapiro, Chairman, SEC, and Elizabeth Warren, Chair, Congressional Oversight Panel (Apr. 23, 2009), *available at* http://online.wsj.com/public/resources/documents/BofAmergLetter-Cuomo4232009.pdf. Moreover, Lewis testified that Bank of America did not disclose Merrill's financial condition to Bank of America shareholders in connection with their approval of the merger "based on direction from Paulson and [FRB Chairman Ben] Bernanke." *Id.*

321. *See, e.g.*, Peter Eavis, *Goldman's Price of Protection*, WALL ST. J., Mar. 18, 2009, at C14 (noting that the AIG bailout enabled AIG to deliver $2.5 billion in collateral and $5.6

many opponents of consolidating significant remedial authority in a single agency or branch of government.

Second, cartelization can also result from government control of financial services conglomerates—whether through direct ownership of common stock or the right to acquire common stock through the exercise of warrants or convertible preferred shares. In the automotive industry, commentators have voiced significant concern that government-owned automakers will enjoy superior access to capital, financing, and regulatory accommodation to those owned by public or private shareholders.[322] Ownership or financing by a public-private partnership between the FRB and the industry may present similar risks but, unlike under the current PPIP's proposals, the government would play little role in the selection of private partners and the industry would presumably take the lead in managing the business or assets of the failing entity until resolution is desirable. Moreover, Congress and the SEC have been moderately successful over the past several decades in reining in some of the more egregious anticompetitive rules established by the stock exchanges; regulatory oversight of the organization's rules can check such abuses to a degree.

Third, there is a risk that industry members may exploit the information shared by regulators such as the FRB during a market crisis to profit from trading in public or private over-the-counter markets. There is ample speculation that Bear Stearns may have been driven into illiquidity and thence insolvency as a result of short selling of its shares and short positions taken in derivative contracts written on its securities.[323]

Enforcement actions against such manipulation will always occur after the damage is done. A self-regulatory organization may, nevertheless, develop rules designed to deter more abusive conduct during periods where the FRB is actively consulting with systemically significant firms to prevent or contain a crisis. For example, the self-regulatory organization could, at the instigation of the FRB or SEC, ban participating firms from betting against the failure of at-risk firms by taking uncovered short positions for the pendency of the crisis, in much the same way that the SEC has sought to ban market-wide short selling during periods of market stress. Industry participants might object to such measures, insofar as they would naturally hamper the ability of their clients to purchase long securities or to take long positions in a firm's prospects. To the extent, however, that it is illegal to

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billion in cash to Goldman due under Goldman's credit default swaps with AIG, which had a notional value in excess of $20 billion).

322. *See, e.g.*, Matthew Dolan, *Ford to Face Tougher Rivals Following U.S. Rescue*, WALL ST. J., June 8, 2009, at B1 (describing the disadvantages to Ford flowing from GMAC's receipt of federal funds and ability to offer federally backed debt); Editorial, *Treasury to Ford: Drop Dead*, WALL ST. J., Jan. 2, 2009, at A14 (criticizing the gift of federal funds to GMAC as hurting companies such as Ford and Toyota while helping Chrysler and GM); George F. Will, Op-Ed, *Have We Got a Deal for You*, WASH. POST, June 7, 2009, at A19 (criticizing the federal government's increasing interference in private industry).

323. *See* Amendments to Regulation SHO, Proposed Rule, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042, 18,046–49 (Apr. 20, 2009) (describing the volume of comments from academics, legislators, and the public regarding the perceived abuses of short selling during the recent market crisis and the resulting erosion of investor confidence); Burrough, *supra* note 1.

trade in securities on the basis of material, nonpublic information in breach of a duty of trust or confidence owed to the source, there is little reason to object to such a prohibition, especially if participating firms are receiving privileged information from the FRB to assist in containing their own exposure to their competitors. Moreover, exceptions could be made for bona fide market-making or derivatives dealing operations.

Fourth, in order to participate in an industry-orchestrated bailout, firms would have to adjust compensation structures and other internal controls to ensure that employees internalize the risk of a firm's potential liability. For ex ante incentives to deter high risk behavior and enhance vigilance, the officers, directors and high level employees of such firms must share equally in their firm's exposure under the proposed framework. As discussed above,[324] before the era of public financial services conglomerates, partners maintained equity in their firms for their entire career and were therefore inherently vested in the fortunes of their firm. With modern equity-based or performance-based compensation schemes, there is an incentive for traders to structure transactions in such a way that the risk of the transaction spikes after the traders' compensation has fully vested and after they are no longer immediately concerned with their employer's fortunes.

Both regulators and industry participants are actively considering ways to restructure compensation so that firms can claw back compensation from executives or other highly compensated individuals. The SEC has, for example, taken the position that its clawback powers under § 304 of the Sarbanes-Oxley Act of 2002[325] may be applied against executives even if they are not alleged to have participated in accounting fraud.[326] A fortiori, regulators should be able to pursue claw-back remedies against individuals who participated in or supervised highly risky activities that may result in financial stress. It is the design of clawbacks, however, that poses difficulties. Because equity compensation packages or other bonus packages typically vest after a fixed number of years, firms would have to lengthen vesting periods or adopt "hold through retirement" policies to create appropriate incentives. Otherwise, clawbacks would be fruitless if employees are permitted to draw upon their compensation in the interim.

Finally, it may simply be too difficult to establish a governance structure for such a self-regulatory organization or a set of rules for allocating risk in the wake of a crisis. Many bankruptcy scholars, for example, have noted that bankruptcy reorganizations under Chapter 11 are increasingly difficult to effectuate because claims trading, derivatives, and the rise of professional creditors result in "fragmented and conflicting" ownership interests, and that bankruptcy judges require "more discretion, not less" to ensure formation of coalitions able to negotiate a reorganization plan.[327] As a result, bankruptcy reorganization begins to

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324. *See supra* note 55 and accompanying text.

325. 15 U.S.C. § 7243 (2006).

326. Complaint, SEC v. Jenkins, No. 2:09-cv-01510-JWS (D. Ariz. July 22, 2009), *available at* www.sec.gov/litigation/complaints/2009/comp21149.pdf; *see also* Litigation Release No. 21149A, 2009 WL 2192780, at *1 (July 23, 2009) (noting that the case against Jenkins was "the first action seeking reimbursement under Section 304 from an individual who is not alleged to have otherwise violated the securities laws").

327. Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy* 6, 54 (Univ. of S. Cal.

look more like the ad hoc processes used in systemic crises, and consequently is a less useful model for reforming systemic risk regulation than bankruptcy adherents believe.

This last criticism must, of course, be viewed in light of the reality that the FRB and Treasury will largely finance remedial efforts in the wake of any systemic crisis. The goal of the proposal is not to definitively set out each firm's ex ante share of a prospective bailout package, but rather to bring all of the major firms to a bargaining table with a rough expectation of their likely exposure. Just as Congress has delegated to SROs the amorphous task of promulgating "just and equitable principles of trade" for their members,[328] it is not beyond credulity to suggest that an industry body—under the oversight of an SEC-like monitor—could develop similarly equitable principles of contribution to be interpreted by a deep pocket such as the Treasury or the FRB.

CONCLUSION

Rethinking the scheme for regulating investment banking and handling systemic risk naturally raises many concerns. There is a danger both that too much ex ante regulation might stifle the availability of financing while channeling banking activity into unregulated businesses and that too much ex post regulation might make market conditions worse by sapping firms of resources when they need them most. Nevertheless, the broader goals of addressing systemic risk compel at least a consideration of whether regulation can help internalize (if not socialize) the foreseeable costs of a federal bailout. Reliance on a system that checks the central bank's significant leverage over the financial community with a system of rules and principles for crafting ex post relief might achieve that goal.

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328. 15 U.S.C. § 78f(b)(5) (conditioning registration of a stock exchange on adopting rules to promote, inter alia, "just and equitable principles of trade"); 15 U.S.C. § 78o-3(b)(6) (conditioning registration of a national securities association on a similar requirement); see also FINRA, FINRA MANUAL, Rule 2010 & Interpretation Memos thereunder (2008) (interpreting the requirement that members observe "just and equitable principles of trade"), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504.