Financial reform legislation has given new powers and directives to regulatory agencies, but reforms are undercut by a nagging concern that before the financial crisis these same agencies failed to use the powers they already had. Enacting new laws or adopting new regulations that are not enforced is an exercise in futility.

Can reformers ensure that new laws and regulations are enforced, rather than ignored?

The Current Situation

Regulatory agencies and the U.S. Department of Justice often did not—or were unable to—enforce existing laws before, during and after the 2008 financial crisis. Yet, Wall Street executives bristled at public criticism of the lack of criminal convictions, or even prosecutions, after the crisis. To them, public disapproval just showed ingratitude.

Robert Benmosche, CEO of American International Group (AIG), spoke for many Wall Street executives when he said the criticism of AIG bonuses in the midst of the financial crisis “was intended to stir public anger, to get everyone out there with their pitchforks and their hangman nooses, and all that—sort of like what we did in the Deep South. And I think it was just as bad and just as wrong.”

Andrew Ross Sorkin, financial reporter for The New York Times, does not compare criticism of Wall Street to lynching, but argued, “while things happened that were upsetting and frustrating and unethical and immoral, sadly, it may not have been criminal.”

The former head of the U.S. Department of Justice’s Criminal Division, Lanny Breuer, explained that even when the circumstances appear to show obvious criminal conduct, a criminal case may still be impossible to prove. “With respect to Wall Street cases,” Breuer told PBS’s show Frontline last year, “we looked at those as hard as we looked at any others, and when a case could be brought, we did. But when we cannot prove beyond a reasonable doubt that there was criminal intent, then we have a constitutional duty not to bring those cases.”

Shortly after that interview, however, Breuer acknowledged that in a system of equal justice under law, sometimes some are more equal than others. Last December, the U.S. Department of Justice announced with great fanfare a “record” $1.92 billion settlement with HSBC Holdings (HSBC), a British bank with extensive U.S. operations, for laundering billions of dollars for governments under international sanctions, including state sponsors of terrorism, nuclear proliferators and the genocidal Sudanese regime. HSBC also laundered money for other organizations suspected of terrorist ties as well as the Colombian and Mexican drug cartels. “HSBC is being held accountable
for stunning failures of oversight,” Breuer said. But despite indisputable evidence of serious crimes, Breuer said, the U.S. Department of Justice decided against indicting HSBC or HSBC officials “over concerns that criminal charges could jeopardize one of the world’s largest banks and ultimately destabilize the global financial system,” an argument available to few criminal defendants. The fine was about five weeks of HSBC profits, taken from shareholder funds.

When Attorney General Eric Holder told the Senate Judiciary Committee about the decision not to prosecute HSBC, he said, “I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy. And I think that is a function of the fact that some of these institutions have become too large.”

Are some financial institutions so big and important that they—and their executives—should not be held criminally accountable? The American public doesn’t think so. A recent CBS/New York Times poll found that 79 percent of Americans—77 percent of Republicans, 79 percent of Democrats, and 81 percent of independents—think more bankers and other financial executives should have been criminally prosecuted for their role in the financial crisis. It is not just the public that objects to the lack of prosecution. A New York Times editorial called the HSBC settlement “a dark day for the rule of law.” “When prosecutors choose not to prosecute to the full extent of the law in a case as egregious as this,” the editorial reads, “the law itself is diminished. The deterrence that comes from the threat of criminal prosecution is weakened, if not lost.”

The question of political influence in investigations and prosecutions is not new in American politics. In fact, it is a recurring theme in our history. More than 80 years ago, the Teapot Dome scandal was in part about the Justice Department’s failure to expose and prosecute the Secretary of the Interior, among others, for defrauding the federal government.

In 1989, the Keating Five scandal involved five U.S. Senators who interfered with a regulatory investigation of the Lincoln Savings and Loan Association. The regulators backed off the investigation, and the savings and loan later collapsed. The collapse cost the federal government more than $3 billion, and cost many of the savings and loan’s bondholders and shareholders their life savings. The chairman of the savings and loan, Charles Keating, had made very significant campaign contributions to the five senators. Keating ultimately served five years in prison for role in the collapse.

The decisions not to investigate possible violations or take enforcement action is often not intentionally corrupt, however. In fact, regulators rarely consciously betray the public interest, but their view of the public interest may be greatly influenced by the
industries subject to their regulation. Willem Buiter, a prominent economist, explained that the response of policymakers to the financial crisis as “cognitive regulatory capture,” in which “those in charge of the relevant state entity internalized, as if by osmosis, the objectives, interests and perceptions of reality of the vested interest they are meant to regulate.”

Others note a tendency of regulators to treat violation of existing rules as requiring “problem solving” with the regulated institution rather than enforcement. James Kwak, a faculty member at the University of Connecticut law school and a prominent economics blogger, argues that the acceptance of the virtue of financial deregulation was largely the result of “cultural capture,” “an idea that people adopt in part because of the prestige it confers.”

Reformers must push hard for the appointment of regulators and Justice Department officials committed to enforcement. Reformers are not entirely stymied, however, if regulators and prosecutors lack that commitment. The task of ensuring enforcement presents reformers with two circumstances that require different strategies: when regulators and prosecutors want to enforce laws and regulators, and when regulators and prosecutors, for whatever reason, do not.

Let’s consider first the case of regulators and prosecutors who do in fact want to enforce the law, or only need modest encouragement.

**Fight for Funding: Enforcement Is Not Free, or Even Cheap**

Reformers fought to guarantee that the new Consumer Financial Protection Bureau (CFPB) has an independent source of funding through the Federal Reserve, rather than depend on annual appropriations from Congress. Independent funding is critical to the new agency’s effectiveness. There are many opportunities for the “regulated community” of an agency to influence openly, or in private, an agency’s funding to hobble enforcement or even to cow or capture an agency. Unfortunately, the fight for independent funding is not over. Consumer lenders and their allies in Congress continue to push to require annual appropriations from Congress to fund the CFPB.

Two agencies with critical enforcement roles, the Securities and Exchange Commission (SEC) and the Commodity Future Trading Commission (CFTC), depend on annual funding from a captured Congress. The industries regulated by each agency have taken full advantage of the opportunity to influence the agencies’ funding. As a result, both agencies often settle enforcement actions quickly and cheaply for publicity value, often agreeing to penalties that are less than the profits the defendants realized from the forbidden practices. According to Columbia law professor John C. Coffee Jr., “from a deterrence perspective, it is similar to issuing modest parking tickets for major frauds. As long as the expected gain is not canceled, the incentive to commit fraud persists.”
Obviously, reformers must make a priority of enforcement funding, but the funding will likely never be available for either agency to match the resources of the financial industry’s defense firms in large, complex, high stakes cases. The largest banks have spent tens of billions of dollars in legal defense costs since the financial crisis, and have waged lawsuits and enforcement actions as wars of attrition, wearing down private litigants and government agencies alike.

Coffee suggests that the SEC retain private counsel on a contingency-fee basis for “megacases,” and award attorney fees as a percentage of recovery. With millions or even of billions of dollars at stake in enforcement actions, contingency fee arrangements would provide the economic motive for private law firms representing the SEC to match the efforts of defense firms and free the SEC to “focus on what they are best at: insider trading, Ponzi schemes and smaller frauds not involving a complex institutional structure and multiple actors.”

All of Coffee’s arguments are equally applicable to enforcement actions by the CFTC. A 2007 executive order signed by President George W. Bush prohibits federal agencies from entering into contingency fee agreements with private law firms. It is not clear whether the executive order applies to the SEC or the CFTC, but President Obama can reverse the order with a stroke of a pen, and he should.

The financial industry’s political allies will strenuously oppose contingency fee arrangements. The National Credit Union Administration (NCUA), as conservator of failed credit unions, entered contingency fee agreements with two prominent law firms to pursue legal claims for mortgage-backed securities the credit unions purchased from investment banks. Representative Rep. Darrell Issa (R-CA), chairman of the House Committee on Oversight and Government Reform, wrote the NCUA’s Inspector General on October 16, 2012, to complain that the arrangement violated the executive order and that the fee arrangements “impose exorbitant or unnecessary costs on taxpayers who have a right to expect the government to operate transparently and efficiently.” Tort reform organizations, all closely allied with business interests, suggested that the fee arrangements were a political pay off for the firms.

The Inspector General replied that the Bush executive order did not apply to the NCUA as conservator of failed credit unions, and that the representation was for “protracted, complex litigation with considerable risk that there would be little or no recoveries” that “occurred at a time when the National Credit Union Share Insurance Fund (NCUSIF) was under enormous pressure due to the then five failed [credit unions].” In other words, without a contingency fee arrangement, NCUA would be unable to pursue effectively, or perhaps at all, the estimated $16 billion in losses on mortgage-backed securities, which was of course what Rep. Issa and industry-funded “tort reform” organizations intended.
There are many other circumstances in which agencies are less willing to bring enforcement actions, or need encouragement. There are strategies available to reformers in those circumstances as well.

**Who Shall Watch the Watchers? Congress Shall**

At hearings, members of the House of Representatives and the U.S. Senate have asked regulators questions about decisions on enforcement actions and criminal prosecutions. But government powers don’t end there, several committees and subcommittees, some chaired by reformers, have oversight jurisdiction to conduct investigations and hearings specifically on those decisions. There is ample precedent for such congressional investigations.

The Senate Judiciary Committee investigated the Teapot Dome scandal, which resulted in the leading Supreme Court decision on Congress’ subpoena and contempt power. The Senate regarded political influence in criminal prosecutions as “grave and requiring legislation attention and action,” the court said. During the Nixon Administration, the Senate held hearings into the Watergate burglary and the obstruction of the criminal investigation.

More recently, the House Judiciary Committee conducted an investigation into the firing of U.S. attorneys during the Administration of George W. Bush. Sworn testimony and documents obtained by the committee supported the conclusion that the U.S. attorneys were fired for the proper exercise of prosecutorial discretion to bring criminal prosecutions that hurt Republicans and not to bring criminal prosecutions that would hurt Democrats.

Effective oversight is not limited to investigations of the great scandals in American history. Routine hearings can have a salutary effect on regulation. Few regulators want to explain at a congressional hearing the failure to investigate or take enforcement action in the face of obvious evidence of violation.

A handful of reformers in Congress, even without the chairmanship of a committee or subcommittee, can precipitate an investigation by the inspector general of an agency. It now appears likely that the most effective effort at accountability for the misrepresentation of mortgage-backed securities will be the private litigation brought by the Federal Housing Finance Agency (FHFA), as conservator of Fannie Mae and Freddie Mac. These two government sponsored enterprises bought tens of billions of dollars in mortgage-backed securities issued by private investment banks. FHFA recently agreed to settle claims against JPMorgan Chase for $4 billion for mortgage-backed securities purchased by Fannie Mae and Freddie Mac from Chase, Bear Stearns and Washington Mutual. According to published reports, FHFA is demanding more to settle claims against Bank of America for mortgage-backed securities that Fannie Mae and Freddie Mac purchased from Bank of America, Countrywide and Merrill Lynch.
FHFA and its acting director, Ed Demarco, deserve credit for the lawsuits and the recovery of taxpayer losses on the mortgage-backed securities. There were rumors, at least, of industry machinations to prevent FHFA from bringing the lawsuits, or to force FHFA to settle quickly and cheaply. Reformers, including members of Congress, gave FHFA strong encouragement to take a tough stance, and effectively created pressure on FHFA to countervail pressure from financial industry.

At the end of 2010, FHFA approved a settlement with Bank of America for $1.35 billion for mortgages sold by Bank of America to Freddie Mac. The contract between Bank of America and Freddie Mac gave Freddie Mac the right to require Bank of America to repurchase mortgages that did not satisfy Bank of America’s representations and warranties. On January 17, 2011, four Democratic members of the House Financial Services Committee (including the author) wrote the inspector general of FHFA to question the adequacy of the settlement, and to ask for more details. The Office of the Inspector General questioned employees of FHFA and Freddie Mac involved in the settlement. Two employees independently expressed concerns about the settlement and provided the Office of the Inspector General information that supported their concerns. The Office of the Inspector General expanded the inquiry.

On September 2, 2011, FHFA filed lawsuits against 17 banks and other financial institutions for mortgage-backed securities that Freddie Mac and Fannie Mae purchased that did not satisfy the representations and warranties that the banks made about the securities. Industry spokesmen were scathingly critical, called the lawsuits “meritless” and said that the lawsuits were an attempt to shift blame from the two government sponsored enterprises’ own failings.

On September 27, 2011, the FHFA Office of the Inspector General issued a critical evaluation of Freddie Mac’s settlement with Bank of America, an evaluation conducted as FHFA made final decisions about the lawsuits based on mortgage-backed securities. The Office of the Inspector General determined that Freddie Mac performed an inadequate review of foreclosed mortgages, which could cause Freddie Mac to lose “billions of dollars” in claims that would mitigate taxpayer losses from the conservatorship. Moreover, Freddie Mac’s senior managers feared that a “more aggressive approach to repurchase claims would adversely affect Freddie’s business relationship with Bank of America and other large lenders,” especially “capital markets” business such as issuing Freddie Mac’s mortgage-backed securities and corporate debt.

There is no way to know what influence the FHFA Office of the Inspector General and reformers in Congress had on the relative vigor of FHFA’s pursuit of the lawsuits. FHFA’s leaders knew, however, that a cheap settlement would undoubtedly result in another inquiry from members of Congress to the Office of the Inspector General, the agency would have to explain the settlement, and a settlement that FHFA could not credibly defend would result in even harsher public criticism.
A Few Bright-line Rules Can Help

There is a tension in legislation and regulation between clarity and flexibility. A law or regulation that is very clear invites evasion. Many financial industry “innovations” are just ways around existing rules. There is value, however, in some automatic, bright-line rules that do not vary with the circumstances, require proof of intent, a balance of competing considerations, or depend upon cost-benefit analysis.

A rule to require the separation of commercial and investment banking now seems hopelessly simplistic, especially compared to the complexity of the the Dodd-Frank Wall Street Reform and Consumer Protection Act’s Volcker Rule and the its various exceptions, such as hedging and market-making. The requirement of just such a separation in the Glass-Steagall Act was effective for half a century, despite—or perhaps because of—the relative brevity of the act. There are various proposals now for a modern version of the Glass-Steagall Act or other separation of functions, such as between commercial banks and broker-dealers. There are also proposals to set a cap on the size of bank holding companies, or to require that some functions be compartmentalized in separately capitalized and managed subsidiaries.

Some rules necessarily require a complicated analysis of many considerations, and agencies need flexibility to address new abusive practices. Other rules, however, should set outer limits on conduct, and those rules should be simple and enforcement should be binary: the conduct either complies with the rule or violates it.

Sometimes the planets align to allow reformers a say in the remedies created by statute and regulation. Reformers should push for private remedies that do not depend upon a willing or well-funded regulator because private remedies are the most effective form of enforcement of all.

Cry “Havoc” and Let Loose the Lawyers

Business interests have spent billions to demonize “trial lawyers” and to limit statutory remedies for good reason. Private remedies are perhaps the most effective measure to assure enforcement of financial reform legislation and regulation. The most committed, well-funded regulator will not enforce laws as effectively as private litigants acting to vindicate their own rights, or with an incentive to vindicate the rights of the public. Many successful statutes have allowed “private attorneys general”—usually any citizen—to bring a lawsuit to enforce the law.

For example, the Civil Rights Act of 1964 guaranteed the right to “full and equal enjoyment” of public accommodations without regard to race. It would have taken decades for the Department of Justice to bring enforcement actions against every movie theatre in every small town in the South that required African-Americans to sit in the balcony. Instead, the act allowed any “person aggrieved” by discrimination to bring a lawsuit for injunctive relief—a court order requiring that the public
accommodation end any discrimination or segregation. The Civil Rights Act allowed the court to appoint a lawyer to represent the plaintiff in the lawsuit, and to allow an award of attorney fees to the prevailing party.

The Clean Water Act also allows “any citizen” to bring a lawsuit against a polluter to benefit the general public, not just the plaintiff.

Other statutes create incentives for whistleblowers to report violations or to bring lawsuits on behalf of the government and the public. The False Claims Act allows whistleblowers a share of the recovery that results from bringing an action on behalf of the government against anyone who defrauds the government. Whistleblower lawsuits under the act have resulted in billions in recovery for taxpayers and have been a powerful deterrent to dishonest federal contractors.

**Conclusion: Reformers Must Be Fine Old Oaks**

“I can’t tell just how many of these [reform] movements I’ve seen in New York during my forty years in politics, but I can tell you how many have lasted more than a few years—none…” Tammany Hall boss George Washington Plunkett said more than a century ago. “They were mornin’ glories—looked lovely in the mornin’ and withered up in a short time, while the regular machines went on flourisin’ forever, like fine old oaks.” Reformers, Plunkett said, did the “talkin’ and posin’,” but “go down and out in the first or second round,” while machine politicians “answer[ed] the gong every time.”

Reformers won some rounds following the financial crisis, but the industry has answered the gong every time. The hard-won reforms will be meaningless if not enforced, and the industry will continue to fight to limit enforcement. Reformers cannot wither up now. They must remain vigilant to advocate for the appointment of regulators and Justice Department officials committed to enforcement. They need to protect funding for enforcement or push agencies to retain private law firms in complex, high stakes cases. Reformers need to assure through congressional oversight and public criticism that decisions not to enforce laws and regulations do not go unnoticed. They also need to create a few clear, automatic rules to set an outer limit on industry conduct and to create private remedies that do not require willing regulators.

**Brad Miller**

Brad Miller represented North Carolina for a decade in the U.S. House of Representatives. He was a leading reform advocate on the House Financial Services Committee. He introduced legislation on predatory mortgage lending that became part of the Dodd-Frank Act, and was a leading supporter of the creation of the Consumer Financial Protection Bureau. He is now a Senior Fellow for Economic Policy at the Center for American Progress and Of Counsel to the law firm of Grais & Ellsworth LLP.