AN UNFINISHED MISSION

Making Wall Street Work for Us

A Report by

Americans for Financial Reform
& the Roosevelt Institute

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Edited by Mike Konczal and Marcus Stanley

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Americans for Financial Reform is a coalition of more than 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups.

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Introduction

Lisa Donner, Mike Konczal, Marcus Stanley

Three years after the Dodd-Frank Act was approved, its practical implications are coming into focus. At the same time, we can see the unmet challenges of the transformation of the financial system into one that is safer, more accountable, and truly designed to serve the economy and society as a whole.

In this report, we outline the key developments so far — both the steps taken, and some not taken, down the bumpy road of the Dodd-Frank Act implementation. As well, we take a hard, deep look at the crucial problems and big decisions that remain.

The first several chapters examine important parts of the Dodd-Frank Act. What have the relevant regulators done to carry out the reforms mandated by the law? What impact are those reforms having or likely to have? What more will need to be done to address the problems the reforms were meant to solve?

The first chapter, by the MIT financial economist John Parsons, deals with the world of derivatives. It lays out the three major goals of Dodd-Frank derivatives reform—universal supervision, transparency and clearing with capital—and assesses the progress made in each case.

The next chapter, by Seton Hall law professor Stephen Lubben, discusses the new legal process of "resolution authority" that was designed to allow for the safe dismantling of "too big to fail" financial firms. Professor Lubben examines the Federal Deposit Insurance Corporation's proposal for a resolution process with a "single point of entry," and analyzes what it will take for such a system to work as intended.

Mike Konczal of the Roosevelt Institute follows with a chapter on capital requirements as a lynchpin of a safer financial system, an idea that has gained support recently at the Federal Reserve and among other influential policymakers and opinion leaders. The right kind of capital requirements, Konczal argues, can support a number of the important goals of financial reform.

Mike Calhoun of the Center for Responsible Lending follows with a chapter on changes to mortgage origination rules sanctioned by the Consumer Financial Protection Bureau. He takes stock of the significant changes now in regulation, those about to go into effect in January, and the unresolved risks in the mortgage market.

The remaining chapters concentrate on the more elusive problems revealed by the 2008 financial crisis, which lack comprehensive legislative remedies. Some of these could be addressed through the Dodd-Frank Act, while others will require further measures.

Jennifer Taub of Vermont Law School writes about the issue of so-called "sophisticated investors." Legislators and regulators, she argues, have relied too heavily on the supposed ability of sophisticated investors to police the market. After explaining some of the practical weaknesses of this approach, Professor Taub outlines several more promising avenues of reform.

Alfred State College professor Ron Rhoades takes up the important topic of fiduciary requirements. Debate over fiduciary duties has heated up in recent months in the context of rulemaking by both the Department of Labor and the Securities and Exchange Commission. Professor Rhoades retraces the history and evolution of this standard, and underscores its importance.

University of Denver law professor Jay Brown explores the issue of runaway executive pay. Focusing on both the financial sector and the corporate world in general, he identifies a set of additional reforms needed to ensure that compensation is based on sustainable performance and does not drive excessive risk-taking.

Brad Miller of the Center for American Progress writes about regulatory enforcement. A former Congressman, Miller has been on the front lines of the effort to make our financial watchdogs accountable. He explains why it is important that rules and laws are actually enforced, and lays out a number of strategies for ensuring that they are.

The final chapters turn to issues of reform that, although central to the crisis and to the Dodd-Frank Act, will not be settled even in the lengthy time frame of this law's implementation. These are the questions that will dominate the financial reform conversation for the rest of the decade.

Marcus Stanley of Americans for Financial Reform writes about the policy paradox of shadow banking. What is shadow banking, and what kind of regulatory regime and safety net is necessary for it? How does it compare and contrast with the older banking sector? Crucially, Stanley outlines the way in which the Dodd-Frank Act tries to regulate this new sector, and explains the conflicts and debates regulators will continue to have as they negotiate how banking works in the early 21st century.

Wallace Turbeville of Demos explains the systemic overuse and abuse of derivatives in the financial and commodity markets. He argues that the use of derivatives has far exceeded their economically useful potential and their often-invisible costs undermine the efficient intermediation of capital.

Saule Omarova of the University of North Carolina at Chapel Hill and Cornell concludes the report with a discussion of the proper scope of banking activities. Over the past 30 years, regulators have greatly expanded the scope of activities in which banks are allowed to engage, weakening the walls that once existed between finance and the real economy. Omarova recounts the history and reasons for those barriers, and explains how they might be reengineered in the future.

These chapters do not tell the whole story of needed financial reforms. We hope, however, that they provide useful insight into important problems. This report calls our attention to a crucial question: how do we have a financial sector that is first and foremost a tool for the benefit of the real economy, promoting broad-based prosperity, useful innovation, and productive private and public investments? We hope that the ideas sketched out here will move that conversation forward.

Where are We in the Reform of OTC Derivatives Markets?

John E. Parsons

Unregulated derivatives played a major role in the 2008 financial crisis, making clear the need for reform. Indeed, consensus was reached quickly on the necessary features of derivative market reform. The quick consensus is especially striking in light of the many debates that continue to this day on the right direction for the reform of other components of the financial system.

That consensus has its roots in the peculiar history of the derivatives industry in the U.S., which stretches back 150 years to the trading of wheat futures on the Chicago Board of Trade. Heading into 2008, the U.S. derivatives industry operated along two parallel regulatory frameworks and market structures. The older of the two, the futures and options markets, was firmly regulated according to principles fashioned over the course of more than a century. The "new kid on the block" was the unregulated swaps market, also known as the over-the-counter (OTC) derivatives market. Originally carved out as a provisional exception to the long established rules governing futures markets, its unregulated status and different market structure were given firm sanction in the Commodity Futures Modernization Act of 2000. The OTC derivatives market quickly grew to become the dominant segment of the derivatives market. It was this unregulated OTC derivatives market that played such a destabilizing role in the 2008 financial crisis. Its older cousin, the futures markets, did not play a similar role, and, instead, provided a working example of a derivatives market operated under sound principles, which could be adapted to the OTC derivatives market.

Despite the consensus on direction, implementation of the derivatives reform has dragged along very slowly. At times, it seems as if it might stall out entirely. Why? Three things undermine the momentum provided by the quick consensus.

First, there are the economic interests tied to the specific market structure of the OTC derivatives industry. Operating outside of any regulatory framework, the OTC derivatives industry evolved a ramified set of crisscrossing business entities, extending from the derivative dealers housed in the largest banks to the associated brokers, technology vendors and customers of all types. Many of them can probably win a profitable place in a reformed market, but the transition creates important competitive dangers. For others, the transition defines away a good portion of their business, and they will not go without a fight. All of them have worked to slow the reform.

Second, the uncontested status of the reform vision for the derivatives markets masks a remarkable diversity of attitudes among supporters of reform. For some, derivatives are esoteric financial instruments relevant to Wall Street traders but incidental to real business. For others, derivatives are inherently evil, rocket fuel for a casino economy rigged to benefit the few at the expense of the many. Only a small subset of supporters of reform affirmatively embrace a vibrant, well-managed derivatives market as an essential feature of a successful growing economy that benefits the whole population. While this subset designed the vision of derivatives reform currently being implemented, they have not yet sold it as part of a broader vision of shared prosperity. This divergence in attitude weakens the public case for reform.

Third, despite the clear consensus at a strategic level, some important details are yet to be worked out. The crisis exposed the error in leaving the OTC derivatives market unregulated. It undercut the foolish claim that swaps were essentially different from other derivatives, and reminded us of what we already knew about how to structure healthy derivatives markets. But while swaps are not essentially different, some swaps—being customized or otherwise suited to a small base of customers—are ill suited to exchange trading and clearing. We would be in a better position now if, during the several decades when the market was evolving, we had moved in tandem to gradually tailor rules appropriate to these circumstances. This would have provided room to test and fine tune the rules. Having failed to take the time when we had it, the crisis forces us to act hurriedly now. Still, there is a practical limit to how quickly we can successfully devise some rules. The process must be informed by experience. This limit tests our patience, and the debates on these details endanger the consensus, providing opportunity for opponents of the entire reform project.

The reform of the derivatives market lies along a clear track, but without much power or speed. The tracks laid out in the consensus architecture define a clear course forward, so that at this slow speed there is no danger of veering off course to the right or the left. But it is always possible that the train could start moving in reverse.

In the following, I will highlight the role that derivatives played in the crisis and how that informed the shape of the reform. Then I will provide an update on how far the reform has proceeded. Finally, I will discuss what lies ahead and some features of the debates to come.

Derivatives in the Crisis

All the devils at play elsewhere in the financial system were also at play in the derivatives markets, but two points deserve highlighting. Derivatives served as a trigger for key events in the 2008 financial crisis and as a vector for contagion, helping to spread the crisis throughout the financial system. Both points were manifested in the collapse of insurance giant American International Group (AIG), among the most notorious episodes of the crisis.

The company's London subsidiary, AIG Financial Products, had long profited by selling credit default swaps. The deregulation of the OTC derivatives market allowed these to be sold without any up-front capital or margin. The state insurance commissioners who supervised AIG's other insurance businesses had no authority vis-à-vis these derivatives, despite the fact that these swaps were marketed to serve a role comparable to insurance. AIG's financial regulator, the Office of Thrift Supervision, was ill equipped and completely ineffective at supervising the company's derivative operation. As losses on these credit default swaps accumulated and AIG's financial position deteriorated, the firm suffered the effects of a classic bank run, losing access to short-term financing such as commercial paper and repo. The U.S. government stepped in and committed more than $180 billion to AIG's rescue, including a loan from the Federal Reserve as well as Treasury funding under the Troubled Asset Relief Program (TARP).

More than any other single event, it is the case of AIG that provides the political clarity behind the need to regulate the derivatives market. In Senate testimony in 2009, Federal Reserve Chairman Ben Bernanke said, "If there is a single episode in this entire 18 months that has made me more angry, I can't think of one, other than AIG. … AIG exploited a huge gap in the regulatory system. There was no oversight of the Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets—took huge losses." For the public and for President Obama, the case of AIG is especially notorious because even after the company had taken taxpayer bailout funds, its Financial Products division proceeded to pay top managers enormous bonuses.

The case also provides intellectual clarity on the necessary shape of reform. In the midst of the crisis, regulators found themselves ill equipped to respond. U.S. law had exempted AIG's derivative transactions from oversight, and so no government authority had knowledge about the company's trades, nor did any authority have substantive knowledge about the larger market in which those trades took place. Lacking this information, no government authority could have acted in advance of the crisis. Any reform must provide regulators with information about any and all corners of the derivatives market and the authority to act on it.

A second lesson was that risk management deficiencies involving derivatives at one institution like AIG could threaten other central parts of the financial system. As the news of AIG's financial woes became known, concern immediately arose about major banks, both American and European, with large exposure to AIG through the web of derivative contracts between the banks and AIG. Any reform of the derivatives market should help reduce the transmission of problems between institutions, and should be integrated with the larger reform of the financial system.

The other crisis events in which derivatives played a role are less widely known, but equally important in guiding the design of reform. In particular, derivatives played a supporting role in the troubles at several other financial institutions in 2008, increasing the fragility of the system. For example, both Bear Stearns and Lehman Brothers were large investment banks with major businesses dealing derivatives. In both cases, losses on mortgage-related investments began to cast doubts on the solvency of the banks. These suspicions led various sources of short-term financing to dry up, creating liquidity crises. Both banks' positions as derivatives dealers played vital roles in their liquidity crises, when derivative counterparties began to reassign contracts away from them and refused new transactions, which drained cash from the firms.

Before 2008, economists discussed bank runs using the archetypal example of the traditional commercial bank that takes deposits. The 2008 crisis forced economists to incorporate into their discussion other components of the financial system that are also susceptible to runs—notably money market funds, but extending as well to investment bank lines of business such as prime brokerage and derivative dealerships. Any reform of the derivatives market should here, too, be integrated with the larger reform of the financial system designed to protect against bank runs.

The Shape of Reform

In light of these experiences, one can appreciate the architecture for reform that arose in the wake of the crisis. At the September 2009 Summit of the G20 Leaders in Pittsburgh, it was agreed that OTC derivatives should come under regulation and oversight, and that:

> All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.

This statement points to three major conditions of reform:

- The first is the key principle of universal supervision. There can no longer be a carve out for OTC derivatives that makes them exempt from supervision. Universal supervision represents a reversal of the explicitly deregulatory mandate of the United States' Commodity Futures Modernization Act of 2000.

- The second is transparency. Moving transactions onto exchanges and mandated reporting are actions designed to help shine light onto the markets, for the benefit of the regulator as well as for competition and the wider public advantages that stem from transparency. Meanwhile, price transparency makes the market work better for all participates, while also giving regulators a crucial tool in examining systemic risk.

- The third is clearing. The mandate to clearing through central counterparties is designed to reduce the amount of credit risk accumulating in the system overall—the well-established purpose of central counterparty clearing—and also to locate credit risk where it is best supervised by regulatory authorities. Requiring capital for non-centrally cleared contracts is both a tool to encourage central clearing and a component of sound banking practice.

The three principles defining the G20 Pittsburgh consensus on derivatives reform already governed the regulation of the U.S. futures markets. All trade in the futures and options markets had long been subject to regulatory oversight. Indeed, the existence of the unregulated OTC derivatives market is due to an exemption from the pre-established principle of universal supervision of all futures and options trading. The futures and options markets are mostly transparent, dominated by exchange trading, with data feeds easily accessed by the regulatory authorities and important data available to the public. As well, all contracts are cleared by a central counterparty. As a specific example, look at the oil futures market, which is the largest among the commodity derivative markets. It is registered with the U.S. Commodity Futures Trading Commission (CFTC), largely exchange traded, with rigorous reporting and publicly accessible data feeds, and entirely cleared.

The industry customs and regulatory framework for the U.S. futures and options industry evolved over more than a century, so there is deep experience with them. For example, the recent debate over whether or not to mandate the clearing of most derivative trades actually reprises a debate over the evolution of U.S. futures markets that took place at the end of the 1800s and the first three decades of the 1900s. Central counterparty clearing was introduced to the U.S. in 1896 by the Minneapolis Grain Exchange, home to futures trading in grains. This innovation helped to reduce the aggregate amount of risk in the system and therefore lowered the amount of capital required to manage futures markets. This in turn lowered the cost charged to non-financial companies hedging with futures. Central counterparty clearing also improved access to the futures market, keeping the market competitive and growing. Established futures exchanges in other cities gradually recognized these advantages of central counterparty clearing and copied the innovation. As new futures exchanges were established, central counterparty clearing was often the chosen structure right from the start. This was the case at the Chicago Mercantile Exchange, established in 1919 for trade in butter, eggs, and other products. In 1925, the Chicago Board of Trade, which was the largest futures exchange at the time, switched to central counterparty clearing. From that date forward, central counterparty clearing reigned as the standard practice for futures trading in the U.S., and remained so for the next 50 years. Looking back, it is clear that the innovation of central counterparty clearing was a boon to the growth of U.S. futures markets throughout the 20th century.

None of the problems arising in the 2008 financial crisis involved these regulated derivatives markets, although even with these regulations in place, important stability issues sometimes arise, as we have seen in the past. In contemplating how to reform the previously unregulated OTC derivatives markets, economists and policy makers had experience with futures and options markets to inform their choices.

How Far Have We Come?

In the United States, this basic architecture for derivatives reform was quickly codified as Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and signed into law in July 2010, less than a year after the Pittsburgh G20 summit. The relatively fast legislative action in the U.S. has been followed by slow-moving regulatory implementation. Although the law directed the CFTC and the U.S. Securities and Exchange Commission (SEC) to draft the appropriate implementing regulations within a year, it is now three years later and the job is not complete. Nevertheless, the CFTC in particular has been insistently moving the ball forward.

By count, a little more than one-half of the rulemaking has been completed. That leaves another one-half yet to be finished. This kind of crude accounting, however, can be misleading. On the one hand, where rules are not yet complete, they are nevertheless substantially underway. On the other hand, where rules are complete, some of the deadlines for changes to market practice lie in the future, so that a completed rule does not yet mean the market is functioning any differently.

Looking at some crude measures, we find that changes are beginning to take place in the U.S. Already most derivatives trades must be reported to approved data repositories. The requirement that derivative trades be cleared is one step behind data reporting. The first deadline mandating clearing for one class of swaps by certain traders arrived this past March. Further stages in the mandate have since arrived, and more are to come. In the U.S., approximately 65 percent of new trades in interest rate swaps are now being cleared, according to a report released last month by the Financial Stability Board (FSB), an international body made up of finance ministries, central banks and international financial institutions. For credit derivatives, the figure is approximately 40 percent. These are very preliminary data that cannot be readily checked by outsiders, and a more reliable accounting will not be possible for a while. The requirement that derivative trades move onto exchanges—swap execution facilities (SEFs) in the U.S. legislation—is two steps behind. The first of these new exchanges just opened for business earlier this month, and the initial trading is light. However, the requirements to use the exchanges only come into force in a staged process over the coming months and into the next calendar year.

Globally, the process is moving forward at a varied pace. In Europe, the basic reform architecture was codified in the European Market Infrastructure Regulation (EMIR), which in its final shape passed the European Parliament and the European Council in July 2012. Some other countries still have not completed the legislative work. Implementation in Europe trails the U.S., perhaps because the ongoing European banking crisis has distracted authorities. Trades are ostensibly being reported to data repositories, although data are not yet available in a practical form. Major clearing facilities are either just opened or still being readied. Globally, the FSB reports that approximately 42 percent of the outstanding positions in interest rate derivatives and 14 percent of credit derivatives have been centrally cleared. For other classes of derivatives, central clearing has yet to make a mark.[1]

Roughly speaking, in the U.S. we stand now at a transition point between writing the rules and overseeing their translation into practice. That task will be a difficult one as we try to move beyond the letter of the rule toward fulfilling the spirit. Take as an example the simple requirement that all transactions be reported to data repositories. Data can be reported and still not be meaningfully organized or usable. CFTC Commissioner Scott O'Malia captured many people's attention earlier this year when he recounted the difficulty regulators had in making use of the data feeds coming from the U.S. trade repository, the Depository Trust & Clearing Corporation (DTTC). He said, "The problem is so bad that staff have indicated that they currently cannot find [JP Morgan's now famous] London Whale in the current data files." Obviously, much work must be done to standardize data formats, contract features and various other practices so that the data on trades is usable and informative.

Even more extensive work lies ahead in regard to the clearing mandate and the move to exchange trading. Authorities must assure that all contracts that can be cleared are cleared. This will require both evaluating the contracts that are traded as well as encouraging standardization where feasible. Evaluating the transparency of trade on exchanges is a similarly demanding task. The successful implementation of both mandates will involve complicated questions of industry structure and competition. These will be difficult and contentious to resolve.

The Path Ahead

The next stage of implementation is complicated by three important problems. The first is the necessity and difficulty of global cooperation. This was highlighted recently when European authorities, together with authorities from a number of other G20 countries, criticized the U.S. CFTC for moving too quickly and aggressively in implementing its rules. The Europeans objected to the CFTC enforcing its regulations on U.S.-parented entities trading derivatives outside the U.S. The vigor with which the Europeans made their complaint stood in odd contrast to the slow speed with which they have been implementing their own reform. On the U.S. side, there is a concern that U.S. companies will move their derivative trades to jurisdictions where the reform is as yet incomplete, with the ultimate risk returning to the U.S. government and economy when the next crisis hits. Successfully resolving this dispute is one of the most vital tasks facing the reform in the months ahead. Obviously the principle of universal supervision would lose any substance if a U.S. company could escape supervision by moving its derivative operations to a nation without real supervision. The dispute has temporarily been resolved with a commitment by all sides to implement comparable regulations and, where comparable regulations exist, to recognize them. Whether this agreement will be realized in practice is yet to be seen.

Coordination is equally essential in other areas as well. Already, different national regulations regarding data privacy constrain sharing data with authorities in other states, not to mention public reporting. This could make a farce of transparency unless it is addressed. Clearing, too, will require international cooperation in order to produce the anticipated benefit of cancelling offsetting exposures and liabilities in significant quantities. So far, there has been a lot of talk about this, and going forward it will be important to turn that talk into action.

The second problem involves defining the details respecting how different types of derivatives trade. For example, the unregulated swaps regime did provide a space for customization and for trade in relatively illiquid instruments ill suited to exchange-trading and clearing. Accordingly, the G20's Pittsburgh consensus requires only that the majority of derivatives be exchange-traded and cleared. So an important unfinished task is defining the boundary between those products that must be moved onto exchanges and cleared, and those products that will not. What rules will govern trade in these customized and less liquid products? This is new territory.

The Dodd-Frank Act's Title VII is especially problematic in this regard. It preserves the parallel structure of the U.S. derivatives industry, with one regime for futures and options and a new regime for swaps. It then requires that this new regime obey mandates for reporting, exchange-trading and clearing, like those that govern the futures market—albeit with exceptions for some swaps. This burdens the agencies with deciding not only how to handle the exceptions, but also what criteria should differentiate the larger quantity of swaps traded in a market parallel to the futures market and obeying the same principles.

The problems that are likely to arise were previewed this past year in the debate over "futurization" that ensued when certain segments of the U.S. OTC derivative trade started to migrate over to the futures markets. One noted case came to public attention in August 2012, when the Intercontinental Exchange (ICE) announced that it would repackage all of its cleared OTC energy swap products as futures, subjecting them to the old, established futures regulatory rules. A second case involved products being developed by the CME Group, a large futures exchange company, and Eris Exchange, a futures exchange, designed to mimic interest rate swaps previously traded under the old unregulated OTC marketplace, but in this case structured as futures contracts, subject to the old, established futures regulatory rules. Before the reform, swaps had the advantage of regulatory arbitrage—where futures markets were supervised, swaps were not, where futures markets were transparent, swaps were not, and where futures markets were cleared, swaps were not. The Dodd-Frank Act erased these distinctions between futures and most swaps. Now, after the reform, other criteria will determine the relative place of the two markets. What will those criteria be? The legislation has essentially devolved to the CFTC the task of developing an economic rationale for the parallel markets.

Finally, implementation will be complicated by the fact that the process of reform is concurrent with other, unrelated forces that are changing the nature of trading on financial markets. Changing technologies have upended the old order in equity markets, and the same thing is happening in foreign exchange markets and in futures markets. Established regulations need to be revised in light of these new technologies, but this also reopens previously settled questions about the purpose of the regulations and how trading should be structured. We have already seen in the U.S. equity markets the type of chaos that can ensue. The incumbent swaps industry would like to use confusion here as cover to reverse the derivatives reform and preserve their franchise in its old structure. Negotiating this process will be a difficult task.

Conclusion

For more than 150 years, the U.S. pioneered the establishment of vigorous derivative markets that served as an important source of stability to business and contributed to economic growth. Our recent experiment with unregulated derivatives produced instability and set our economy back. The key elements of reform—universal supervision, transparency through exchange-trading and price reporting, and central clearing—are tools for reclaiming the powerful good these financial instruments can provide. There remains much to be done to realize that goal.

Endnotes

1. These figures on the global market are not comparable to those quoted earlier for the U.S. since they reflect, in part, legacy un-cleared contracts that have not been moved to clearinghouses; new contracts may be clearing centrally at a greater rate. Of course, this lack of comparability in reported data is precisely part of the problem that the new reforms are ultimately intended to eliminate.

John E. Parsons

Dr. Parsons is a financial economist specializing in risk management, corporate finance and valuation. His research focuses on the problems of risk in energy and environment markets, the role of trading operations in energy companies, and the valuation and financing of investments in energy markets. At MIT's Sloan School, he teaches the finance elective Advanced Corporate Risk Management. He is the Executive Director of MIT Center for Energy and Environmental Policy Research and the Head of the MBA Finance Track. Dr. Parsons is also a Visiting Scholar at the U.S. Federal Energy Regulatory Commission.

For ten years Dr. Parsons worked in the Finance Practice at the economics consulting firm CRA International, where he was a Vice-President and Principal. He worked with major international oil companies, mining companies and commodity processors, electric utilities and international pharmaceutical companies, among others on a wide variety of risk management and valuation matters.

OLA After Single Point of Entry: Has Anything Changed?

Stephen J. Lubben

Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act created the new Orderly Liquidation Authority (OLA) that can potentially replace chapter 11 of the Bankruptcy Code as the resolution tool for bank holding companies and their non-regulated subsidiaries.[1] It only potentially displaces chapter 11 because chapter 11 remains in place unless financial regulators decide to invoke OLA,[2] through a comically intricate process that culminates with the D.C. District court having 24 hours to say "no" under very limited circumstances.[3]

Basically, OLA expands the Federal Deposit Insurance Corporation's (FDIC) bank receivership powers to cover a greater part of the financial institution.[4]

This allows the FDIC to conduct a purchase and assumption transaction with regard to some non-bank parts of the institution, or transfer the institution to a newly created "bridge bank."[5] The latter allows the FDIC to split the good assets from the bad, in a process that is very much like that used in "363 sales" under chapter 11, widely publicized by the automotive bankruptcy cases.[6]

The existence of OLA is crucial to the idea that the Dodd-Frank Act has actually ended "too big to fail." Since financial institutions remain very big, it is up to OLA to provide a means for them to fail.

The real question is whether OLA will work and, as OLA was originally presented, there were good reasons for doubt.[7]

Most importantly, OLA does not include foreign entities, while vital pieces of most global systematically important financial institutions (SIFIs) are resident in London.

The FDIC has figured out a clever way to avoid the problems with OLA. Under the new "single point of entry" approach, only the holding company would be placed in OLA, and the FDIC would then continue to prop up the operating subsidiaries, wherever located.

The new question is: Will single point of entry work?

This short essay explores this question and what remains to be done to create a workable bankruptcy system for global banks.

In short, I argue that while single point of entry is a great improvement, it still has its potential faults, and the excitement over it obscures many lingering questions. And nothing has been done to improve the ability of chapter 11 to handle a large financial institution, despite the fact that OLA is only supposed to "backstop" the normal bankruptcy process.

Single Point of Entry

The FDIC's new approach under OLA—the single point of entry plan—focuses entirely on ensuring the holding company can absorb the organization's losses, including those sustained by its operating subsidiaries.

Single point of entry is rooted in the undeniable premise that holding company claimants are less "runnable" than operating company claimants. Shareholders and bondholders might sell their holdings, depressing the market price, but that does nothing to withdraw liquidity from the financial institution.

Thus the FDIC would save the enterprise by taking control of the holding company, eliminating existing claimants of that company, and selling new equity in the holding company to recapitalize it. While this process is pending, financing from the FDIC under the provisions of OLA would keep the holding company—and its worldwide operating subsidiaries—afloat.

In the case of Lehman Brothers, the filing of the holding company several weeks before the operating subsidiaries brought to the fore the reality that while most derivative transactions might be entered into by operating companies, by their terms the contracts provide that the failure of a "credit support provider" (*i.e.* the holding company) triggers an immediate right to terminate the trade.

The Dodd-Frank Act does provide the FDIC with the power "to enforce contracts of subsidiaries or affiliates of the covered financial company, the obligations under which are guaranteed or otherwise supported by or linked to the covered financial company."[8]

It is not clear what it means for the holding company to enforce a derivative that it is not directly a party to, but the FDIC has used this as the basis for rules that prohibit termination of a derivative because of the OLA filing of a parent company.[9] At least superficially, this seems to address a key lesson learned during the Lehman Brothers bankruptcy.

In short, single point of entry is a marked improvement over OLA as originally envisioned. It offers the prospect of saving a financial institution as a going concern, whereas the drafters of the Dodd-Frank Act seemed to see it as a method for liquidating the financial institution's domestic parts, while leaving the foreign bits to their fate.

Unfortunately, if we push beyond the happy press releases trumpeting the wonder of single point of entry, we see that questions remain.

For example, it is not clear that the FDIC's solution to the derivatives problem will hold up if challenged. How does the FDIC get the power to prevent the termination of a contract between two parties, neither of which is in OLA?

Congress might exercise such a power under the Commerce Clause, but when done by rule on the basis of a confused piece of statutory text, the risk of litigation looms large. Whatever the merits of that litigation, it has serious potential to gum up an OLA proceeding.

More broadly, while it is certainly theoretically true that the pain of financial distress falls first on bank shareholders, then on bank bondholders, then on uninsured depositors, and so forth, reality might be somewhat different. Recent events have made that quite clear.

First note that while terminating existing stakeholders might be preferable to the 2008 model—where stakeholders were, at worst, diluted in every case other than Lehman Brothers—it does nothing to address the distressed SIFI's immediate problems. Indeed, returning the SIFI to solvency is of minor importance compared to refurbishing its liquidity.

Nevertheless, much of the discussion of single point of entry, and regulation in general, has focused on the question of solvency.

A SIFI might have ample capital, but face a liquidity shortfall. Indeed, the classic bank run of Jimmy Stewart fame does not depend on a rational assessment of the balance sheet, but rather comes from a panic that drains the institution's liquidity, leaving it in breach of its obligations while still possessing more assets than liabilities.

Before the Dodd-Frank Act, the Federal Reserve's section 13(3) powers provided an obvious solution here, but since the power is now limited to programs of "broad-based eligibility," it may no longer be quite as useful in the case of a single institution facing a run. Indeed, the Federal Reserve now is expressly prohibited from lending under this section for the "purpose of assisting a single and specific company avoid bankruptcy, resolution under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or any other Federal or State insolvency proceeding." This limitation may compromise the Federal Reserve's ability to address such a liquidity crunch before it reaches the systemic level.

Recapitalization of the institution under OLA might solve the SIFI's long-term liquidity needs, but successful recapitalization is going to depend on the value of the enterprise. That value will be largely a function of the value of the SIFI's subsidiaries, perhaps with a little premium that reflects the synergies of having all those subsidiaries working together under a single roof.

If that value is no longer sufficient to support the capital the financial institution needs, the FDIC will face a real problem. Either losses will have to be imposed at the subsidiary level to cut the SIFI down to size or the FDIC will simply have to inject value into the institution. The latter looks suspiciously like a bailout in all but name, while the former undermines the benefits of single point of entry, which is not supposed to touch the operating companies.

Recall that the Dodd-Frank Act still requires the liquidation of a failed financial institution.[10] The FDIC has converted that requirement into the liquidation of the holding company, not quite the same thing. Preserving the institution as a going concern might be wise from both a regulatory and creditor recovery perspective, but one has to wonder if it is totally faithful to the congressional charge. Using liquidity provided to the parent company to stave off the failure of non-liquidated subsidiaries also pushes again the command that "[n]o taxpayer funds shall be used to prevent the liquidation of any financial company under this subchapter."[11]

This also highlights the degree to which single point of entry depends on the existence of a problem that is easily isolated. A general collapse of a SIFI, across multiple business units, is not what the FDIC is interested in discussing at the moment.

In short, inflicting pain on holding company stakeholders also does nothing to address the financial institution's immediate liquidity needs. This is where the Dodd-Frank Act's lending mechanism between the U.S. Treasury and the FDIC would come in, but it is easy to imagine such lending quickly could become a stealth bailout of subsidiary creditors.

The FDIC will note that any funding it provides will be secured by a priority lien on the debtor's assets. But since the holding company's only assets will be shares in the operating subsidiaries, this will create a kind of cyclical need for FDIC financing. To preserve the value of its collateral, the FDIC will need to meet any and all funding requirements of the subsidiaries if single point of entry is to work as advertised.

In the case of a global SIFI, it would be easy to imagine that this number could become quite large, quite quickly. In a systemic crisis, the FDIC might be making many such loans.

The FDIC argues that once it takes charge, "because the group remains solvent, retail or corporate depositors should not have an incentive to 'run' from the firm under resolution insofar as their banking arrangements, transacted at the operating company level, remain unaffected."[12]

Assuming rationality in a financial crisis is a doubtful solution to a difficult problem. Given the obvious fragility of the wholesale funding market, and the lack of any real change to that market since the bankruptcy of Lehman Brothers, assuming that counterparties will continue business as usual while the parent company is undergoing an untested OLA proceeding seems somewhat cavalier. The FDIC might as well assume it will never have to use OLA if we are going to rely on these sorts of *deus ex machina* solutions.

Regulators might require the holding company itself stand ready to provide liquidity to the subsidiaries in times of stress. Of course, not only would this be quite expensive from a cost of capital perspective—the holding company would be investing shareholder funds in something akin to a T-bill portfolio, if we want to be sure the liquidity will be available in times of stress—but any such source of liquidity would presumably be tapped before OLA was invoked, assuming that OLA is truly to be a mechanism of last resort.

To a similar effect are the proposals that call for some portion of the holding company's debt to take the form of subordinated or contingent convertible debt. Converting debt to equity, or simply "vaporizing" it, provides a small liquidity boost equal to, at most, six months worth of interest payments.[13] Unless this tranche of debt is quite large—which is not totally consistent with the broader regulatory agenda of reducing leverage—it seems unlikely that this newfound cash could make or break a teetering financial institution. Indeed, any benefit would also have to be offset against the negative signal that such a conversion would send to the market.

The FDIC does have the ability to recoup unpaid lending from other SIFIs, but even under the best-case scenario this means some risk to taxpayers during the gap between the rescue of a distressed SIFI and the assessment of the others. Since the gsap could be as long as 10 years, the concern is not easily dismissed.

Even if the money is fully paid back, the access to such funding is itself a privilege that most businesses do not enjoy. For example, when Circuit City faced bankruptcy, it was forced to take the only loan that the market would offer. That loan, which provided a very short window for reorganization, was a key reason why the company ultimately liquidated.

Giving special privileges to banks might be inevitable, since SIFI failure is so disruptive, but if the risk of bailout remains, the justification for up front regulation that might avoid failure becomes even stronger.

It's relatively easy to rail against "moral hazard" in the abstract, and say that large financial institutions should be left to face "market forces," such as insolvency and liquidation. But the financial system exists so that those with money to lend can get that money to those who need it, and there are real consequences of allowing that system to fall apart.

For example, *The New York Times* recently reported that Goldman Sachs controls about a quarter of the aluminum in the United States. Much of that metal belongs to other companies, but what would happen to countless U.S. manufacturers if that aluminum suddenly became entangled in a liquidation?

The Bank of New York Mellon Corporation reports on its own website that "[a]s of June 30, 2013, BNY Mellon had $26.2 trillion in assets under custody." That is, it is holding more than $26 trillion of assets that belong to other people. There is no way to allow this firm to liquidate or face "market forces" that will not have serious effects on the owners of those assets.

On its website, Bank of America explains that:

> We serve approximately 51 million consumer and small business relationships with approximately 5,300 retail banking offices and approximately 16,350 ATMs … Bank of America is among the world's leading wealth management companies and is a global leader in corporate and investment banking and trading across a broad range of asset classes, serving corporations, governments, institutions and individuals around the world.

If Bank of America faces "market reality" someday, all of these customers will feel the pain too.

In the face of those real consequences, it is probably best to acknowledge that large financial institutions will be bailed out in some circumstances. Probably the better goal is to make sure that those bailouts are paid for in advance, by the entities that are most likely to need them. Single point of entry itself does nothing to address that core goal. Much continues to rest on pre-failure prudential regulation and the ability of regulators to avoid the need to ever use OLA.

The Chapter 11 Backstop

The OLA option is meant to be used rarely and only in those unexpected circumstances where a financial institution's failure and resolution under the Bankruptcy Code would have adverse ramifications for U.S. financial stability and only where a finding to that effect is made at the most senior levels of the Treasury Department, the Federal Reserve, and the FDIC.

That would seem to require a viable alternative, since the Bankruptcy Code was found lacking in cases like American International Group (AIG). Yet no efforts have been made to modify the Code.

To provide a workable alternative to OLA, what would the Code need?

The conversation must begin with equalizing the treatment of derivatives under the Bankruptcy Code with that under OLA.

That means at least a short stay on the closeout of positions, and also a prohibition on the enforcement of "walk away" clauses, which give an extra incentive to terminate. OLA provides that "walk away" clauses—which allow the non-debtor party to terminate without paying damages—are unenforceable. OLA also provides a one-business day stay on the termination of derivatives. The Bankruptcy Code should provide at least as much.

A stay on the termination of contracts guaranteed by the parent company, when the non-debtor subsidiary otherwise continues to perform, would also bring the two systems into alignment.

Speed is another advantage that OLA offers over chapter 11. The Lehman Brothers sale took place within a week of the chapter 11 filing. It seems safe to assume that this is the outer limit of how quickly a sale might happen under the Bankruptcy Code. Some judges might not be willing to move that fast, especially outside the context of a financial crisis.

The Code should make clear that sales conducted at high speed are not only permissible but desirable when they involve large financial institutions.

At the same time, debtor institutions must have the ability to stabilize their business during the chapter 11 process. In some instances, normal debtor-in-possession financing under section 364 of the Code will do the trick, but not if the financial institution is too big, or fails during a credit crunch.

In these sorts of cases, the SIFI in chapter 11 should at least have access to the same FDIC financing that would be available in an OLA proceeding, with similar controls and payback requirements.

There is also a need to expressly allow the SIFI's regulators to participate in the proceedings. This begins with giving the regulators, or at least a primary regulator, the right to file an involuntary bankruptcy petition, but continues to provide the regulator with a voice in all other key aspects of the case.

Moreover, the bankruptcy court must have authority to consider the larger context when a financial institution enters chapter 11. For example, if a particular action would be beneficial to creditors, but systemically dangerous, it is not clear under current law that the court could deny the requested relief.

On the specific point of the bankruptcy judges, it is also vital that Congress address the uncertainty regarding those judges' power and authority following the Supreme Court's decision in *Stern v. Marshall*.[14] This confusion, although damaging to all aspects of the bankruptcy system, is particularly troublesome in the context of a SIFI failure. Once the bankruptcy court begins the process of resolving a financial institution, its actions must not be subject to doubt and question.

Endnotes

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10. 12 U.S.C. § 5394.
11. 12 U.S.C. § 5394(a).
12. http://www.fdic.gov/about/srac/2012/gsifi.pdf
13. Interest on corporate debt issued in North America is typically paid biannually.
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Capital Requirements: Hitting Six Birds With One Stone

Mike Konczal

Financial reform has to cover a huge amount of public policy goals. However, one part of reform has the ability to boost the efficacy of the other, crucial parts of financial reform. That reform is the regulation of capital requirements, or the mix of equity and leverage that financial firms use to carry out their business. The proper regulation of capital requirements has the ability to hit six different financial reform birds, all with one stone.

These six birds are solvency, risk management, ending "too big to fail" through resolution, preventing liquidity crises in the shadow banking sector, right-sizing the scale and scope of our largest financial institutions, and designing financial regulations with an eye towards preventing bubbles.

Much has already been done, and more is forthcoming when it comes to this area. Indeed the very first part of The Dodd-Frank Wall Street Reform and Consumer Protection Act, Title I, gives regulators broad powers to determine capital requirements going forward. Indeed, the Dodd-Frank Act requires regulators to take risks to the system as a whole into account, with "large, interconnected financial institutions" subject to "prudential standards...more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States."

However much of the work on capital requirements either waited for, or was developed alongside, the global regulatory standard Basel III. Created by the Basel Committee on Banking Supervision and still under revisions, Basel III is a major overhaul of capital regulators that is slowly being imported to the United States. There still is much work to be done, with large parts of capital requirements underdeveloped and not sufficient for the task of bringing stability to the global financial sector.

With the reform of capital requirements, what are the details of the six associated benefits to financial reform at large? Or, to continue the metaphor, what are the six birds?

1. Solvency: Making Firms Less Likely to Fail

As we saw in 2008, the amount of capital with which banks finance themselves proved too low to deal effectively with the financial crisis. Banks often had as little as 3 percent in equity, leaving little room to deal with a downturn. The crisis required extensive backstopping from the Federal Reserve and extensive, coordinated bailouts from Congress to prevent the total collapse of the system.

The United States never adopted the Basel II accords, which used a technique of "risk-weighting" to determine the asset level that was used to determine an appropriate capital ratio. If an instrument had a risk-weighting of 50 percent, half as much capital would have to be held than if the risk-weight was 100 percent.

This technique came under extensive criticism even before the financial crisis.[1] Under the United States adoption of Basel III, two tests will determine the capital ratios. The first test will still use risk-weighted assets. There will be a requirement of 8 percent total capital. This is broken down with common equity tier 1 (CET1) requiring 4.5 percent, additional tier 1 requiring 1.5 percent and tier 2 requiring 2 percent.

In addition, there is a capital conservation buffer of 2.5 percent, a countercyclical buffer of up to 2.5 percent, and a potential surcharge for systemically risky large financial institutions yet to be determined. These will be discussed below.

These rules were finalized in July of 2013. If regulators or Congress decide to readdress this, relying more on CET1 and less on substandard forms of equity is crucial. As it stands, these levels remain very low when it comes to risk-weighted assets.

It's worth noting that the economic costs of raising capital requirements is low and second-order, while the benefits are large and public. As Anat Admati argues persuasively in "The Bankers New Clothes," equity requirements adjusts the funding but not the activities of our largest financial institutions. The return on equity is not fixed but instead a price that adjusts depending on the overall funding mix. As Admati and Hellwig note, to the extent it does increase, "the main reason that total funding costs of banks might increase as a result of higher equity requirements is that with more equity banks would be less able to benefit from guarantees and subsidies, which come at the expense of taxpayers."

As former governor of the Bank of England Mervyn King said, "Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending." As Thomas Philippon has found, a simple, annual unit cost of finance has been relatively stable over periods of time with remarkably different background capital requirements over the 20th century, implying that capital requirements play a very small role in terms of industry-wide fundamentals.[2]

2. Risk Management: Relying Less on Models and the Ratings Agencies

U.S. regulators have rightfully been skeptical about risk-weighting of assets. There is a second approach in Basel III that is meant to balance against the benefits and problems of risk-weighted assets. This approach involves expanding the role of leverage requirements, requirements that were already a part of U,S. banking regulations.

Leverage ratios are not-risk based, and as a result they are seen as a backstop against risk-weighted results. A leverage requirement is the ratio of tier-one capital against total leverage exposure, not including off-balance sheet exposures.

These two different ratios—risk-based and leverage—supplement each other, and play off each other's strengths and weaknesses. A sole leverage requirement gives firms an incentive to take on more risks by having a smaller balance sheet loaded with riskier assets. However, a leverage ratio corrects for well-known errors in risk-based models. They each will bind in different circumstances, providing a check on each other and on the financial firm itself.

Note that a significant amount of research indicates that leverage requirements are associated with substantial stability and lack of bank financial distress. This is unique among other metrics. There is significant evidence that higher leverage requirements provide both bank level benefits in terms of micro-prudential regulations as well as macro-level benefits in terms of preventing contagion and systemic risk.[3]

As of July 2013, the proposed rule is to have a 4 percent leverage requirement across all institutions. However, for global, systemically important banks, or roughly the eight largest U.S. bank holding companies, there will be a supplemental leverage requirements (discussed below). That buffer will function like the capital conservation buffer (also discussed below). As it is breached, a bank will be limited in how it can dispense bonuses and capital purchases.

This is problematic on both the numerator and the denominator. A 5 percent leverage requirement still puts the system at risk, as it is not substantially higher than what came before. The 2 percent buffer in the leverage requirements is smaller than the 2.5 percent risk-weighted buffer.

Meanwhile, and even more importantly, the denominator doesn't include a sufficiently high enough level of assets as the Federal Reserve has currently written the rule. Even the Basel Committee understands this, and is currently moving to expand their definition of the denominator. In a recent paper[4], they've moved to change the denominator to include derivatives and their collateral, repurchase/reverse repurchase agreements, and off-balance sheet treatment.

Under the current U.S. definitions, the denominator doesn't include off-balance sheet exposures at a sufficient level. Indeed, according to one set of estimates, "the denominator of the Basel III supplementary leverage ratio is roughly 43 percent higher than the denominator of the U.S. leverage ratio."[5]

U.S. regulators have indicated that they'd revisit the issue of the denominator in their leverage ratios once the Bank for International Settlements has come to consensus on the best practice. This paper strongly encourages regulators to follow through on this important piece.

3. Resolution: Making the End of "Too Big To Fail" More Credible

Implementing Title II of the Dodd-Frank Act, the "ordinary liquidation authority" (OLA), often referred to as resolution authority, is seen as crucial to both ending "too big to fail" as well as addressing the problems of the financial crisis.

However, the OLA doesn't exist in a vacuum. Capital plays an essential role in any successful resolution. Higher levels of capital will help with resolution by making it less necessary, and also giving regulators more space to act when problems arise. Indeed, there are two very specific roles capital ratios play in determining a successful resolution.

The first is using capital requirements to force regulators to act. Regulators, in practice, and even in the last crisis, have often delayed putting financial institutions into receivership, in the hopes that problems will take care of themselves. This problem was addressed for commercial banks in the early 1990s through a process known as "prompt corrective action," which forces changes by both regulators and firms if capital falls below a certain threshold.

This is also part of Basel III. There are two "conservation buffers" mentioned above, with one for risk-weighted assets (2.5 percent) and one for leverage (2 percent). If a firm breaks into these buffers, they receive limitations on both their ability to pay bonuses and make capital purchases. This is meant to force banks to seek recapitalization, as it incentivizes shareholders and internal managers with the needs of regulators seeking well-capitalized banks.

The second role capital ratios may play in resolution is a potential requirement to oblige the largest and riskiest financial firms to hold long-term, subordinated, unsecured debt that is convertible to capital once a bank has failed. This won't necessarily help the bank stay in business once it is failing. It will, however, give the Federal Deposit Insurance Corporation (FDIC) debt to work with once the bank has failed. Thus holding some substantial portion of debt in subordinated debt where the rules are signaled ahead of time, which falls under capital requirements, can make the job of the regulators much easier in times of crisis and stress.

This doesn't replace the role of equity as it is described here, but it does make the job of resolution, which everyone agrees is an essential part of financial reform, more dependable. It is unclear whether or not the OLA will work, and even the terms under which "working" will mean something. A crucial element of a successful OLA process is regulators intervening early while a single-point-of-entry strategy is still workable. If losses are so severe that they have to be imposed at the subsidiary level, then single-point-of-entry will have significant troubles. Giving regulators space through capital buffers, plus predetermined debt to use in a resolution, will help make FDIC's job easier and keep taxpayer money from being at risk.

4. Liquidity Crisis: Helping Bring Order to Shadow Banking

We should distinguish between a crisis generated by a firm being insolvent versus a crisis triggered by concerns over the liquidity of a financial firm. The overreliance on short-term funding for large, systemically important financial firms generated panics and made the crisis in 2008 significantly worse. When creditors providing short-term funding started getting worried about the firm's ability to meet their obligations, they raised their terms, which began something akin to a bank run. This will be a condition of any crisis, where it is hard to sell assets in order to make payments.[6]

Basel III introduced a "liquidity coverage ratio" (LCR) designed to make sure banks have enough high-quality assets that can be turned into cash in order to survive a 30-day period of funding stresses. By encouraging financial firms to capitalize for the long-run, they'll lose a regulatory arbitrage they have over commercial banks that allows them to compete for the same business while using cheaper funding. This will also encourage financial firms to focus on long-run survivability by using funding that is less likely to disappear in a panic.

A liquidity rule will be necessary. The makeshift backstop for liquidity in the 2008 crisis was the Federal Reserve's 13(3) powers. However, these have been significantly curtailed as a result of the Dodd-Frank Act, with only broad-based funding available.

In January 2013, the Basel Committee made certain changes significantly weakening the LCR's requirements. First, it moved from two levels of assets, level 1 and level 2, to three. It also includes equity with a 50 percent haircut, as opposed to the 15 percent haircut assets in Level 2A will get. Equity is a poor choice for a liquidity buffer, as its value is directly correlated with a crisis. It is least likely to be there when needed, which is the purpose of a liquidity buffer. The other major change was reducing the "outflow rate" for liquidity facilities and corporate deposits, among other outflow sources.

Regulators recently proposed a LCR rule, with Federal Reserve Board Governor Daniel Tarullo arguing that the "proposed Liquidity Coverage Ratio we review today is 'super-equivalent' to the Basel Committee's LCR standard."[7] This new rule makes two crucial distinctions.

It is graduated, which is important for dealing with the largest financial institutions (see below). Firms with more than $250 billion in total consolidated assets are subject to the entire rule, while firms with $50 billion in total assets are subject to a lighter version of the rule. Crucially, the rule goes beyond the final Basel III rule, importantly limiting the range of assets that will qualify as well as the assumed rate of outflows.

Due to their lack of liquidity, covered bonds, mortgage-backed private-label securities and municipals are excluded in the proposed rule.

As U.S. regulators consider how to implement the LCR, this stronger implementation should be the focus. Changes to it should be placed under strict scrutiny. Exposure to short-term funding exacerbated the financial crisis, bringing in more panic, contagion and risk than would have occurred otherwise. Particularly with the unstable nature of liquidity facilities, a quick draw down is something that can happen easily in times of crisis.

5. Size: Pricing Size and Complexity Among the Largest Financial Institutions

U.S. regulators have yet to propose Basel III rules for the capital surcharge for systemically important financial institutions (SIFIs). Regulators are expected to announce a SIFI surcharge around the end of this year.[8] If it is in line with Basel III, it will be on the order of 2.5 percent of risk-weighted capital.

A strong implementation of a SIFI surcharge is important for four different reasons. The first is that it internalizes risks a firm poses to the financial system as a whole to the individual firms themselves. To the extent that the largest, most risky, firms pose risks to the system as a whole, they should be required to fund themselves with more equity and maintain a stronger balance sheet.

A related second reason is that it would combat the widespread notion that the largest banks receive a backstop from the federal government. For reasons both economic and political, a serious surcharge would send a signal to the market that the largest institutions will be under heightened scrutiny, as called for by the Dodd-Frank Act. There have been significant debates over whether or not the largest financial firms receive special funding treatment in the capital markets as a result of being seen as "too big to fail."[9] This will help combat both the appearance and the substance of said treatment.

A third reason is that it would help control the size and scale of our largest financial institutions. As a result of the financial deregulation of the past 30 years, there has been a massive consolidation at the top end of the financial industry. The top five banks went from 17 percent of total industry assets in 1970 to 52 percent in 2010.[10]

Efforts to put size caps on large financial institutions, which received some votes in the Senate, as well as some support among commentators, have failed.[11] These caps, usually in the form of non-deposit liabilities as a percentage of GDP, are unlikely to become law anytime soon. A surcharge would do some of the work a size cap would, making sure that increases in size and risk among megabanks would be a function of economic efficiency, instead of just a function of government backstops and hopes of future bailouts.

A fourth reason is that it would make the OLA more practical and much more likely to work. The chief FDIC regulator has stated that size alone can make a successful OLA procedure more difficult to pull off.[12] The OLA is an untested solution to a major policy problem; efforts to boost its effectiveness at the margin are crucial. Even if successful, taxpayer funds are potentially used to provide backstop liquidity to the process, to be recouped later. Taxpayers are correct to demand a more extensive surcharge here.

There are two steps here: increasing the risk-based capital for the largest firms, and increasing the leverage ratio as well. The risk-based capital surcharge should go above what Basel III calls for, as the size, influence and risk of the largest firms are the issue that still remains most in doubt in the political economy of the United States after the financial crisis.

However, regulators have already taken some steps to incorporate a surcharge for size when it comes to leverage ratios. The largest firms, with assets over $700 billion in consolidated total assets, will be subject to a proposed "supplementary leverage ratio" (SLR), where insured depository subsidiaries of the holding company will have a 6 percent leverage ratio, and the consolidated holding company will be at a 5 percent ratio.

As mentioned above, while a promising step, this is still far too low of a leverage ratio, given the numerous benefits it would have for financial stability. But as Americans for Financial Reform (AFR) note, there is a dangerous precedence in introducing a potential regulatory arbitrage here.[13] As AFR notes, "if the consolidated capital ratio is lower than the capital ratio at depository subsidiaries, then the depository subsidiaries will implicitly be serving as a source of strength to the rest of the holding company, which reverses the principles of U.S. banking law."

In addition, note that even with the SLR, after the surcharge it is likely that the gap between the leverage ratio and the risk-weighted capital ratio will grow. This will introduce additional risks into the regulatory environment by downplaying the balance between the two. Regulators should keep this in mind when debating the final size of the SLR.

6. Macro-prudential Regulation: How the Federal Reserve Will Manage the Credit Cycle

There have been widespread worries, even before the crisis, that risk-weighted capital requirements are procyclical. That means that they tend to be lower when the economy is heating up and higher when the economy is weak, which is generally the opposite of what should be happening. By fundamentally being backward looking, they generate lower requirements when a market is in a bubble.

Meanwhile, central banks in general, and the Federal Reserve in particular, have been looking at the interplay between monetary policy, credit allocation and full employment. There is concern among some policymakers that a monetary policy aggressive enough to ensure full employment will necessarily endanger the stability of the financial sector.

The exact wrong lesson to draw from this relationship, if it exists, is that the economy as a whole should live with a lower level of production and GDP, and a higher level of idleness and unemployment, in order to protect the financial sector.[14] The correct way would be to structure financial regulations to lean against this trend, and counter-cyclical capital ratios will be the front line of this effort.

The research into this field is still young. However, the biggest fear should be that regulations won't push on this tool to ensure financial stability when the time comes. Stricter guidelines and public disclosures should complement the Federal Reserve's actions here. It may be that the Federal Reserve, instead of just announcing a single interest rate, also announces several other metrics that it uses to ensure full employment and price stability—something like the ratio on bank capitalization. It's important that regulators provide space and resources for additional studies here, while laying the groundwork for this transition.

Conclusion

Capital requirements are a clean, straightforward way of increasing the stability of the financial sector. Not only that, they also make other parts of financial reform easier to implement. It's because of this realization that experts from the left and the right, as well as ex-regulators and current industry stakeholders, all agree: stronger and smarter capital requirements for large financial institutions can and should be implemented.[15]

However, it should be noted that hitting, not killing, six birds is the extended metaphor of this piece, and the word choice is conscious. Higher capital requirements will not absolve regulators from having to design a system for the clearing and transparency of derivatives, or a legal regime to allow banks to fail without engendering systemic risk. But capital will, in fact, make these easier, putting less pressure on regulators by providing a secondary layer of protection and solvency for the system as a whole.

However, capital requirements are coming in too low. Large systemically-risky financial institutions should carry significantly more capital, with leverage ratios approaching 10 percent and a risk-weighted buffer above that. In addition, their capital ratios should be designed to facilitate the FDIC's ability to resolve such institutions, they should hedge against liquidity risks, and they should help maintain the credit cycle against the broader economy. Also, the most expansive definition of assets should be used in the calculations of ratios. The public benefits of these goals are numerous and the costs are negligible.

The United States is a little more than halfway through the implementation of new, post-crisis capital requirements. There is still significant rule writing to be done, and old rules can be revisited. Understanding how important capital is, and how it both strengthens all the other parts of financial regulations while making it less vulnerable to any one failure, will be essential to having a financial sector that works for the real economy.

Endnotes

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Dodd-Frank Measures Fundamentally Reform the Mortgage Market

Mike Calhoun

A major trigger of the financial crisis was that millions of families were put into home loans that they could not repay unless house prices rose rapidly and borrowers were able to refinance the loans. The mortgage market, worth more than $10 trillion, is a crucial component of the financial system. When housing prices leveled off and then fell, this mortgage market collapsed, driving the housing market and the entire economy into free fall.

The Dodd-Frank Act responded with a comprehensive overhaul of the mortgage markets, setting out detailed statutory standards and requirements. It also revamped the supervision of the mortgage industry, creating for the first time an agency with unified authority over mortgage lending laws. Together, these dramatically improve the safety of the housing market for individual homebuyers and the overall economy.

Perhaps unique among parts of the Dodd-Frank Act, these reforms have been executed swiftly and well by the newly created Consumer Financial Protection Bureau (CFPB). However, understanding what challenges remain, and where reform could be unwound, is essential to correcting the major failures that took place in the financial markets leading up to the crisis.

The Housing Market Collapse Triggers the Financial Crisis

The housing and mortgage markets have historically been cyclical markets. Home values have risen and fallen in real, inflation adjusted dollars, as mortgage rates, housing price expectations and other factors impacted prices. For example, in the early 1980s and again in the early 1990s, after national house prices had risen quickly, they then fell by 15 percent and 16 percent, respectively in real, inflation-adjusted dollars.[1] Overall, during the past 50 years, house prices have increased by slightly more than inflation, with the exception of the housing boom of the late 1990s through 2006. During that period, housing prices rose by 80 percent in real terms, before they fell rapidly. Low interest rates, designed to spur the post-9/11 economy, encouraged this rise, but other factors helped push this boom to levels that had not been seen before.

Principal among these was the large increase in new mortgage products and subprime lending. These mortgages, designed to have artificially low initial monthly payments, were promoted and financed by Wall Street. Mortgage brokers and lenders received huge fees for steering borrowers into these loans, so not surprisingly, the volume of these products exploded, going from being a very small part of the market to becoming the dominant mortgages at the peak of the housing boom. For example, no documentation or stated income loans, where the loan file contains only an income figure with no documentation, went from being a rare loan type designed for business owners with complicated finances to comprising nearly half of subprime loans and a third of other loans.[2] Similarly, negative amortization loans, where the borrower pays less than the accruing interest each month, so that the principal amount owed actually increases over time, had been initially designed for borrowers who could afford the much larger monthly payments that would become due in a few years when fully amortizing payments were required. These loans, though, were then aggressively marketed to borrowers who could barely afford the initial, very reduced payments, much less the larger later ones. Subprime mortgages, with built-in large payment increases, grew twentyfold, from a small market in the 1990s to over $600 billion dollars of loans made in 2006.[3]

What these subprime and exotic loans had in common was that mortgage brokers and lenders who sold the loans were paid double or more for putting a borrower into one of these loans as compared to providing a standard thirty-year prime loan. The firms that packaged these loans and sold them to investors likewise earned far more from these loans.

Those who received these loans were at great risk of losing their home, indeed, the rate of foreclosures from the housing boom has been heavily determined by the type of loan households received. African-American and Hispanic families were far more likely to receive these dangerous loans and end up in foreclosure, and these disparities persist even after controlling for borrowers' credit record and income. The Center for Responsible Lending, in a groundbreaking study, combined and matched different data sources to follow borrowers and determine their credit standings, the type of loan they received and whether they ended up in foreclosure.[4] The research found that the type of loan was the leading predictor of foreclosure and that families of color were steered to the riskiest loans. Risky loan types had foreclosure rates four to five times that of standard loans. African-American and Hispanic families were much more likely to receive risky loans even after accounting for other factors, and they were twice as likely to face foreclosure. For example, families of color with good credit were three times more likely than white families to receive subprime loans.

The flood of foreclosures from these unsustainable mortgages was delayed as long as borrowers could refinance when they fell behind on payments or could not afford impending payment increases. However, once housing prices leveled off and then fell, these loans failed in droves, accelerating the plunge in housing prices. The result was widespread hardship for homebuyers, collapsing housing prices for all homeowners and communities, losses for investors, and a deep and widespread general recession. For families of color, a generation of wealth building was lost. Wealth disparities between them and white households grew to record levels—white households now have more than 15 times the median wealth of African-American and Hispanic families.[5]

A Dysfunctional Mortgage Market

In earlier decades, lenders and investors had favored loans that were fully underwritten and documented to established standards. This changed as Wall Street investment banks were attracted first to subprime loans, then to more exotic loans, and the high interest rates they both carried. Types of loans that were previously offered by small portfolio lenders now became part of an "originate to distribute" model, where most lenders quickly sold loans into the secondary market rather than holding them. Wall Street investment banks not only provided funding for all of the loans they could buy, they set up their own subprime lenders to acquire more loans. The demand for the resulting securities was so great that large amounts of so-called synthetic securities were produced. These synthetic securities were not used to fund actual loans, but instead paid yields based on the performance of loan portfolios. This greatly expanded the amount of investment tied to these loans, which in turn multiplied the losses produced when these loans ultimately failed.

Early on, there were warnings from community and consumer advocates about the dangers of subprime loans, including that they were driving many established homeowners into foreclosure.[6] These concerns, however, were drowned out by the financial industry's defense of the products and the flood of money produced by the high fees and interest of these loans. Federal regulators not only failed to oversee this new market, they actively blocked efforts by the states to establish protections. State legislatures had seen growing problems in mortgage lending practices, and in response they had passed laws regulating mortgage lending.[7] The federal banking agencies, principally the Office of the Comptroller of the Currency (OCC), which regulated national banks, and the Office of Thrift Supervision (OTS), which regulated national thrifts, both used their preemption rules to block the application of state laws to their members. In addition, the Federal Reserve had been given the authority and responsibility under the 1994 Home Owners Equity Protection Act to prevent abusive home lending practices by all mortgage lenders, but it refused to use that authority prior to the crisis. [8]

The resulting mortgage market was a classic "race to the bottom" where, in the absence of standards or oversight, lenders competed with each other to offer complex loan structures that few borrowers understood. The quality of loan originations plummeted, as the rising home prices temporarily hid the defects. Entities with the duty to provide quality control, such as loan underwriters, appraisers and credit rating agencies, acted as enablers, all earning huge fees for looking the other way as standards continued to erode.

The Dodd-Frank Act Established Basic Safeguards and Standards for the Mortgage Market

This dysfunctional system was flawed in myriad ways, and the Dodd-Frank Act addressed a broad range of issues to reform this key market. First, it required that lenders make a determination of the borrower's ability to repay the loan, and that lenders document the borrower's income and debts as part of this process. This makes mortgages more transparent, and it reduces unsustainable lending—allowing the market to better judge, price and reserve for risks. Second, the Dodd-Frank Act updated and added key protections for high-cost and subprime loans. Third, it addressed the steering of borrowers to riskier loans. Fourth, it reduced the ability of federal banking regulators to use preemption to undercut state mortgage protections. Fifth, it also improved servicing standards, so that loans that fell behind would have a better chance of being modified and cured. Finally, it established a market wide regulator, the CFPB, with a broad mandate to supervise mortgage companies that had operated under weak and fragmented regulators.

Qualified Mortgage/Ability to Repay Requirement

The most significant and prominent of the Dodd-Frank Act mortgage provisions is its requirement that lenders do the common sense work of making a reasonable determination that the borrower has the ability to repay the loan, based on the circumstances at the time the loan is made.[9] While this provision might seem unnecessary, as any rational lender would do this, this was not the case during the crisis, when unsustainable lending was widespread. Several features of the mortgage market encouraged the unaffordable lending that proliferated before the crisis. First, the party originating the loan often did not have or retain any of the economic risk if the loan failed. Mortgage brokers and others were, and still are, paid at closing, and are incented to get the borrower into a loan even if the loan is unsuitable. Lenders then and now sell most of their loans into the secondary market, and have limited recourse for loans that fail.[10] Finally, other loans, including many subprime loans, were "asset based lending." The lender was lending based on the borrower's substantial home equity, and could reap high interest rates and do well even if the loan defaulted, as the home equity would protect against losses.[11]

The Dodd-Frank Act established a new lender duty to determine the borrower's ability to repay the loan. Lenders must also verify and document the borrower's income and expenses that establish that ability. This new duty to determine ability to repay carries liabilities if it is violated, including penalties and damages, and it can be raised as a defense if the loan is foreclosed. The statute directs the CFPB to define a class of safe loans that, in exchange for meeting certain clear standards, will be assumed to meet ability to repay rules, and where lenders will be partially shielded from liability. These so-called "Qualified Mortgages" (QM) and the accompanying ability to repay provisions have become known as the QM rule. The goal of these rules is to return the market to much safer and more transparent loans. The exotic loans, which took over the market and led to the housing collapse, are either prohibited or limited to borrowers who can afford the large payment increases that are often imbedded in these loans.

Under the Dodd-Frank Act statute and implementing regulations, lenders must verify and calculate the borrower's income for all loans. 'No-doc' loans, where income is not documented, are prohibited.[12] These no- doc loans were major contributors to the crisis; they made up, for example, the largest portion of losses for Fannie Mae and Freddie Mac, even though they were a small percentage of their loans.[13] Negatively amortizing loans, and other exotic loans such as interest only loans, and loans with initial teaser payments that later increase are not prohibited, but they are sharply limited and discouraged. Borrowers must be qualified for these loans based on a monthly payment that includes the full interest rate of the loan and amortizes the principal. That is, they cannot be considered able to afford the loans if they cannot, at the time of origination, afford payments at the full interest rate—not an initial, temporary teaser rate—that are fully paying down the principal of the loan.

To qualify as a QM loan, loans have to meet additional standards. First, adjustable rate loans have to be underwritten to the maximum possible payment in the first five years. So, if the interest rate and payment on the loan can increase, the lender's determination of the borrower's ability to repay must be based on the highest possible interest rate and payment that the borrower could face in the first five years. For example, if an adjustable rate mortgage loan starts at 4 percent interest, but the interest rate could increase in the upcoming years if overall interest rates increase, the affordability determination must assume that the mortgage interest rate rises to its highest permitted level. Second, the borrower cannot have an excessive total debt to income ratio (calculated based on the borrowers' gross, pretax income and recurring debts, the housing obligation, and debts like car payments and credit card loans). Debt to income ratios are a standard industry measure of affordability, reflecting how much of a borrower's income is used to pay debts, and how much is left for other expenses. The CFPB set this debt ratio at 43 percent, which is the standard used by the government-sponsored enterprises (GSEs) and Federal Housing Administration (FHA). These agencies permit a borrower to exceed 43 percent only if there are compensating factors that show the borrower can afford a higher payment, for example higher credit scores, larger down payment, or borrower reserves. A lender can go over 43 percent and still meet QM only if the loan meets these additional Fannie Mae, Freddie Mac, FHA or other government loan programs standards.[14] Finally, these loans can have no more than 3 percent in points and fees charged on the loans.[15] Loan points and fees are earned immediately when the loan closes; they are not refundable if the borrower refinances or pays off the loan early. This encouraged brokers and lenders to focus on the money earned at closing rather than on the successful performance of the loan over time. Also, high points and fees strip borrower equity, as in refinancing transactions they are almost always taken out of the home equity, by being added to the amount being financed. Limiting the points and fees on QM loans aligns lender and borrower incentives, by having the lender earn more of its revenue from the performance of the loan, rather than just the fees it collects at loan closing. It also discourages equity stripping, a practice that was widespread during the housing boom.

These new lender duties are enforceable by borrowers, both against the original lender, and in the limited circumstance of defending against foreclosure, against subsequent holders of the loan, including trusts that hold mortgage securities. All lenders must establish they properly determined and documented the borrower's income. For loans that do not meet the QM standards, the lender must also show that based on the information it had when the loan was made, it reasonably concluded the borrower could afford the loan. The Dodd-Frank Act provided that loans that meet the additional QM standards were to be provided some legal protections against claims that the loan was unaffordable; they are presumed to meet the ability to repay requirement. For these loans, the lender must document borrower income and expenses. If the lender can further show that the loan meets all of the QM additional standards, it is presumed under the statute that the loan was reasonably affordable.

The specific legal protection that QM loans should receive was the subject of much debate. Consumer advocates argued that the presumption that loans that meet the QM standard are affordable should not be conclusive. That is, the borrower should be able to show that in the specific facts and circumstances of its loan, the loan was still unaffordable even though it met the QM standards. The standards for QM loans do make them safer. However, in order to make the standards flexible enough to not unduly limit access to credit, it was set at a place where there will be some borrowers who meet the standard but will still not be able to afford the loan. For example, a 43 percent debt ratio is a standard measure, but for a family on limited, fixed income, it may not leave enough money for their other essential expenses, such as food, utilities, health care and transportation. If the presumption is conclusive, these loans would be immune from a challenge that the lender should have known the loan was unaffordable. The financial industry, repeating arguments from before the crisis, claimed that if lenders and investors faced liability for unaffordable loans, they would respond by lending only to wealthier borrowers who were less likely to default.

The CFPB chooses to take a divided approach. Its final rule provides that for QM loans that have prime or near prime interest rates, the presumption of affordability is conclusive, and constitutes a "safe harbor." For QM loans above this interest rate standard—more than 1.5 percent above the best mortgage rate—the presumption may still be rebutted by showing that, based on information provided to the lender before the loan closed, the borrower did not have sufficient money left after paying other expenses to be able to repay the loan. This distinction reflects that for prime loans there is more alignment of borrower and lender incentives, as the lender's profitability is tied to the loan performing. With a limited interest rate and limited points and fees, a prime interest rate QM lender, including anyone who buys the loan, primarily makes its revenue from the ongoing payments of a sustainable loan. For subprime loans, the higher interest rate enables lenders to make many more loans that the borrower may not have an ability to repay, since losses are covered by the higher interest payments.

QM standards incentivize loans that are safer, and more sustainable, as well as more consumer friendly. Among the open questions regarding these rules are whether the safe harbor for prime QM loans will permit abusive and unaffordable lending to continue in some numbers in this particular space. Ongoing oversight and supervision by the CFPB will be important to understanding the impact of this rule, and the CFPB may have to take further action if there are problems. In addition to the CFPB's supervisory and enforcement authority, there is also a more public check on loan performance established by the Dodd-Frank Act in the form of the mandated foreclosure and default database. Another open question is how much non-QM lending there will be at all, given the greater potential legal liability, and the public designation as "less safe" of such loans. There is not doubt, in the meantime, that there will be continuing industry efforts to roll back pieces of the QM statute or rule, including through changing the definition of points and fees, slowing its implementation, or arguing that despite its flexibility the rule already excessively restricts access to credit.[16]

High-cost and subprime loan protections
The Dodd-Frank Act also specifically targeted high-cost and subprime loans, including enacting long overdue updates to the Home Ownership and Equity Protection Act (HOEPA).[17] The HOEPA was enacted by Congress in 1994 in response to predatory lending that had developed at that time with very high fees and interest rates. The law provided strong protections for loans defined as "high-cost." However, the definition had huge loopholes that lenders easily learned to exploit. High-cost loans were defined as those with very high fees—8 percent or more—or very high interest rates—equivalent to 6.5 percent higher interest than prime loans. Very few loans exceeded the triggers, as lenders sought to avoid the high-cost loan rules. In practice, the triggers set the outer fee and interest rate boundaries for most lending and they were very high boundaries indeed. Lenders had learned to continue to charge high fees and interest rates, but avoid the law by charging just below the eight point standard, and to charge additional fees that were not included in the calculation of the trigger. In addition, the HOEPA protections only applied to refinance loans, not home purchase loans.

The Dodd-Frank Act revisions of the HOEPA lowered this fee threshold to five points, and more important, included key fees such as payments to mortgage brokers and prepayment penalties that had previously been excluded. They also expanded coverage of the law to include purchase loans.

The Dodd-Frank Act also added to the protections that apply to the broader set of subprime mortgages that do have fees or interest rates high enough to trigger the new revised HOEPA protections. It required that subprime loans have escrow for taxes and insurance, so that borrowers would not be hit with payment shocks when those bills come due. During the boom, 75 percent of subprime mortgages had no escrow, which made the monthly payments look lower when the loans were marketed to borrowers, but put them at risk of default when the lump sum annual bill for taxes and insurance was owed.

Anti-Steering provisions
The Dodd-Frank Act also sought to deal with mortgage abuses by preventing the financial incentives that encouraged brokers and lenders to steer borrowers to more expensive and riskier loans than they qualified for, which had ultimately harmed both individual consumers and the market as a whole.

Other things being equal, a loan that has a higher interest rate sells for a higher price in the secondary market. For example, if the prevailing market rate for a mortgage to a borrower was 5 percent, a loan at the rate would sell in the secondary market for the face amount of the loan, or par. For a $100,000 loan, it would be sold for close to $100,000.[18] If the borrower could be persuaded to take out a loan with a higher interest rate, for example 6 percent, this produced higher monthly payments and a higher return to investors. The loan would then sell to the secondary market at a higher price, above par, at approximately $104,000.[19] This extra money, which was paid by the borrower through the higher interest rate and higher monthly payments, was divided up among the mortgage broker or loan officer, the lender, and the secondary market participants who packaged and sold the loans. The bonus paid to mortgage brokers was called a "yield spread premium." This name reflects that the loan was selling at a premium because it had a higher yield or interest rate.

In addition to this "up selling" of loans within the same loan type—that is, simply raising the interest rate on an otherwise similar loan—there was also frequent steering to particular loan products, with brokers and lenders directing borrowers to types of loans that generally had higher interest rates. The exotic loan types, including no documentation loans and interest only loans, had higher interest rates than traditional loans.[20] Again, mortgage brokers, lenders, and others in the mortgage system made far more by steering borrowers to these exotic loans.[21] As one lender explained: "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans. What would you do?"[22]

Steering borrowers to more expensive and riskier loans was facilitated by the complexity of these loans, which made it much harder for consumers to judge the true cost of the loans. Borrowers also expected mortgage brokers, whom they hired to help find a loan, to watch out for their interests. The brokers, on the other hand, disclaimed that they had this duty, and openly demanded the payment of premiums from lenders, shunning those lenders who did not pay them. The resulting steering inflicted disproportionate harm on communities of color, where nearly half of borrowers were put into expensive subprime loans, even though many qualified for cheaper prime loans.[23]

The Dodd-Frank Act reined in these steering practices in several ways. First, it created a general prohibition against steering, and provided remedies for borrowers. Financial incentives for steering were also reduced. The Dodd-Frank Act prohibited mortgage broker and loan officer compensation from being tied to loan structures, such as negative amortizing or no interest loans, or to the interest rate of the loan. As a result, the previous widespread practice of lenders paying mortgage brokers and loan officers additional fees for steering borrowers to more expensive or riskier loans is now prohibited.

Importantly, the Dodd-Frank Act also substantially restricted prepayment penalties, which were an important component of the steering incentives. If a lender or a loan purchaser was going to pay a substantial premium on a loan, it required that the borrower be locked into the loan with a prepayment penalty. Otherwise, there was the risk of paying the premium to the mortgage broker, but not collecting higher interest if the borrower was able to refinance into a better loan. Thus lenders and investors insisted on prepayment penalties as a condition of paying substantial yield spread premiums to brokers, and, of course, brokers preferred loans with yield spread premiums. From the borrower perspective, prepayment penalties locked borrowers into bad loans, especially in the subprime market, and they stripped equity if borrowers refinanced and paid the substantial penalty, as many did. The Dodd-Frank Act prohibited all prepayment penalties for subprime loans (loans with an interest rate more than one and half percent above the best mortgage rate), sharply limited the amount and duration of them for other loans, and further substantially discouraged them by counting them towards the three point fee limit for QM loans. Together, these provisions greatly reduce the risk of steering.[24]

Restriction of preemption by federal bank regulators
Another problem that contributed to abuses in the lead up to the crisis was the aggressive use of preemption by federal banking agencies to block state law mortgage protections. During the pre-crisis years, the bank regulators competed with each other to favor the banks that they supervised (which paid supervision fees to them and funded their budgets) with extensive preemption of state consumer protection laws.

In the Dodd-Frank Act, consumer advocates sought a restoration of the space for state law making. The national banks fought back hard, and the resulting provisions were a compromise that rolled back some preemption claims, but not as much as consumer advocates believed necessary. The Dodd-Frank Act blocked the most aggressive regulator claims of preemption and established a more limited range of state laws that could be preempted. Also, stronger standards of review of preemption action were established, and banks were blocked from setting up subsidiaries and claiming preemption for them. Still, the law leaves opportunities for federal regulators to block common sense state consumer protections from being applied to national banks. This is offset in part by the applicability of the rules of the new CFPB, which will apply to all actors, including the national banks.

Mortgage servicing reforms
The Dodd-Frank Act addressed the widespread failure of the mortgage market to properly service loans. This failure resulted in millions of unnecessary foreclosures, which further aggravated the distressed housing market, as well as causing catastrophic

harm to families and their communities. Going into the crisis, the mortgage servicing industry was largely unregulated, and it depended on very low staffing levels and the imposition of abusive fees for it profitability. Consumers had no say in who serviced their loans. When record numbers of troubled loans occurred, servicers failed to take reasonable steps to modify loans when that would have increased the value for the loan investor as well as kept the homeowner in the house.

The Dodd-Frank Act added new servicing protections and empowered the CFPB to oversee and regulate the servicing industry. The CFPB in turn issued regulations that created new standards for servicers, including the correct credit of borrower payments, limitations on fees, and enhanced duties to modify loans. The rules require servicers to make any loan modification programs they offer for any servicer available to other borrowers they service, unless prohibited by their servicing agreement with the investors. Yet, the rules stopped short of mandating consideration of modifications for all borrowers. Going forward, the CFPB has made overseeing the servicing industry a major priority.

Additional protections

Other Dodd-Frank Act provisions enhance the safety and transparency of the mortgage market. These include new appraisal standards that were needed because in the lead up to the crisis, appraisals often far overvalued properties. Also included were simplified standard disclosure forms to help borrowers better understand loans and enriched Home Mortgage Disclosure Act Data, which will allow the public to better understand who is getting what kind of mortgages. It also mandated a new mortgage delinquency and foreclosure database that will track and provide regulators and the public with timely information about both local and national trends on mortgage performance.

The CFPB oversight of mortgage lending

The overall lax supervision of mortgage lending during the housing boom, along with inconsistent standards based on the legal charter of the lender, substantially contributed to the housing crisis. One of the most important Dodd-Frank Act mortgage reforms was the creation of the CFPB with the authority to establish rules for all mortgage lenders and servicers.[25] Leading up to the crisis, oversight of mortgage lenders was patchy and weak. Responsibility for different rules was divided among different agencies, and consumer protection was usually a low priority for all of them. Lenders had different regulations and regulators depending on how they were organized, and they were able to "regulator shop" in pursuit of the laxest oversight. Nonbank lenders (including non bank lenders who were subsidiaries of banks) were often able to escape any effective federal supervision at all. The CFPB was created to consolidate, increase and standardize oversight of consumer financial services across markets. This is an enormous change for the mortgage market; it now has a single agency focused on the safety and interests of consumers, with the authority to deal with key players in this market and effectively address a wide range of mortgage practices.

Ongoing challenges

While substantial progress has been made in reforming the mortgage market, as with other areas of financial reform, opponents are not only fighting additional reform, they are attempting to roll back the reform measures that have been adopted to date.

The QM/ability to repay rule and the new mortgage servicing rules are effective January 2014. Some lenders and trade associations are pushing Congress for the creation of new loopholes in the standards. One leading bill would amend the QM standard to allow unlimited payments to mortgage brokers, leading to the resumption of steering of borrowers that was a core cause of the financial crisis. The bill would also exempt other loan fees, such as inflated charges for title insurance, allowing them to be piled on to loans with the lender still receiving the QM legal protections. Other efforts call for long delays in implementation of the rules, delaying reform and gaining more time for industry to attempt to gut the standards.

These attacks on the reforms are also directed at the CFPB. Industry representatives have far greater resources available to them than consumer and civil rights advocates. Consequently, the CFPB is under a continued and coordinated widespread attack on its rules and procedures. The CFPB—notwithstanding the long-delayed confirmation of its director, Richard Cordray—remains the target of legislative efforts to handcuff the agency. While these bills are unlikely to be passed in regular Congressional order, those who oppose the CFPB repeatedly attempt to add them to "must pass" bills, including continuing appropriations resolutions.

Conclusion

The enactment and implementation of the Dodd-Frank Act mortgage provisions, combined with the creation of the CFPB, has created a fundamentally reformed mortgage market. Basic standards have ended many past practices that so harmed consumers and the overall economy. Equally important, new attempted abusive practices face scrutiny and oversight by the CFPB. These protections make it safer for families who are engaged in their most important financial transaction, one that often determines their long-term financial trajectory. These reforms also protect mortgage investors and the overall economy, as mortgage risks are reduced, and the mortgage market now is safer, more transparent and less volatile. Yet, as with other areas of financial reform, substantial work remains in both finishing these reforms and rebuffing the efforts of those who want to return to the practices of the past.

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14. This provision for loans with greater than 43 percent DTI will expire at the earliest of seven years, or for the GSE eligible mortgages, when the GSEs' conservatorship ends.
15. Higher fee limits are provided for smaller loans of less than $100,000.
16. Non-QM loans, which do not receive any presumption of compliance, will also be available, though it is uncertain how much of the future mortgage market they will comprise.
17. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Sections 1431-33.
18. The actual price can vary to reflect whether the right to service the loan is being transferred with the loan and whether the lender collected origination fees from the borrower, or added them into the rate, so that they will collect them when they sell the loan.
19. The exact price would vary depending on prevailing interest rates at the time and other factors.
20. During the housing boom, these exotic loans paid high premiums because they carried higher interest rates, yet credit rating agencies wrongly predicted they would not have significantly higher default rates.
21. Of course, the lower initial payments were appealing to borrowers who often did not understand the future higher payments they would owe.
22. Vikas Bajaj and Christine Haughney, Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages, New York Times (January 26, 2007).
23. Rick Brooks and Ruth Simon, Subprime Debacle Traps Even Credit-Worthy Borrowers, Wall Street Journal, December 3, 2007; accessed at: http://online.wsj.com/article/SB119662974358911035.html.
24. Specialty lenders and brokers, though, can still market only risky, high-cost products, and can even pay and receive high fees for selling these mortgages, so long as the fee does vary by mortgage type or interest rate.
25. All lenders are subject to the rules of the CFPB. The CFPB also supervises the mortgage operations of all depository lenders except for community banks and credit unions with assets of less than $10 billion, for whom the primary supervisors remain their primary prudential state and federal regulators.

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There is No There There:[1] Sophisticated Investors as the Guardians of Financial Stability[2]

Jennifer S. Taub

> We want the sophisticated investor to protect himself, but we also want a system that identifies crooks and comes down like the wrath of God on them. We need both.[3]
>
> —Charles Munger, vice chairman of Berkshire Hathaway

> And here I think what's intriguing is we have a failure of both.[4]
>
> —Joseph Grundfest, Stanford Law School professor

The conditions that created the financial crisis of 2008 were enabled by decades of government deregulation justified by the premise that for transactions among sophisticated investors government interference was unnecessary, if not counterproductive. Instead of laws and rules to protect investors and markets, we were told we could rely on savvy counterparties to promote financial stability. Sophisticated investors purportedly had the expertise and incentives to properly assess risk, and to select and monitor complex investment options. [5]

The concept of the sophisticated investor exception is embedded in the federal securities laws. It allows securities issuers to sometimes bypass legal requirements intended to protect ordinary retail investors. The securities laws were designed, initially, to protect such retail investors from confusing, worthless, or high-risk investments.[6] However, many investment options can be offered to sophisticated or accredited investors and sold without many protections. These sophisticated or accredited investors (collectively "sophisticated investors")[7] include pension funds, mutual funds, hedge funds, endowments, broker-dealers, insurance firms, banks, and sovereign funds, among others. They also include individuals who earn as little as $200,000 per year.[8]

In retrospect, reliance upon sophisticated investors was misguided. In the lead-up to the 2008 financial crisis, these institutions created instability both for their firms and for the system at large. As detailed in "The Sophisticated Investor and the Global Financial Crisis," [9] there are numerous examples of sophisticated investors' failures involving matters central to the credit crunch and financial crisis.

Addressing Sophisticated Investor Shortcomings in the Dodd-Frank Act

There are several provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[10] that attempt to address the shortcomings of sophisticated investors. One example is that the Dodd-Frank Act seeks to push sophisticated investors to conduct more thorough independent assessments of credit risk, instead of what many perceived as sole reliance on ratings furnished by Nationally Recognized Statistical Rating Organizations (NRSROs or credit rating agencies). Another example, the Dodd-Frank Act permits the U.S. Securities and Exchange Commission (SEC) to enact a rule requiring sophisticated investor firms (and other issuers) to include candidates nominated by shareholders on the official proxy ballot.[11] On their own, neither of these provisions are likely to improve the performance of sophisticated investors, due to the reasons set out below.

The Dodd-Frank Act tackles the problem of inflated credit ratings somewhat indirectly. It does not end the conflict of interest that lies at the heart of the problem, namely that the issuers of securities select and pay the credit rating agencies to provide the ratings.[12] Instead, the law employs other tactics, including imposing new governance requirements on credit rating agencies, and attempting to create new liability if they give permission for their ratings to be included in public offering documents. In addition to seeking to improve the internal practices and accountability at credit rating agencies, the law also tries to improve the behavior of the sophisticated investors who use ratings when purchasing debt securities. This focus addresses the assumption that sophisticated investors unduly relied on triple-A ratings provided for complex mortgage-linked securities without sufficient independent investigation and analysis. The Dodd-Frank Act mandates that certain references to the credit rating agencies be eliminated where referenced in federal laws. Similarly, it requires federal agencies to remove from regulations references to or reliance on credit rating agencies and substitute instead other measures or standards for creditworthiness.[13]

While this mandate may appear to be a way to alter sophisticated investor behavior, it overlooks two important observations. First, even before the crisis, certain institutional investors were not legally permitted to solely rely on NRSRO ratings. For example, under Rule 2a-7 of the Investment Company Act of 1940, money market mutual funds generally were required to limit their investments to holdings that received high ratings from NRSROs. In addition, however, Rule 2a-7 also required that the money market fund board determine that any security acquired presented "minimal credit risk." Thus, it was an overstatement to suggest that all institutional investors were legally permitted to blindly rely on these ratings. Indeed, Reserve Primary Fund, the money market fund that "broke the buck" on September 16, 2008, and triggered a massive run on the money market fund industry that week, was subject to the minimal credit risk requirement. Nevertheless, it had $785 billion in short-term (including repo) exposure to Lehman Brothers.

The second observation is that the removal from statutes and regulations of NRSRO credit ratings will not necessarily change the reliance under contractual arrangements. Money managers enter into agreements with large investor clients under which they have used, and many continue to use, these credit ratings as guidelines. Considered together, it is worth exploring how much has or will change for those investors that previously were mandated (by law or by contract) to engage in a minimal credit risk analysis and those investors who continue to rely on NRSRO ratings.[14]

The Dodd-Frank Act also seeks to empower the shareholders of sophisticated investors and other corporate issuers to hold their own executives and directors accountable. It is difficult for shareholders who are dissatisfied with the performance of a CEO to take meaningful action. Shareholders must rely upon the board of directors to discipline or fire a CEO. Correspondingly, if the shareholders seek to pressure their board of directors, there are limited options. Though state corporate law grants shareholders the right to vote for directors, this right is often illusory. The directorial election process involves the ratification of board-nominated candidates; if there are ten seats on the board up for re-election, ten board-nominated candidates will appear on the ballot. Though state law also often gives shareholders the right to nominate candidates, in practice, this is a difficult and costly endeavor. To conduct such a "proxy fight," the insurgent shareholder would need to pay for a separate mailing to shareholders to present the slate of alternate candidates. Given these obstacles, to facilitate the nomination of directors by shareholders, over the years, the SEC considered allowing long-term, large shareholders to nominate some of their own candidates for election and have them included on the official corporate ballot in the proxy mailing that is sent to shareholders in advance of the annual meeting.[15]

Section 971 of the Dodd-Frank Act clarifies that the SEC has the statutory authority to issue a rule that provides shareholders access to the proxy to nominate directors for election. In response, the SEC issued Rule 14a-11 (the Proxy Access Rule) that permitted qualified shareholders (those with at least 3 percent of the voting power for 3 years) to request approval by shareholders of a corporate procedure allowing one or more shareholder nominees (for up to 25 percent of total seats) to be included on the official ballot. [16] The Business Roundtable and U.S. Chamber of Commerce promptly sued the SEC. A year later the Federal Circuit Court for the D.C. Circuit struck down the Proxy Access Rule.[17]

Supporters of proxy access contended that this new power to nominate individuals other than management's "lapdogs" was critical to reining in management excess and ensuring the company performs well, thus, maximizing the long-term value of shares. Supporters have put forward research showing a correlation between firm performance and strong boards. In addition, supporters of proxy access viewed it as a remedy to poor board oversight at failed firms including Enron Corporation, Lehman Brothers and American International Group (AIG). Notably, certain board members of firms that failed miserably during the financial crisis maintain their board positions at those or other firms.

Opponents decried this nomination right, arguing that shareholders with special interest agendas, such as unions and public pension funds would hijack corporate boardrooms and deeply damage the capitalist system. Moreover, they contended that shareholders lacked the requisite skills to select qualified board members.[18]

The Proxy Access Rule could have helped remove ineffective board members, and thereby perhaps encourage managers of sophisticated investor firms to be more diligent in their research and selection of complex investments. However, given the D.C. Circuit decision, unless the SEC is successful in a future attempt to issue a replacement, this important attempt to address sophisticated investor shortcomings will not be effective.

Addressing Sophisticated Investor Shortcomings through Enforcement

Government enforcement actions related to the financial crisis might be an avenue to address sophisticated investor shortcomings. However, most high-profile government enforcement efforts have targeted the sellers of toxic mortgage securities, not the buyers. For example, Goldman Sachs settled with the SEC for $550 million in connection with its sale of tranches of Abacus—a complex synthetic collateralized debt obligation structure. Though the purchasers were apparently sophisticated institutions, including a German and Dutch bank (that lost $1 billion on the deal), they were not as sophisticated as John Paulson, the hedge fund manager who had apparently worked with Goldman Sachs employees to structure the deal so that he could bet against a careful selection of mortgage-backed securities for which the underlying homeowners were very likely to default.[19]

The SEC prevailed in a civil fraud case against Fabrice Tourre,[20] the Goldman Sachs banker involved in the Abacus deal, who perfected the art of sophisticated investor arbitrage. Tourre seems to have understood that there were two types of sophisticated investors: those with skills equal to the bankers they were doing business with, and those institutional investors and real people who qualified under the law as "sophisticated" but were quite easy to fool. This can be seen in the "fabulous Fab's" testimony during hearings before a Senate subcommittee. In his prepared written remarks, from which he read, Tourre defended his role in selling the Abacus bonds. "I was an intermediary between highly sophisticated professional investors—all of which were institutions. None of my clients were individual, retail investors," he explained. However, during the question-and-answer period of the hearings, Sen. Susan Collins (R-Maine) challenged this assertion, reading from an e-mail that Tourre sent, in which he expressed disappointment with the list of target investors. He wrote: "This list might be a little skewed towards sophisticated hedge funds with which we should not expect to make too much money since (a) most of the time they will be on the same side of the trade as we will, and (b) they know exactly how things work and will not let us work for too much $$$, vs. buy-and-hold rating-based buyers who we should be focused on a lot more to make incremental $$$ next year."

In the view of Sen. Collins, "This sounds like a deliberate attempt to sell your products to less sophisticated clients who would not understand the products as well so that you can make more money."[21]

The government has had limited success, however, bringing cases against buy-side sophisticated investors, for example, arguing that they mislead their own investors or otherwise breached their fiduciary duties. There are notable examples where the government lost cases against the individual decision makers at buy-side firms. These includes the criminal prosecution of Ralph Cioffi and Matthew Tannin, the two Bear Stearns hedge fund managers, and the SEC's civil suit against Bruce Bent and Bruce Bent II, the father and son who ran the investment advisory firm for the Reserve Primary Fund.

After receiving an internal report concerning trouble with triple-A tranches of subprime-backed collateralized debt obligations in the Bear Stearn-sponsored hedge funds' portfolios, Tannin sent an email to Cioffi declaring that the "subprime market looks pretty damn ugly" and if the report were accurate, then they should shut down the hedge funds because the "entire subprime market is toast." But a few days later, they assured investors during a conference call that all was well. Cioffi and Tannin were charged with crimes including conspiracy, wire fraud, and securities fraud. However, a jury acquitted them.[22]

The SEC contended that the Bent duo and their management firm "engaged in a systematic campaign to deceive the investing public into believing that the Primary Fund—their flagship money market fund—was safe and secure despite its substantial Lehman holdings." The complaint alleged the two knowingly disseminated "false information to the Primary Fund's Board of Trustees, investors, and rating agencies." A jury found the Bents not liable for fraud, but did find the son negligent. The investment advisory firm and broker-dealer, however were found liable for fraud.[23]

Ongoing Threats to Financial Stability

Meanwhile, many of the conditions that helped cause the 2008 crisis persist. First, the top six U.S. banks are larger than they were before the crisis. Second, though a proposal to restrict leverage has been suggested, banks (and their holding companies) are legally permitted to borrow $97 for every $100 in assets they own, and private pools of capital, including hedge funds, face no leverage restrictions at all. Third, trillions of dollars are borrowed through the short-term, often overnight, repo market. Fourth, credit derivatives remain insufficiently regulated.[24]

Many experts including policymakers, bankers and scholars recognize that the problem of "too big to fail" has not been resolved.[25] However, often overlooked in discussions about continued vulnerabilities are the markets in which sophisticated investors still operate without significant government controls. In particular, the continued dependency of large financial firms on overnight and other short-term repurchase (repo) funding to finance their balance sheets has received insufficient attention, despite the fact that it was a run on repo that triggered cascading collapses in 2008. Indeed, the near-demise of Bear Stearns in March 2008 was precipitated by a sudden withdrawal of repo funding, and led to the unprecedented $30 billion in government support of a "private" rescue by JPMorgan Chase. Similarly, the bankruptcy of Lehman Brothers in September of 2008 came after a withdrawal of repo and other wholesale funding by sophisticated investors. Lehman Brothers had $200 billion outstanding in overnight repo loans before it collapsed. One mutual fund family that had been rolling over $12 billion in overnight repo loans to Lehman Brothers, suddenly demanded its money, tapering down to just $2 billion a week later.[26] Lehman Brother's failure triggered a run on other aspects of the shadow banking system, including a $300 billion run on the institutional money market funds the week it failed.

These frailties in both the repo and money market funds have not been remedied. At the peak, in spring of 2008, about $2.8 trillion in collateral was posted through the tri-party repo market.[27] Today, Treasury Secretary Jack Lew and others recognize that repos remain a fragile source of funding[28] with roughly $1.8 trillion in collateral financed through the tri-party repo market in July 2013.[29] The tri-party arrangements are only one part of the overall repo market.[30]

Given both the failure of sophisticated investors to either guard their own firm's financial stability or to prevent systemic risk, it is foolhardy to expect financial reforms that continue to depend upon sophisticated investors either to self-police, police the market, or to provide regulators with enough critical information. Even post-crisis—as demonstrated by the more than $6 billion London Whale trading loss at JPMorgan Chase and the money laundering behavior at HSBC—we have learned that sophisticated investors, can withhold or fail to provide information about their firms because their own employees make mistakes or commit fraud. Moreover, as the jitters regarding raising the U.S. debt ceiling showed, the vulnerabilities and interconnections between the repo markets, money market funds, and broader financial stability continue to be a tinderbox, awaiting another asset reversal or shock to ignite.

Endnotes

1. Gertrude Stein, Everybody's Autobiography (New York, NY: Random House, Inc., 1937), p. 298 ("what was the use of my having come from Oakland it was not natural to have come from there yes write about it if I like or anything if I like but not there, there is no there there.")
2. For a thoughtful discussion of a different type of financial stability guardian, see James R. Barth, Gerard Caprio Jr., and Ross Levine, Guardians of Finance: Making Regulators Work for Us (Cambridge: MIT Press, 2012).
3. "Legal Matters with Charles T. Munger," Stanford Lawyer, vol. 43, spring 2009, 16.
4. Ibid.,
5. See, Remarks by Chairman Alan Greenspan, the Annual Conference of the Association of Private Enterprise Education, Arlington, Virginia, April 12, 1997 in a 1997: "As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures. This is a likely outcome since governments, by their nature, cannot adjust sufficiently quickly to a changing environment, which too often veers in unforeseen directions;" available at http://www.federalreserve.gov/boarddocs/speeches/1997/19970412.htm
6. Stephen J. Choi, "Regulating Investors, Not Issuers: A Market Based Proposal," Berkeley Program in Law and Economics Working Paper Series 2000–1 (1990), p. 2.
7. It's important to note that while Rule 506, which allows for an exemption to registration requirements, allows sales to an unlimited number of accredited investors, it also allows issuers to sell unregistered securities to a small number of those with don't qualify as accredited, but who "have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment … or be able to bear the investment's economic risk." This narrow exception is sometimes referred to as the sophisticated investor exception; however, as a practical matter,

because it is difficult to judge whether an investor has that knowledge and experience, issuers rely on the "accredited investor" definition and other objective definitions that use an objective measure of assets or income. Accordingly, when industry members refer to investors as sophisticated, they are typically referring to the objective measures of wealth, not the subjective question of actual knowledge or skill.

8. The protections that remain are prohibitions against fraud. See Donald C. Langevoort, "The SEC, Retail Investors and the Institutionalization of the Securities Markets," Virginia Law Review 95 (2009), p. 1025.
9. Jennifer S. Taub, "The Sophisticated Investor and the Global Financial Crisis," in Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis, eds., Hawley, Kamath and Williams (Philadelphia, PA: University of Pennsylvania Press, 2011) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1784299
10. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, 124 Stat. 1376 (2010).
11. Section 971 of Dodd-Frank amended the 1934 Act to provide that the SEC "may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors [and that the SEC may] by rule or order, exempt an issuer or class of issuers from the requirement made by this section or an amendment made by this section";
12. Paul Krugman, "Berating the Raters," New York Times, April 26, 2010: "Issuers of debt — which increasingly meant Wall Street firms selling securities they created by slicing and dicing claims on things like subprime mortgages — could choose among several rating agencies. So they could direct their business to whichever agency was most likely to give a favorable verdict, and threaten to pull business from an agency that tried too hard to do its job. It's all too obvious, in retrospect, how this could have corrupted the process."
13. Claire A. Hill, "Limits of Dodd-Frank's Rating Agency Reform," Chapman Law Review, vol. 15, no. 1, p. 133 (2011): "while Dodd- Frank's rating agency reforms are not bad, they also are not particularly good. . . [rating agencies] engaged in considerable self-deception and reckless, if not willful, blindness, similar to the self-deception practiced at many investment banks and law firms."
14. See SEC Money Market Fund Reform, Final Rule, 17 CFR Parts 270 and 274 [Release No. IC-29132; File Nos. S7-11-09, S7-20-09], 2010, available at http://www.sec.gov/rules/final/2010/ic-29132.pdf (Many commentators have argued that "eliminating NRSRO ratings from the rule would do nothing to prevent a fund manager from being highly dependent upon NRSRO ratings in making its minimal credit risk determination"); Dannielle Carbone, "The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies," Insights: The Corporate & Securities Law Advisor, vol. 24, no. 9 (September 2010); DavisPolk, "Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010," July 21, 2010, pp. 76-79.
15. Jennifer S. Taub, "Money Managers in the Middle: Seeing and Sanctioning Political Spending After Citizens United," NYU Journal of Legislation and Public Policy, vol. 15, p. 101 (2012).
16. Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384 (Aug. 25, 2010) [hereinafter, Proxy Access Rule]; also see SEC Press Release, SEC Adopts New Measures to Facilitate Director Nominations for Shareholders, August 25, 2010, also availble at http://www.sec.gov/rules/final/2011/33-9259.pdf; see also Lisa Fairfax, "Proxy Access Forum: The New Proxy Access - Some Initial Thoughts," The Conglomerate, August 25, 2010: "it also seems noteworthy that while the SEC recognized and took note of state law changes aimed at facilitating proxy access, such as the Delaware and ABA amendments, those changes did not dissuade it from fashioning a federally mandated rule. Under the SEC's view, even if proxy access bylaw amendments were permissible in every state, the fact that shareholder proposals could face significant obstacles that could undermine shareholder efforts to obtain proxy access warranted a federal rule."
17. Business Roundtable v. SEC, 647 F3d 1144 (D.C Cir. 2011).
18. J. Robert Brown Jr., "Staying Access," The Race to the Bottom, October 6, 2010 ("As we have noted, access is the beginning of a paradigm shift in corporate governance. Opposition to the provision has been powerful and unabated, particularly from the issuer community. The opposition is understandable. It will ultimately contribute to a more shareholder centric approach to governance, altering the way things are done inside the boardroom.")
19. Securities and Exchange Commission, "Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO: Firm Acknowledges CDO Marketing Materials Were Incomplete and Should Have Revealed Paulson's Role," press release, July 15, 2010; "Factbox: How Goldman's ABACUS Deal Worked," Reuters, April 16, 2010.
20. Nate Raymond, "SEC Wins as Ex-Goldman Executive Tourre Found Liable for Fraud," Reuters, August 1, 2013.
21. Fabrice Tourre, testimony before the Senate Permanent Subcommittee on Investigations hearing, "Wall Street and the Financial Crisis: The Role of Investment Banks," April 27, 2010, available at http://hsgac.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_id=f07ef2bf-914c-494c-aa66-27129f8e6282.
22. Tom Hays, "Ralph Cioffi, Matthew Tannin Verdict: Ex-Bear Stearns Hedge Fund Managers NOT GUILTY On All Fraud Charges," Huffington Post, November 10, 2009; Zachary A. Goldfarb, "Former Bear Stearns Executives Acquitted of Lying to Investors," Washington Post, November 11, 2009;
23. SEC v. Reserve Management Company, Inc., RESRV Partners Inc., Bruce Bent Sr., and Bruce Bent II (Defendants) and the Reserve Primary Fund (Relief Defendant), Complaint, May 5, 2009; Grant McCool, "Fund Pioneer Bent, Testifying at Trial, Tries to Shift Blame," Reuters, October 12, 2012; Kirsten Grind and Julie Steinberg, "Reserve Primary's Managers Cleared in SEC Fraud Case," Wall Street Journal, November 12, 2012; Nathaniel Popper and Jessica

Silver-Greenberg, "Money-Market Pioneer and Son Cleared of Fraud," The New York Times, November 12, 2012.
24. See, Jennifer S. Taub, "Delays, Dilutions, and Delusions: Implementing the Dodd-Frank Act," forthcoming, 2013.
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26. Sandler, L., "Lehman Had $200 Billion in Overnight Repos Pre-Failure," Bloomberg, January 28.
27. Copeland, A., Martin, A., and Walker, M. (2011), "Repo Runs: Evidence from the Tri-Party Repo Market," Federal Reserve Bank of New York Staff Report No. 506, Revised in 2012, pp. 1, 9.
28. Treasury Secretary, Jack Lew, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs Hearing on the "The Financial Stability Oversight Council Annual Report to Congress," including prepared remarks and Q&A, May 21, 2013.
29. Federal Reserve Bank of New York (2013), Daily Average Collateral Value Financed in the Tri-Party Repo Market, available at http://www.newyorkfed.org/banking/pdf/daily_avg_size_tpr_jul2013.pdf
30. For more information on the role of repurchase agreements in the 2008 Financial Crisis, see Jennifer S. Taub, "What We Don't Talk About When We Talk About Banking," in The Handbook of the Political Economy of Financial Crises (New York, NY: Oxford University Press, 2013, Gerald Epstein and Martin H. Wolfson, eds.

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The Fiduciary Standard and the Dodd-Frank Act: An Elegant Return to a Centuries-Old Principle

Ron A. Rhoades

Under the law there are two distinct forms of relationships: arms-length and fiduciary. A broker-dealer and its registered representatives are in an arms-length relationship when providing trade execution services. While providing trade execution services, the low suitability standard applies. The low suitability doctrine demands only that a broker/brokerage firm "will make specific recommendations of securities only if it has a reasonable basis for believing that they are suitable for the customer."

In contrast, the fiduciary duties of due care, loyalty and utmost good faith have, for more than a century, been applied to the delivery of financial and investment advice. In recent decades, broker-dealers and their registered representatives have moved away from the world of fixed commissions for stock sales, and instead now recommend mutual fund and other investment managers and provide a wide variety of other financial and investment advice. Having transformed their businesses to incorporate the delivery of financial and investment advice, broker-dealers and their registered representatives should assume the duties and obligations of relationships of trust and confidence with clients; their relationship with customers has changed from arms-length to fiduciary.

The fiduciary obligations of broker-dealers and their registered representatives have been recognized by the U.S. Securities and Exchange Commission (SEC) and Financial Industry National Regulatory Authority (FINRA) since the early 1940s, and by the courts, via application of state common law, throughout the 20th Century. The Dodd–Frank Wall Street Reform and Consumer Protection Act empowers the SEC to formally apply, by rule, these fiduciary standards upon broker-dealers. In so doing, the SEC will merely codify securities regulation to reflect current state common law as applied to the expansion by broker-dealers of their activities into the delivery of personalized investment advice.

Should the SEC proceed to adopt rules under the Dodd-Frank Act to impose the fiduciary standard upon broker-dealers, the SEC would rebuff Wall Street's attempt to create, out of thin air, a "new federal fiduciary standard," which would only require casual and non-meaningful disclosures of conflicts of interest. Disclosure alone neither negates nor fulfills a fiduciary's duties. In addition, while broker-dealers providing personalized investment advice are permitted to receive commission-based compensation, variable or differential compensation practices should be circumscribed. Broker-dealers' sale of proprietary funds when providing personalized investment advice presents a fiduciary conundrum; yet, guidance in formulating appropriate regulation on the sale of proprietary products by fiduciaries to their clients can be gleaned from other regulators.

The Dodd-Frank Act's section 913 represents an elegant return to the centuries-old fiduciary principle. The fiduciary standard is appropriate for the delivery of personalized investment advice to individual investors, who are too often faced with the daunting task of ensuring their retirement security while navigating the complexity of today's modern capital markets.

Distinguishing Arms-Length and Fiduciary Relationships

There are two types of relationships between product and service providers and their customers or clients under the law. The first form of relationship is an "arms-length" relationship. This type applies to the vast majority of relationships between service providers and customers. In these relationships, the doctrine of "caveat emptor" (*i.e.*, let the buyer beware) generally applies, although this doctrine is always subject to the requirement of commercial good faith. Additionally, this doctrine may be modified through the imposition of specific rules or doctrines by law, such as the low requirement of "suitability" imposed upon registered representatives of broker-dealer firms (i.e., brokers).

The second type of relationship is a fiduciary relationship. This in relationship involves trust, which includes vulnerability for the party who is placing trust in another. In such situations, one's guard is down, one is trusting another to take actions on one's behalf. Under such circumstances, to violate a trust is to infringe grossly upon the expectations of the person placing their trust. Because of this, the law creates a special status for fiduciaries, imposing duties of due care, loyalty, due care, and utmost good faith upon them. Under the law, the "fiduciary relationship" requires the fiduciary to carry on with their dealings with the client (a.k.a. "entrustor") at a level far above ordinary, or even "high," commercial standards of conduct.

The Sales Relationship	The Trusted Adviser Relationship
Product Manufacturers	Client
Salesperson	Fiduciary (Adviser)
Customer	Product Manufacturers

Arms-Length Relationships: The Broker's Low Suitability Standard

When providing only trade execution services the sales—or arms-length—relationship exists between the broker-dealer or their registered representative and the customer. The "suitability doctrine," explicitly set forth as a rule by FINRA and recognized by the SEC as a "fundamental duty of brokers" enforceable by FINRA under the securities laws' general antifraud rule (Rule 10b- 5),[1] applies to govern the conduct of broker-dealers and their registered representatives in such circumstances. However, the low suitability doctrine demands only that a broker/brokerage firm "will make specific recommendations of securities only if it has a reasonable basis for believing that they are suitable for the customer."[2]

Suitability essentially imposes upon broker-dealers the responsibility to not permit their customers to "self-destruct." Suitability does not generally impose upon broker-dealers any obligation to recommend a "good" product over a bad one, or a less expensive product, or a product that meets the client's objective for a tax-efficient and prudent investment portfolio. In other words, the suitability standard permits the sale of highly expensive, tax-inefficient and risky investment products, leaving the broker-dealers customer with little or no redress.

In the context of advisory recommendations, suitability serves to confine the duties of broker-dealers and their registered representatives to their customers to below that of the broad common law duty of due care. With the early 20th Century rise of the concept of the duty of due care, and the commencement of actions for breach of one's duty of due care (via the negligence doctrine that saw accelerated development during such time), broker-dealers sought a way to ensure they would not be held liable under the standard of negligence. After all, "[t]o the extent that investment transactions are about shifting risk to the investor, whether from the intermediary, an issuer, or a third party, the mere risk that a customer may lose all or part of its investment cannot, in and of itself, be sufficient justification for imposing liability on a financial intermediary."[3] This appears to be a valid view as to the duty that should be imposed upon a broker-dealer; provided, however, that the broker-dealer is only providing execution services to the customer.

The sales of mutual funds and other pooled investment vehicles exploded a thousand-fold[4] shortly following the SEC's abolition of all fixed commission rates effective May 1, 1975. No longer were broker-dealers just performing trade execution services, but they were, in fact, recommending investment managers. Yet, inexplicably, the SEC and FINRA permitted the suitability doctrine to be extended, over the decades, to incorporate broker-dealers' recommendations of investment managers. In essence, brokers continue to operate with a free hand today, unburdened by the duty of nearly every other person in the United States with respect to advisory activities, which, at a minimum, require adherence to the duty of due care of a reasonable person.

History

The fiduciary principle has its roots in antiquity. It is clearly reflected in the provisions of the Code of Hammurabi nearly four millennia ago, which set forth the rules governing the behavior of agents entrusted with property.[5] Ethical norms arising from relationships of trust and confidence also existed in Judeo-Christian traditions,[6] in Chinese law,[7] and in Greek[8] and Roman[9] eras.

Through elaboration in English law and U.S. law, fiduciary law has evolved over the centuries to refer to a wide range of situations in which courts have imposed duties on persons acting in particular situations that exceed those required by the common law duties of ordinary care and fair dealing (as exist in arms-length relationships). Fiduciary duties find their origin in a mix of the laws of trust law, tort law, contract law, and agency law. Today fiduciary status attaches to many different situations. For instance, there has long been recognition that the mere provision of advice may result in a fiduciary relationship.[10]

During the early part of the 20th Century, stockbrokers were known to possess duties akin to those of trustees, including the duty of utmost good faith and the avoidance of receipt of hidden forms of compensation. By the early 1930s, the fiduciary duties of brokers acting as financial services intermediaries were widely known.

To a degree this was simply an extension of the laws of agency. Meanwhile, early court cases confirmed the existence of broad fiduciary duties upon brokers in situations where brokers possessed relationships of trust and confidence with their clients. For example, in the 1934 case of *Birch v. Arnold*[11] involving a non-discretionary account, the relationship between a client and her stockbroker was found to be a fiduciary one, for it was a relationship based upon trust and confidence. In *Birch,* the Massachusetts Supreme Court held that, in these circumstances, facts "conclusively show that the relationship was one of trust and confidence"[12] and therefore the broker could not make a secret profit from the transactions for which the advice was provided.

The 1934 Securities and Exchange Act was an attempt to raise the conduct standards by which broker-dealers must adhere. As Matthew P. Allen observed, "Roosevelt and Congress used the 1934 Exchange Act to raise the standard of professional conduct in the securities industry from the standardless principle of caveat emptor to a 'clearer understanding of the ancient truth' that brokers managing 'other people's money' should be subject to professional trustee duties."[13] The subsequently enacted Investment Advisers Act of 1940 ("Advisers Act") was designed to apply to *investment counsel*, a relatively new type of professional who was paid directly by the customers for advice. The Advisers Act required investment advisers to register with the SEC and imposed a fiduciary duty upon investment advisers. Brokers were exempted from the registration requirements of the Advisers Act, provided that their investment advice remained "solely incidental" to the brokerage transactions and they received no "special compensation."

Early statements by the National Association of Securities Dealers (NASD), now known as the Financial Industry National Regulatory Authority, confirmed the existence of high fiduciary standards of conduct for brokers in the very early days of its existence. In only the second newsletter for its members issued by the self-regulatory organization for broker-dealers, the NASD unequivocally pronounced that brokers were fiduciaries.

The SEC also chimed in, early in its history, to confirm that broker-dealers were nevertheless fiduciaries when they assumed a role of providing personalized investment advice to their customers, stating: "Notwithstanding the absence of an explicit fiduciary standard, broker-dealers are subject to substantially similar requirements when they act as more than mere order takers for their customers' transactions."[14]

Recently the fact that broker-dealers may, when providing more than trade execution services to individual investors, possess broad fiduciary duties was confirmed by the *SEC Staff Study on Investment Advisers and Broker-Dealers (As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act)* (Jan. 2011).[15] In modern times, the courts continue to find broker-dealers and their registered representatives to be fiduciaries when providing personalized investment advice.[16]

Since the mid-1970s, broker-dealers have blurred the line between their arms-length trade execution services and the delivery of personalized investment advice. Today they customarily provide personalized investment advice, yet far too often seek to negate or deny the associated fiduciary obligations.

Additionally, in recent years registered representatives began to utilize titles that imply relationships based upon trust and confidence, to which fiduciary duties should apply, such as "financial adviser," "financial consultant," "wealth manager," etc. Yet, under state common law, the utilization of such titles remains a significant factor in determining whether a fiduciary relationship exists. For example, in a 2007 case, a registered representative crossed the line in "holding out" as a financial adviser. The registered representative sold a variable annuity and stated that ongoing advice would be provided to his customers, as well as other representations. The court found him to have formed a relationship of trust and confidence with the customers to which fiduciary status attached.[17] Moreover, over the past several decades a shift occurred to employ trust-based sales techniques,[18] leading to fiduciary status for financial and investment advisers.

Public Policy Considerations Support the Application of Fiduciary Standards upon the Delivery of Personalized Investment Advice

There are numerous reasons for imposing fiduciary duties on the range of new specializations in the delivery of certain financial services. The major reasons involve a combination of the disparity in knowledge between fiduciaries and their entrustors (clients), the difficulties in monitoring fiduciary conduct, and the promotion of important public policy goals.

The Increased Knowledge Gap Between Financial Advisers and Consumers in Today's Complex Financial World

Without question there exists a substantial knowledge gap between fiduciary investment advisers and the vast majority of their clients in today's modern, complex financial world. Indeed, the world is far more complex for individual investors today than it was just a generation ago. There exists a broader variety of investment products, including many types of pooled or hybrid products, which in turn employ a broad range of strategies.

This explosion of products has hampered the ability of individual investors to sort through the many thousands of investment products to find those few that best fit within the investor's portfolios. Furthermore, as such investment vehicles have proliferated, individual investors are challenged to discern an investment product's true total fees and costs, investment characteristics, tax consequences, and risks. As the sophistication of our capital markets had increased, so has the knowledge gap between individual consumers and financial advisers. In constructing an investment portfolio today, a financial adviser must take into account not only the individual investor's risk tolerance and investment time horizon, but also the investor's tax situation and risks to which the investor is exposed in other aspects of his or her life.

This complexity of the modern securities markets, combined with the need for investors to properly manage investment portfolios over decades as a means of ensuring their retirement security, makes reliance upon another for personalized investment advice essential. As observed by the Financial Planning Association of Australia Limited, "The average person will no more become an instant financial planner simply because of direct access to products and information than they will a doctor, lawyer or accountant."[19]

The Limited Ability of Consumers to Close the Knowledge Gap
Academic researchers have long known that emotional biases limit consumers' ability to close the knowledge gap. Recent insights from behavioral science call into substantial doubt some cherished pro-regulatory strategies, including the view that if regulators force delivery of better disclosures and transparency to investors that this information can be used effectively.

Note as well that, as observed by Professors Stephen J. Choi and A.C. Pritchard, "instead of leading investors away from their behavioral biases, financial professionals may prey upon investors' behavioral quirks … Having placed their trust in their brokers, investors may give them substantial leeway, opening the door to opportunistic behavior by brokers, who may steer investors toward poor or inappropriate investments."[20]

Moreover, Robert Prentice, who researches ethical decision making, writes, "not only can marketers who are familiar with behavioral research manipulate consumers by taking advantage of weaknesses in human cognition, but … competitive pressures almost guarantee that they will do so."[21] As a result, much of the training of registered representatives involves how to establish a relationship of trust and confidence with the client. Once a relationship of trust is formed, customers will generally accede to the recommendations made by the registered representative, even when that recommendation is adverse to the customers' best interests.

Financial Literacy Efforts, While Important, are Known to be Ineffective
Financial literacy is important, for the more educated the individual American, the better he or she will undertake financial decisions, with or without the aid of an adviser. However, financial literacy efforts are insufficient to overcome the vast knowledge gap between registered representatives and their customers.

As recently stated by Lauren E. Willis, "high financial literacy can be necessary for good financial decisionmaking, but is not sufficient; heuristics, biases, and emotional coping mechanisms that interfere with welfare-enhancing personal finance behaviors are unlikely to be eradicated through education, particularly in a dynamic market. To the contrary, the advantage in resources with which to reach consumers that financial services firms enjoy puts firms in a better position to capitalize on decisionmaking biases than educators who seek to train consumers out of them."[22]

Due to the Knowledge Gap, the Adviser Has the Ability to Abuse Trust and Power
The expert services of the fiduciary personal financial adviser are socially desirable. As in medicine or law, it can take many years to acquire the requisite degree of knowledge, skill, and experience to be a competent and effective personal financial adviser. Yet, it is this very expertise renders clients of personal financial advisers vulnerable to abuse of trust and lack of care. Hence, the advisory services undertaken by investment advisers are subject to general prescriptions under fiduciary law, as investment advisers must be free to react to a changing market environment. For example, if the fiduciary does not utilize his or her greater knowledge to promote the client's best interests, the fiduciary could usurp the delegated power, authority, or trust in advice for the fiduciary's own benefit. Accordingly, the duty of loyalty is imposed upon fiduciaries.

Reduction of Transaction Costs, when Monitoring Costs are High
In fiduciary relations, it is highly costly for the client to monitor, verify and ensure that the fiduciary will abide by the fiduciary's promise and deal with the entrusted power only for the benefit of the client. Indeed, if a client could easily protect himself or herself from an abuse of the fiduciary adviser's power, authority, or delegation of trust, then there would be no need for imposition of fiduciary duties.

Difficulty in Tying Performance Results to One's Obedience to His or Her Fiduciary Duties
The results of the services provided by a fiduciary adviser are not always related to the honesty of the fiduciary or the quality of the services. For example, an investment adviser may be both honest and diligent, but the value of the client's portfolio may fall as the result of market events. Indeed, rare is the instance in which an investment adviser provides substantial positive returns for each period over long periods of time.

Difficulty in Identifying and Understanding Conflicts of Interest
Most individual consumers of financial services in America today are unable to identify and understand the many conflicts of interest that can exist in financial services. For example, a customer of a broker-dealer firm might be aware of the existence of a commission for the sale of a mutual fund, but possess no understanding that there are many mutual funds available without commissions (i.e., sales loads). Moreover, brokerage firms have evolved into successful disguisers of conflicts of interest arising from third-party payments, including payments through such mechanisms as contingent deferred sales charges, 12b-1 fees, payment for order flow, payment for shelf space, and soft dollar compensation.

Monitoring and Reputational Threats are Largely Ineffective
The ability of "the market" to monitor and enforce a fiduciary's obligations, such as through the compulsion to preserve a firm's reputation, is often ineffective in fiduciary relationships. This is because revelations about abuses of trust by fiduciaries can be hidden (such as through mandatory arbitration clauses and secrecy agreements regarding settlements), and also because marketing efforts by fiduciary firms are so strong that they overwhelm the reported instances of breaches of fiduciary duties.

Public Policy Encourages Specialization, Which Necessitates Fiduciary Duties
As Professor Tamar Frankel, long the leading scholar in the area of fiduciary law as applied to securities regulation, once noted: "[A] prosperous economy develops specialization. Specialization requires interdependence. And interdependence cannot exist without a measure of trusting. In an entirely non-trusting relationship interaction would be too expensive and too risky to maintain. Studies have shown a correlation between the level of trusting relationships on which members of a society operate and the level of that society's trade and economic prosperity."[23]

Fiduciary duties are imposed by law when public policy encourages specialization in particular services, such as investment management or law, in recognition of the value such services provide to our society. For example, the provision of investment consulting services under fiduciary duties of loyalty and due care encourages participation by investors in our capital markets system. Hence, in order to promote public policy goals, the law requires the imposition of fiduciary status upon the party in the dominant position. Through the imposition of such fiduciary status the client is thereby afforded various protections. These protections serve to reduce the risks to the client that relate to the service, and encourage the client to utilize the service. Fiduciary status thereby furthers the public interest.

The Dodd-Frank Act: An Elegant Return to Fiduciary Principles

Through the enactment of the Dodd-Frank Act, the U.S. Congress has rightfully authorized SEC to apply fiduciary standards of conduct upon broker-dealer firms and their registered representatives who provide personalized investment advice to retail consumers. In essence, the U.S. Congress has enabled the SEC to conform brokerage practices involving the delivery of personalized investment advice, which have evolved over the course of the last few decades, to fiduciary principles that have been applied by the SEC and the courts throughout the past century.

The fiduciary standard is based upon principles, so a large number of rules need not be adopted by regulatory agencies. Indeed, the application of the fiduciary standard fulfills Wall Street's repeated call for more "principles-based regulation."

Through the Dodd-Frank Act, the U.S. Congress empowered the SEC to place restraints on the conduct of Wall Street. Specifically, in section 913 Congress explicitly authorized the SEC to promote a fiduciary standard for broker-dealers and their registered representatives providing "personalized investment advice" to "retail customers" which is "not less stringent" than the fiduciary standard applicable to registered investment advisers under the Investment Advisers Act of 1940.

The Dodd-Frank Act's application of the fiduciary standard is an elegant solution. It properly applies the standard of conduct for broker-dealer firms that have strayed into the provision of personalized investment advice.

Recommendation: Go Beyond Wall Street's Unfortunate Attempt to Redefine the Fiduciary Standard as "Suitability + Casual Disclosure"

In situations in which a fiduciary possesses a conflict of interest with a client, disclosure of such conflict is only one of the many requirements of the fiduciary duty of loyalty under the Advisers Act. Disclosure of a conflict of interest and mere consent of the client thereto does not discharge the fiduciary's obligations.[24] Instead, disclosure must be affirmatively and timely delivered in a manner designed to ensure client understanding, so that clients can provide informed consent. Moreover, it is a fundamental truth that no client would provide informed consent to be harmed.

Wall Street's lobbyists often suggest that court precedent exists for the proposition that disclosure alone is all that is required to meet the fiduciary standard when a conflict of interest is present. These lobbyists are either engaged in wishful thinking or mistaken. This argument often relies upon language found in the U.S. Supreme Court's seminal case applying the Advisers Act, *SEC vs. Capital Gains Research Bureau.* However, a correct construction of this case reveals that investment advisers are required to do much more than merely disclose conflicts.[25] This follows centuries of common law applying the fiduciary standard, including application of the time-honored phrase, "no man can serve two masters."[26]

Recommendation: Commission-Based Compensation Permitted, But Variable Compensation Restricted

Charging a retail customer on a commission basis, in and of itself, is not inconsistent with a strong and uniform fiduciary standard of conduct. The Dodd-Frank Act and the SEC's January 2011 Staff Study make it clear that a commission-based pricing model can be consistent with a fiduciary standard. However, to the extent a firm or investment professional chooses to use a commission-based pricing model, it must recognize that it creates inherent conflicts of interest that are not present in asset-based, fixed-fee or hourly-fee based pricing models.

Conflicts of interest occur when variable or differential compensation flows as a result of recommending one investment product over another. Such compensation arrangements—such as those arising from different levels of commissions, payment for order flow, sales contests, and soft dollar[27] compensation—present insidious conflicts of interest and should be banned. In other words, consistent with the fiduciary principle, and regardless of the form of compensation of the broker and its registered representative, the broker's customer should agree to a reasonable method and amount of compensation in advance of making a specific investment recommendation. Any additional compensation should be avoided or rebated back to the client.

The avoidance of variable compensation will require changes in the asset management industry. However, variable or differential compensation poses a substantial threat to the integrity of fiduciaries, as the higher compensation received for the sale of one product over a similar product with lower compensation to the adviser can rarely be justified.[28]

If a firm offers both commission-based and asset-based pricing models, the firm and the investment professional possess the obligation to recommend to the retail customer the pricing model that is in the customer's best interest, and to monitor regularly to assure that the customer remains in the account structure that is in the customer's best interest. All fiduciaries likewise possess the obligation to inform their clients that other firms may provide the substantially same services for lower fees.

Recommendation: Use International Standards

The issue of sales of proprietary products is one of the most vexing issues in applying fiduciary law to the practices of broker-dealer firms. However, banks and their trust departments have a history of selling proprietary mutual funds, when in trustee-beneficiary relationships, under guidelines provided via Office of the Comptroller of the Currency regulations.[29] Moreover, other countries, such as Australia, have recently adopted standards that must be followed by fiduciaries prior to recommending proprietary products to clients.[30] These and other regulations can be referenced as sources for appropriate standards for fiduciaries engaged in the sale of products manufactured by their firms or by affiliates.

Recommendation: Creation of a Fiduciary Board of Standards

One of the problems of securities regulation today is its focus on disclosure. In part, this is because securities examiners can test adherence to disclosure obligations fairly easily. Yet, evaluation of a professional adviser's proper adherence to the full extent of the fiduciary's duty of loyalty, and many aspects of a professional adviser's adherence to the fiduciary's duty of due care, will often require the judgment of professionals with substantial experience.

I suggest that the SEC, in conjunction with other agencies, form a "Fiduciary Board of Standards," composed only of those individual professionals fully committed to a bona fide fiduciary standard of conduct, along with representatives of consumer organizations. This Fiduciary Board of Standards would advise the SEC, the Department of Labor, the Office of Comptroller of the Currency, and state securities regulators on the development and application of professional rules of conduct.[31] Both practitioners and regulators should be permitted to seek advisory opinions from this Fiduciary Board of Standards, as a means of understanding how the fiduciary duties are applied to real-life situations. Through the board's issuance of advisory opinions and commentary on any adopted rules of conduct, the jurisprudence of the fiduciary standard can properly develop over time.

In making this recommendation, I would emphasize that the members of such a panel should be chosen for their commitment to a bona fide fiduciary standard of conduct and the interests of consumers. Otherwise, commercial self-interests could easily result in an evisceration of the true fiduciary standard of conduct.

Conclusion

The SEC should act swiftly to restore the confidence of capital markets participants by applying the fiduciary standard of conduct to the investment advisory activities of broker-dealers. It has long been known that brokers in relationships of trust and confidence with their clients are fiduciaries, despite the broker-dealers' current business models, which were permitted to occur through ineffective SEC and FINRA oversight. Disruption of these business models will necessarily occur as the SEC proceeds with rulemaking in this area.

Wall Street's call to decree a "new federal fiduciary standard" that ignores centuries of fiduciary law should be disregarded as an ill-advised attempt to lower a standard of conduct that has stood for centuries as a protector of consumer interests.

A period of adjustment should be provided for broker-dealer firms to adapt practices to meet their fiduciary obligations. However, the SEC should not delay substantially in this important rule-making effort. Only upon full implementation of the fiduciary standard for the delivery of all personal investment advice will investor confidence in our financial services system be restored, and a new era of capital formation and economic growth fostered.

Endnotes

1. See 17 C.F.R. § 240.10b-5, providing: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

2. Clifford E. Kirsch, Broker-Dealer Regulation § 1:2 (2008). The suitability standard imposes both additional substantive (fairness) and procedural (disclosure) obligations upon broker-dealers, in addition to the requirements of good faith applicable to the performance of contracts between all those in arms-length relationships. The SEC and the U.S. Consumer Futures Trading Commission (CFTC) recently summarized the broker-dealers suitability obligation as follows:

Under the federal securities laws and SRO rules, broker-dealers are required to deal fairly with their customers. This includes having a reasonable basis for recommendations given the customer's financial situation (suitability), engaging in fair and balanced communications with the public, providing timely and adequate confirmation of transactions, providing account statement disclosures, disclosing conflicts of interest, and receiving fair compensation both in agency and principal transactions. In addition, the SEC's suitability approach requires BDs to determine whether a particular investment recommendation is suitable for a customer, based on customer-specific factors and factors relating to the securities and investment strategy. A BD must investigate and have adequate information regarding the security it is recommending and ensure that its recommendations are suitable based on the customer's financial situation and needs. The suitability approach in the securities industry is premised on the notion that securities have varying degrees of risk and serve different investment objectives, and that a BD is in the best position to determine the suitability of a securities transaction for a customer. Disclosure of risks alone is not sufficient to satisfy a broker-dealer's suitability obligation.

A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 2009), available at http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf, at p.9.

3. 60 Am. U.L. Rev. 1265, 1275

4. "In 1980 there were 564 funds with assets totaling $134.8 billion." John Howat and Linda Reid, 12 Fordham J. of Corp. & Fin. Law 685, 686 (2007). The combined assets of U.S. mutual funds were $13.8 trillion dollars in April 2013, according to the Investment Company Institute ("Trends in Mutual Fund Investing: April 2013" per May 30, 2013 release by the I.C.I. available at http://www.ici.org/research/stats/trends/trends_04_13.

5. See Blaine F. Aikin, Kristina A. Fausti, Fiduciary: A Historically Significant Standard, 30 Rev. Banking & Financial Law 155, 157 (2010-11).

6. "[C]ourts have linked the fiduciary duty of loyalty to the biblical principle that no person can serve two masters." Id., at pp.157-8. See also Beasley v. Swinton, 46 S.C. 426; 24 S.E. 313; 1896 S.C. LEXIS 67 (S.C. 1896) ("Christ said: 'No man can serve two masters, for either he will hate the one and love the other, or else he will hold to the one and despise the other. Ye cannot serve God and Mammon [money].'") Id., quoting Matthew 6:24.

7. "Chinese historical texts also recognize fiduciary principles of trust and loyalty. One of the three basic questions of self-examination attributed to Confucius (551 BC–479 BC) asks: 'In acting on behalf of others, have I always been loyal to their interests?'" Aitkin and Fauti, supra n. vi. at p.158.

8. "Aristotle (384 BC–322 BC) consistently recognized that in economics and business, people must be bound by high obligations of loyalty, honesty and fairness and that society suffers when such obligations are not required." Id.

9. "Cicero (103 BC–46 BC) noted the relationship of trust between an agent and principal (known to Romans as mandatory and mandator, respectively), and emphasized that an agent who shows carelessness in his execution of trust behaves very dishonorably and 'is undermining the entire basis of our social system.'" Id. at 158-9.

10. See, e.g., Restatement (Second) of Torts § 874 cmt. a (1979) ("A fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation." citing Restatement, Second, Trusts § 2).

11. Birch v. Arnold, 88 Mass. 125; 192 N.E. 591; 1934 Mass. LEXIS 1249 (Mass. 1934).

12. Birch v. Arnold, citing Reed v. A. E. Little Co., 256 Mass. 442, 152 N.E. 918, and Wendt v. Fischer, 243 N.Y. 439, 443, 444, 154 N.E. 303.

13. Matthew P. Allen, A Lesson from History, Roosevelt to Obama - The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty, Entrepreneurial Bus. Law. J. (2010), at p. 20, citing Steven A. Ramirez, The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?, 70 U. Cin. L. Rev. 527 (2002), at p. 534 (quoting H.R. Rep. No. 73-85, at 1-2 (1933)).

14. Hazen, Thomas Lee, Stock Broker Fiduciary Duties and the Impact of the Dodd-Frank Act. North Carolina Banking Institute, Vol. 15, 2011; UNC Legal Studies Research Paper No. 1767564. Available at SSRN: http://ssrn.com/abstract=1767564. See also Rhoades, Ron A., "Shhh!!! Brokers Are (Already) Fiduciaries ... Part 1: The Early Days," available at http://scholarfp.blogspot.com/2013/04/shhh-brokers-are-already-fiduciaries.html.

15. SEC Staff Study (Jan. 2011) at pp. iv, 51. See also A Joint Report of the SEC and the CFTC on Harmonization of Regulation (Oct. 2009), available at http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf, stating: "While the statutes and regulations do not uniformly impose fiduciary obligations on a [broker-dealer (BD)], a BD may have a fiduciary duty under certain circumstances, at times under state common law, which varies by state. Generally, BDs that exercise discretion or control over customer assets, or have a relationship of trust and confidence with their customers, are found to owe customers a fiduciary duty similar to that of investment advisers … State common law imposes fiduciary duties upon persons who make decisions regarding the assets of others. This law generally holds that

a futures professional owes a fiduciary duty to a customer if it is offering personal financial advice." Id. at pp.9-10. [Emphasis added.]

16. Mathias v. Rosser, 2002 OH 2531 (OHCA, 2002).

17. Western Reserve Life Assurance Company of Ohio vs. Graben, No. 2-05-328-CV (Tex. App. 6/28/2007) (Tex. App., 2007). See also, e.g., Hatleberg v. Norwest Bank Wisconsin, 2005 WI 109, 700 N.W.2d 15 (WI, 2005) (When a bank held out as either an "investment planner," "financial planner," or "financial adviser," the Wisconsin Supreme Court held that a fiduciary duty may arise in such circumstances.)

18. Someone forgot to tell financial advisers that the use of trust-based sales techniques results in the application of fiduciary standards of conduct. In the latter half of the 20th Century, sales techniques evolved, as did salespersons' view of themselves. Codes of ethics were developed, high-pressure sales techniques sometimes disavowed, and needs-based selling became a new paradigm. This evolved into "trust-based selling" and substantial changes in the sales process, with trust as a focus:

In the past few years, many authors have recognized that in the "relational era" there have been radical changes in sales-force activities and sales management practices (Darmon, 1997; Marshall, Moncrief and Lassk, 1999; Wotruba, 1996). In brief, salesmen are expected to become value creators (De Vincentis and Rackham, 1996), customer partners and sales team managers (Weitz and Bradford, 1999), market analysts and planners (Wilson, 1993), and to rapidly shift from a hard selling to a smart selling approach (Sujan, Weitz and Kumar, 1994; Kohli, Shervani and Challagalla, 1998) … trust is a focal construct in the analysis of relationship marketing (see for example Blois, 1996; Doney and Cannon, 1997; Kumar, 1996; Morgan and Hunt, 1994).

Paulo Guenzi, "Sales-Force Activities and Customer Trust." Where do we stand today? In the 2nd edition of the textbook, Sell (Cengage Learning, 2012), Professors Ingram, LaForge et. al. state that trust, when used as a sales technique, answers these questions:

"1. Do you know what you are talking about? – competence; expertise

2. Will you recommend what is best for me? – customer orientation

3. Are you truthful? – honesty; candor

4. Can you and your company back up your promises? – dependability

5. Will you safeguard confidential information that I share with you? – customer orientation; dependability."

(Sell, p.27).

In looking closely at this list, it appears that questions 1, 3 and 5 are closely associated with the fiduciary duty of care. Question 2 is close to the proposition of "acting in the client's best interests" – one of the major aspects of the fiduciary duty of loyalty. And Question 3, acting with honesty and candor, translate into the fiduciary duty of utmost good faith.

19. Submission to the Financial System Inquiry by the Financial Planning Association of Australia Limited," December 1996.

20. Stephen J. Choi and A.C. Pritchard, "Behavioral Economics and the SEC" (2003), at p.18.

21. Robert Prentice, "Contract-Based Defenses In Securities Fraud Litigation: A Behavioral Analysis," 2003 U.Ill.L.Rev. 337, 343-4 (2003), citing Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: The Problem of Market Manipulation," 74 N.Y.U.L.REV. 630 (1999) and citing Jon D. Hanson & Douglas A. Kysar, "Taking Behavioralism Seriously: Some Evidence of Market Manipulation," 112 Harv.L.Rev. 1420 (1999).

22. Willis, Lauren E., "Against Financial Literacy Education," Iowa Law Review, Vol. 94, 2008, at p.3; U of Penn Law School, Public Law Research Paper No. 08-10; Loyola-LA Legal Studies Paper No. 2008-13. Available at SSRN: http://ssrn.com/abstract=1105384. See also Lusardi, Annamaria and Mitchell, Olivia S., "Financial Literacy and Planning: Implications for Retirement Wellbeing" (2005). Michigan Retirement Research Center Research Paper No. WP 2005-108, available at SSRN: http://ssrn.com/abstract=881847 noting that "consumers making retirement saving decisions require substantial financial literacy, in addition to the ability and tools needed to plan and carry out retirement saving plans" and confirming "survey findings about financial literacy from Bernheim (1995, 1998), Hogarth and Hilgerth (2002), and Moore (2003), who report that most respondents do not understand financial economics concepts, particularly those relating to bonds, stocks, mutual funds, and the working of compound interest; they also report that people often fail to understand loans and interest rates."

See also Fernandes, Daniel and Lynch, John G. and Netemeyer, Richard G., Financial Literacy, Financial Education and Downstream Financial Behaviors (October 8, 2013). Forthcoming in Management Science. Available at SSRN: http://ssrn.com/abstract=2333898 ("Policymakers have embraced financial education as a necessary antidote to the increasing complexity of consumers' financial decisions over the last generation. We conduct a meta-analysis of the relationship of financial literacy and of financial education to financial behaviors in 168 papers covering 201 prior studies. We find that interventions to improve financial literacy explain only 0.1% of the variance in financial behaviors studied, with weaker effects in low-income samples. Like other education, financial education decays over time; even large interventions with many hours of instruction have negligible effects on behavior 20 months or more from the time of intervention.")

23. Tamar Frankel, Trusting And Non-Trusting: Comparing Benefits, Cost And Risk, Working Paper 99-12, Boston University School of Law

24. Disclosure, in and of itself, does not negate a fiduciary's duties to his or her client. As stated in an SEC No-Action Letter: "We do not agree that an investment adviser may have interests in a transaction and that his fiduciary obligation toward his client is discharged so long as the adviser makes complete disclosure of the nature and extent of his interest. While section 206(3) of the [Advisers Act] requires disclosure of such interest and the client's consent to enter

into the transaction with knowledge of such interest, the adviser's fiduciary duties are not discharged merely by such disclosure and consent." Rocky Mountain Financial Planning, Inc. (pub. avail. March 28, 1983). [Emphasis added.]

25. See, e.g., Cmt. Letter to the SEC, dated July 4, 2013, from The Committee for the Fiduciary Standard, Exhibit A: "The Fiduciary Adviser and Conflicts of Interest: The True Meaning of SEC vs. Capital Gains Research Bureau – It is Not Just Disclosure," publicly available at http://www.sec.gov/comments/4-606/4606-3132.pdf.

26. See, e.g., Thorp v. McCullum, 1 Gilman (6 Ill.) 614, 626 (1844) ("The temptation of self interest is too powerful and insinuating to be trusted. Man cannot serve two masters; he will foresake the one and cleave to the other. Between two conflicting interests, it is easy to foresee, and all experience has shown, whose interests will be neglected and sacrificed. The temptation to neglect the interest of those thus confided must be removed by taking away the right to hold, however fair the purchase, or full the consideration paid; for it would be impossible, in many cases, to ferret out the secret knowledge of facts and advantages of the purchaser, known to the trustee or others acting in the like character. The best and only safe antidote is in the extraction of the sting; by denying the right to hold, the temptation and power to do wrong is destroyed.")

Wall Street's abusive practices, seen in the late 1920's (leading to the Great Depression) and more recently in the early part of this century (leading to the 2008-9 near-financial-collapse and the resulting Great Recession), have long been seen as fixable. "I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters.'" Harlan Stone (future Chief Justice of the U.S. Supreme Court), The Public Influence of the Bar (1934) 48 Harv. L.Rev. 1, 8-9.

27. IA Release No. 1889, In the Matter of Dawson-Samberg Capital Management, Inc. Now Known As Dawson-Giammalva Capital Management, Inc. and Judith A. Mack (2000), stating:

Soft dollar arrangements are material because of the potential conflict of interest arising from an adviser's receipt of some benefit in exchange for directing brokerage on behalf of client accounts. See Renaissance Capital Advisers, Inc., Advisers Act Rel. No. 1688, 66 SEC Docket 564, 567 (December 22, 1997); Oakwood, 63 SEC Docket at 2488; S Squared Technology Corp., Advisers Act Rel. No. 1575, 62 SEC Docket 1560, 1564 (August 7, 1996); Kingsley, Jennison, McNulty & Morse, Inc., Advisers Act Rel. No. 1396, 55 SEC Docket 2434, 2441-42 (Dec. 23, 1993) (Opinion of the Commission) ("Kingsley Opinion"); 1986 Interpretive Release, 35 SEC Docket at 909. Because the advisory clients' commission dollars generate soft dollar credits, soft dollar benefits are the assets of the clients. See Republic New York Securities Corp., Advisers Act Rel. No. 1789, 1999 SEC LEXIS 278 (February 10, 1999).

28. See, e.g., Mercer Bullard, "Protecting Investors – Establishing the SEC Fiduciary Duty Standard" (AARP Public Policy Institute, Sept. 2011) stating that Dodd-Frank Act's requirement that brokers act in the best interests of their customers "without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice" likely requires that brokers should not be "unduly motivated or influenced by the camount of the compensation the broker-dealer receives in connection with the advice," and further stating:

[B]roker-dealers that receive differential compensation, such as revenue-sharing payments from mutual funds, that varies depending on which investment they recommend, may be more vulnerable to claims that their advice was not given "without regard to the financial or other interests of the broker" than brokers that unbundle their fees and charge the same fee regardless of the investment selected …

[FN34. This unbundling incentive is also reflected in the SEC's proposed 12b-1 fee reforms. See Mutual Fund Distribution Fees; Confirmations, Exchange Act Rel. No. 62544 (July 21, 2010), pp. 244–45. The issue is analogous to the debate regarding proposed rules that implement the Employee Retirement Income Security Act of 1974 (ERISA) requirement that certain advisers' fees not be affected by the recommendations that they make to plan beneficiaries. See, generally, Investment Advice—Participants and Beneficiaries, 75 F.R. 9360 (Mar. 2, 2010) ….]

The Section 913 Study does not indicate what practices should be examined pursuant to this mandate. The most likely candidates for prohibition may be compensation practices that create financial incentives for financial professionals to favor one course of action or investment product over another, regardless of which is in the client's best interests. This would be consistent with Section 913's mandate that the fiduciary standard require a broker-dealer or investment adviser to act in the customer's best interest "without regard to [its] financial or other interest."

Id. at pp.12, 15.

29. See "Conflicts of Interest" (Comptroller's Handbook), June 2000, AM-C Int, Appendix E ("Use of Mutual Funds as Fiduciary Investments"), available at http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/conflictofinterest.pdf.

30. See Australia Securities & Investments Commission Regulatory Guide 175, "Licensing: Financial product advisers – Conduct and disclosure" (December 2012), available at http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-175-published-13-December-2012.pdf/$file/rg-175-published-13-December-2012.pdf.

31. A recent draft of model professional rules of conduct, governing the delivery of financial and investment advice, can be found within Cmt. Letter to the SEC, dated July 4, 2013, from The Committee for the Fiduciary Standard, publicly available at http://www.sec.gov/comments/4-606/4606-3132.pdf.

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Financial Institutions, the Market, and the Continuing Problem of Executive Compensation

J. Robert Brown, Jr.

Introduction

The financial crisis of 2008 occurred in part because of excessive risk taking by financial institutions.[1] Compensation formulas at some of these institutions contributed to the collapse by encouraging the maximization of short-term revenues.[2] As one report noted, compensation systems in the financial services industry were inadequately designed and "provided incentives to take imprudent risks."[3]

Excessive risk, however, was not the only problem associated with compensation that surfaced during the crisis. Payments often seemed unrelated to actual performance. Compensation formulas could result in amounts disproportionate to the services provided and could include lavish perks.[4] The practices raised broad concerns about the role of the board of directors in the corporate governance process.

The source of the problem was—and remains—surprisingly clear. Compensation has traditionally been a matter left to the discretion of the board of directors. Directors in turn have a fiduciary obligation to act in the best interests of shareholders. In the abstract, the duties would seem sufficient to require boards to develop formulas that avoided excessive risk and linked incentives to the long-term performance of the company.

In fact, fiduciary obligations impose no meaningful restraints on the type or amount of executive compensation authorized by boards. Instead, executive compensation is left to the "market" to regulate. Yet as the recent downturn shows, the market has not proved up to the task.

Congress in the new millennium has expressed dissatisfaction with the compensation process and has intervened on several occasions. The Sarbanes-Oxley Act required top officers to reimburse improperly paid compensation in certain circumstances.[5] The legislation also sought to prevent abuses in the compensation process by prohibiting loans to directors and executive officers.

During the financial crisis, temporary restraints were imposed on the compensation practices of financial institutions receiving funds under the Troubled Asset Relief Program (TARP) of 2008.[6] Permanent reforms, however, had to wait until the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[7] It authorized financial regulators to prohibit compensation practices that encouraged inappropriate risk taking. In addition, Congress sought to force corporate boards to adopt more rigorous processes for determining compensation and to give shareholders a permanent role in compensation determinations.

These efforts, although productive, represented a patchwork of changes that left the underlying problems in place. Even under proposed rules by bank regulators, boards largely remained free of meaningful limits in determining compensation. As a result, for years after the adoption of the Dodd-Frank Act, the dynamics that contributed to the financial crisis remained mostly unchanged.

Compensation without Limits: The Dearth of Regulation under State Law

The problem of executive compensation has foremost been a failure of state law. The board of directors determines executive compensation. Traditionally, decisions on CEO compensation were subjected to an exacting standard of review. Under the duty of loyalty, directors had an obligation to establish that the form and amount of compensation was "fair" to shareholders. Directors could be held personally liable to the extent that compensation might be "unfair."[8] The standard meant that boards had to engage in rigorous review of the type and amount of compensation and the impact of compensation practices on the company.

By the 1990s, however, the standard had changed.[9] Executive compensation for the most part ceased to be subject to an obligation of fairness. Instead, decisions were reviewed under the duty of care, a process oriented standard. The shift occurred with little analysis but with profound consequences. As long as companies used "proper" process, the amount and form of compensation ceased to be part of the analysis. The approach resulted in compensation without limits.[10]

The problem was exacerbated by a judicial refusal to make the process meaningful. Compensation had to be approved by a board with a majority of "independent" directors.[11] Director independence was, however, interpreted in a porous fashion. Directors who had obvious ties to the CEO[12] or significant business relations with the company were accepted as independent by courts.[13] They drew arbitrary lines and used excessive pleading standards to prevent shareholders from adequately exploring the issue.

Similarly, efforts in Delaware to heighten the involvement of directors in the oversight of risk taking at financial institutions proved unsuccessful. Shareholders brought an action alleging that the board of Citigroup failed to adequately oversee the bank's involvement in the subprime mortgage market. The court viewed the claim as little more than an attempt by shareholders to recover from a business decision that "turned out poorly" and dismissed the case.[14]

Compensation with Some Limits: Federal Intervention into the Compensation Process

The result of the state law approach was a system that did not impose substantive limits on the amount and type of compensation or adequately require boards to weigh the impact of compensation on risk taking. The lack of oversight fueled abuses and eventually provoked federal intervention. In the aftermath of Enron and Worldcom, Congress addressed the failure of state law to require the repayment of improperly paid compensation. Section 304 of Sarbanes Oxley mandated that the CEO or CFO reimburse the company for "any bonus or other incentive-based or equity-based compensation" that depended upon financial statements later restated due to "material noncompliance" arising from "misconduct."[15]

The Sarbanes-Oxley Act also addressed the lack of board oversight with respect to loans to top officials. The absence of standards under state law meant that boards could award loans to executive officers on commercially unreasonable terms (uncollateralized and below market rates) and could forego repayment.[16] Rather than elevate the standards applicable to the approval of loans, Congress opted for a more blunt approach. Congress added Section 13(k) of the Securities Exchange Act of 1934 ("Exchange Act") to simply bar personal loans to executive officers and directors of public companies.[17]

Sarbanes-Oxley, therefore, addressed some compensation issues but in a limited fashion. The obligation to "clawback" incentive based compensation following restatements fell to the Securities and Exchange Commission (SEC) rather than boards of directors. With little incentive to intervene in the internal compensation process of public companies,[18] the SEC rarely applied the provision[19] and mostly used it as an ancillary charge in conjunction with other securities law violations.[20] As a result, the broad underlying problem arising from an absence of meaningful oversight by the board of directors remained in place.[21]

The problems associated with compensation resurfaced in the financial crisis. Compensation formulas at financial institutions often encouraged excessive risk taking through the maximization of short-term earnings. In the bailout that followed, Congress imposed restrictions on compensation practices as a condition of receiving TARP funds. For those receiving "exceptional assistance," including Citigroup and Bank of America, the Department of Treasury to some degree acted as a second board of directors, reviewing and altering compensation decisions.[22]

Permanent reforms, however, had to await the adoption of the Dodd-Frank Act in 2010. The legislation toughened the procedures used by boards in approving compensation, provided an expanded role for shareholders in the compensation process, and, perhaps most importantly, gave regulators the authority to prohibit compensation practices that resulted in excessive risk taking at large financial institutions.

Section 952 of the Dodd-Frank Act mandated that listed companies employ compensation committees consisting entirely of independent directors.[23] The committee was given the authority to determine its own funding and to hire independent compensation consultants. Most importantly, the SEC received, for the first time, the explicit authority to set out standards defining director independence in connection with the compensation committee.[24]

The duty to recover improperly paid compensation was enhanced. Listed companies were required to adopt an explicit policy mandating clawbacks following certain restatements. Specifically, the policy had to provide for the clawback of incentive based compensation from current and former "executive officers" after any "accounting restatement" arising from a "material non-compliance" with "any financial reporting requirement under the securities laws" during the prior three years.[25]

Congress also authorized a direct role for shareholders in the compensation process through the introduction of "say on pay." Section 951 of the Dodd-Frank Act gave shareholders an advisory vote on the compensation paid to top executives.[26] The authority was augmented by increased transparency, particularly the obligation by companies to disclose the ratio of the median of the total compensation of all employees to the annual total compensation of the CEO.[27]

The most substantive changes, however, occurred in connection with the adoption of Section 956. The provision gave financial regulators authority over "incentive-based compensation arrangements" at "covered financial institutions," a term that included broker-dealers.[28] Regulators were instructed to prescribe regulations that prohibited any compensation practice that encouraged "inappropriate risks."[29]

The Path Forward

The Dodd-Frank Act took a number of important steps. Nonetheless, many of the underlying dynamics that induced congressional intervention into the compensation process remained in place. State law retained the inherent ability to address many of these concerns through the imposition of a stricter standard of review and more meaningful process.

This, however, is not likely to occur. Indeed, since the adoption of the Dodd-Frank Act, the lack of adequate regulation under state law has grown increasingly apparent. Efforts to challenge the compensation scheme of a financial institution that based payments on the percentage of net revenues failed.[30] Concerns over a $40 million severance package to a CEO was summarily dismissed in part because the "amount alone" was insufficient to sustain a legal challenge.[31]

Reform of compensation practices will, therefore, require increased federal intervention. In some cases, regulators already have the authority to alter compensation process but have yet to act. Financial regulators have proposed mandatory vesting periods for incentive compensation at some large financial institutions, but they have not yet completed the rulemaking process. By late 2013, the SEC had not proposed rules implementing the clawback provisions included in the Dodd-Frank Act.[32] In other cases, however, additional reform will require additional action from Congress.

Strong Corporate Governance

Section 956 of the Dodd-Frank Act gave regulators broad authority to prohibit incentive compensation practices that encouraged "inappropriate" risk taking. In the rules proposed to address this provision, the financial regulators recognized that "[s]trong and effective corporate governance is critical to the establishment and maintenance of sound compensation practices." The proposal, however, contained only cosmetic recommendations with respect to the role of boards.[33]

Regulators should be required to develop standards designed to ensure a more meaningful role for boards in the compensation process. This should entail consideration of a requirement that boards retain the burden of establishing the fairness of the compensation formula. Doing so would impose on boards the obligation to show a relationship between the type and amount of compensation and the performance of executive management. The standard would also require an affirmative demonstration by directors that the compensation scheme did not encourage excessive risk taking.

The Problem of "Excessive Compensation"

Section 956 of the Dodd-Frank Act authorized financial regulators to adopt rules prohibiting compensation practices that could "lead to material financial loss." The proposed rules address this in part through substantive regulation. Certain financial institutions would be required to defer a significant portion of incentive based compensation paid to executive officers.

The provision, however, also instructed bank regulators to prohibit practices that could result in the payment of "excessive compensation." The proposed rule contains no substantive requirements implementing this provision. Instead, the proposal merely provides that compensation should not be "unreasonable or disproportionate to the service performed" and includes a list of factors to be considered in making the determination.

Regulators should consider the need for substantive guidance on the meaning of "excessive." Moreover, while providing factors for consideration, the proposal says nothing about the standard of review for directors in making the determination.[34] Nor does the proposal impose any obligation on boards to seek repayment of amounts ultimately deemed excessive.

Improving the Process Used by Boards

The Dodd-Frank Act sent a mixed message on the process used by boards in making compensation decisions. The addition of Section 10C of the Exchange Act imposed additional requirements on compensation committees used by exchange traded companies.[35] At the same time, however, bank regulators interpreted Section 956 of the Dodd-Frank Act to require no meaningful changes to the system of governance in connection with compensation decisions by large financial institutions.

In particular, the existing system of oversight does not adequately ensure that directors involved in compensation decisions are truly independent. Regulators have the authority to address this issue. The SEC could develop a more complete set of factors for boards to consider when assessing independence.[36] Financial regulators could, as part of their supervision of risk, provide guidance on the types of relationships that will disqualify directors from participating in compensation decisions.

A potentially more effective reform, however, would be the implementation of shareholder access. Access allows long-term shareholders to include their board nominees in the company's proxy statement. Although the number of contests would likely be modest, the mere possibility would provide boards with additional incentive to act in the best interests of shareholders.[37]

Congress encouraged the adoption of shareholder access in the Dodd-Frank Act. The legislation clarified that the SEC had the authority to impose the requirement.[38] The SEC adopted a rule that sought to permit long-term shareholders to include a short slate of nominees in the company's proxy statement.[39] The U.S. Court of Appeals for the District of Columbia Circuit, however, struck down the provision.[40] The SEC, therefore, can and should revisit the issue.

Enforcement and the Role of Shareholders

For the most part, the Dodd-Frank Act left enforcement to regulators. Regulators, however, have limited resources. Likewise, they have minimal incentive to intervene into the corporate governance of public companies. Finally, as matters such as the London Whale scandal illustrate, regulators may be unaware of violations. One solution would be to provide an increased role in the governance process for shareholders.

The Dodd-Frank Act recognized the importance of shareholder involvement in the compensation process through the institution of "say on pay." It only provided an advisory vote, however, that could be disregarded by management. Second generation "say on pay" statutes have emerged in other countries. They have been designed to make the role of shareholders more meaningful.[41] In Britain, shareholders are expected to receive the right to a binding vote on compensation policies.[42] In Australia, sufficient opposition to pay packages can trigger a recall vote for the board of directors.[43]

Shareholders could also be given increased authority to enforce existing provisions. Currently, only financial regulators can police the requirements of Section 956. Likewise, the enforcement of the clawback provisions in Section 304 of the Sarbanes-

Oxley Act is limited to the SEC. Allowing shareholders to seek enforcement of the requirements would likely ensure greater compliance.

Conclusion

Executive compensation is not adequately bounded by legal standards under state law. Efforts to address these concerns by Congress have been useful but remain incomplete. The system as it currently exists does not ensure that compensation will be based upon actual performance or that the approach will not encourage excessive risk taking. Only with additional reforms can these issues be addressed.

Endnotes

1. See Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 Geo. L. J. 247, 249 (2010) ("Excessive risk-taking in the financial sector has played an important role in the major financial crisis of 2008–2009. There is widespread concern that executive compensation arrangements could have encouraged excessive risk-taking"); see also Jing Luo & Frank M. Song, CEO Option Compensation, Risk-taking and the Financial Crisis: Evidence from the Banking Industry, European Financial Management Association (Dec. 2012), available at http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2013-Reading/papers/EFMA2013_0417_fullpaper.pdf ("Our analysis strongly supports equity compensation, especially option compensation, to be one of the underlying factors causing the financial crisis."); Sudhakar Balachandran, Bruce Kogut,& Hitesh Harnal, The Probability of Default, Excessive Risk, and Executive Compensation: A Study of Financial Services Firms from 1995 to 2008, Columbia Business School Research Paper, Feb. 1, 2010, available at http://ssrn.com/abstract=1914542 ("The study of compensation incentives poses the question of whether equity-based compensation is causal: did it contribute to causing the financial crisis? The results indicate the answer is yes.").
2. Incentive Compensation Practices: A Report on the Horizontal Review of Practices at large Banking Organizations, Board of Governors of the Federal Reserve System 1 (Oct. 2011) ("Risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007."), available at http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf
3. Incentive Compensation Practices, supra note 3, at 5.
4. See Dr. Charles Elson, Christine Azar & Charles B. Vincent, Personal Use of Corporate Jets: A Call for the End of this High Flying Corporate Perk, CEO Briefing Newsletter, Dec. 27, 2012, available at http://chiefexecutive.net/personal-use-of-corporate-jets-a-call-for-the-end-of-this-high-flying-corporate-perk; see also Christina Rexrode, On Top of Big Salaries, Companies Pile on Perks, AP, May 22, 2013, available at http://bigstory.ap.org/article/top-big-salaries-companies-pile-perks
5. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, July 30, 2002. A copy of the law is here: http://uscode.house.gov/statutes/2002/2002-107-0204.pdf
6. See Section 101, et seq, Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, Oct. 3, 2008, available at http://www.gpo.gov/fdsys/pkg/PLAW-110publ343/html/PLAW-110publ343.htm
7. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, July 21, 2010. A copy of the law is here: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf
8. See Julian v. Eastern States Const. Service, Inc., 2008 WL 2673300 (Del. Ch. July 8, 2008).
9. See J. Robert Brown, Jr., Returning Fairness to Executive Compensation, 84 N.D. Law Rev. 1141, 1149-1154 (2009). See also Randall S. Thomas & Harwell Wells, Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties, 95 Minn. L. Rev. 846, 848 (2011) (noting that courts have historically regulated compensation through the "confines of the waste" but that doctrine "is much too weak to lead to meaningful scrutiny in most cases.").
10. For a discussion of this shift, see J. Robert Brown, Jr., Disloyalty Without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty, 95 Ky L. Rev. 53, 57-70 (2006-2007).
11. The court viewed the presence of a majority of independent directors as eliminating the taint of the conflict of interest. The approach, however, did not require that actual removal of the interested influence. Thus, the compensation decision was entitled to review under the business judgment rule even when the CEO participated in the debate or even voted on the matter. See Brown, supra note 10, at 1150.
12. See discussion of the Disney case and the "saga of two Michaels," Disloyalty Without Limits, supra note 11, at 93-98.
13. See In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del.Ch. Oct. 12, 2011) (director independent despite allegations that company "invested at least $670 million in funds managed by" the director; court found the allegations inadequate because "the complaint does not allege that [the director] relies on the management of these funds for his livelihood"); see also In re Goldman Sachs Group, Inc. Shareholder Litigation,

2011 WL 4826104 (Del.Ch. Oct. 12, 2011) (director independent despite allegations that he was the CEO and chairman of a company where Goldman to arranged financing in the "billions of Euros" and provided loans "in the aggregate amount of 464 million euros"; the court reasoned that "Goldman is an investment bank" and the "fact '[t] hat it provided financing to large ... companies should come as no shock to anyone. Yet this is all that the plaintiffs allege.'").

14. In re Citigroup, Inc. Shareholder Derivative Litigation, 964 A.2d 106, 124 (Del. Ch. 2009) ("When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company.").
15. See Section 304 of Sarbanes Oxley (codified as 15 USC §7243). The requirement of reimbursement applies even where the CEO and CFO have not been alleged to have participated in the misconduct. See SEC v. Baker, 2012 WL 5499497 (W.D.Tex. Nov. 13, 2012) ("A CEO need not be personally aware of financial misconduct to have received additional compensation during the period of that misconduct, and to have unfairly benefitted therefrom.").
16.See J. Robert Brown, Jr., Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance, 90 Marq. L. Rev. 309, 330-334 (2006).
17. Section 402 of Sarbanes Oxley (adding Section 13(k) to the Exchange Act, 15 USC §78m(k)).
18. The provision effectively transformed the SEC into a collection agency on behalf of the company. Any payments obtained under the Section were simply returned to the company. See In re Navistar International Corp., Exchange Act Release No. 62653 (admin proc Aug. 5, 2010) ("If the CEO and CFO do not voluntarily reimburse the issuer, the Commission can bring an enforcement action to compel reimbursement.").
19. SEC v. Baker, 2012 WL 5499497 (WD Tex. Nov. 13, 2012) ("For reasons best known to the SEC, the Commission has been historically reluctant to utilize § 304 in the ten years since Sarbanes—Oxley was enacted."). The SEC settled the first case using § 304 in 2008, see SEC v. UnitedHealth Group, Inc., Litigation Release No. 20836 (D. Minn. Dec. 22, 2008) (noting that pending settlement was "the first with an individual" to clawback compensation under Section 304), and brought the first "stand alone" case under the section in 2009. See SEC v. Jenkins, Litigation Release No. 21149 (D Ariz. July 23, 2009) (describing case at "the first action seeking reimbursement under Section 304 from an individual who is not alleged to have otherwise violated the securities laws.").
20. SEC v. Baker, 2012 WL 5499497 (W.D.Tex. Nov. 13, 2012) (noting that most SEC claims under Section 304 were generally "ancillary" and stood "alongside more traditional securities causes of action").
22. The NYSE and NASDAQ did adopt stricter definitions of director independence in the aftermath of Enron. The definitions did not, however, replace the one used by state courts. See Exchange Act Release No. 48745 (Nov. 4, 2003). Concerns with these definitions, however, remain. See Comment Letters to Exchange Act Release No. 68011 (Oct. 9, 2012), available at http://www.sec.gov/comments/sr-nyse-2012-49/nyse201249.shtml.
22. See Program Status, Executive Compensation, TARP Program, available at http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/executive-comp/Pages/status.aspx
23. Section 952 of Dodd-Frank (adding Section 10C to the Exchange Act, 15 USC §78j-3).
24. The SEC was authorized to define the "factors" used in determining director independence. See Section 10C, 15 USC §78j-3.
25. Section 954 of Dodd-Frank (adding Section 10D to the Exchange Act, 15 USC §78j-4).
26. Section 951 of Dodd-Frank (adding Section 14A to the Exchange Act, 15 USC §78n-1). The SEC implemented the requirement in 2011. See Rule 14a-21, 17 CFR § 240.14a-21. Say on pay, by regulating the voting rights of shareholders, represented the most obvious and significant intrusion into what had traditionally been an exclusive purview of state regulation.
27. See Section 953(b) of Dodd-Frank. The SEC has proposed a rule designed to implement this requirement. See Exchange Act Release No. 70443 (Sept. 18, 2013).
28. Section 956 of Dodd-Frank. The restrictions did not apply to covered financial institutions with assets of less than $1 billion. Section 956(f).
29. Section 956(b) of Dodd-Frank.
30. See In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del.Ch. Oct. 12, 2011) ("The decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment.").
31. See Zucker v. Andreessen, 2012 WL 2366448 (Del.Ch., June 21, 2012) ("Be that as it may, 'the size of executive compensation for a large public company in the current environment often involves large numbers,' and 'amount alone is not the most salient aspect of director compensation' for purposes of a waste analysis.").
32. The actions taken by the SEC on the governance provisions of Dodd-Frank are here: http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtm
33. See Exchange Act Release No. 64140 (March 29, 2011), available at http://www.sec.gov/rules/proposed/2011/34-64140.pdf (noting that board should "actively oversee the development and operation of a covered financial institution's incentive-based compensation systems and related control processes", including approval of "the overall goals and purposes of the covered financial institution's incentive-based compensation system and ensure its consistency with the institution's overall risk tolerance.").
34. Section 956 did indicate that the standards adopted under the provision should be "comparable" to those contained in the Federal Deposit Insurance Act. See 12 U.S.C. 2 1831p–1. Subjecting the board to an increased standard of review would seem consistent with this obligation.

35. 15 USC §78j-3. The rules ultimately adopted by the SEC did not adequately ensure the independence of the committee. Rule 10c-1 left some control over the funding of the committee with the board. 17 CFR §240.10c-1. The Rule provided only that the compensation committee receive adequate funding "for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser retained by the compensation committee." 17 CFR § 240.10c-1(b)(3). This can be compared with the listing standards for audit committees. In addition to the authority to determine reasonable fees for consultants, the audit committee has the right to fix a budget that also includes "ordinary administrative expenses" that are "necessary or appropriate in carrying out its duties". 17 CFR § 240.10a-3(b)(5). As a result, the full board retains significant financial control over the budget of the compensation committee.

36. See Rule 10c-1, 17 CFR §240.10c-1.

37. In adopting Rule 14a-11, the SEC estimated that there would be approximately 45 contests under the Rule. See Exchange Act Release 62764, at n. 806 (Aug. 25, 2010). This is in a population, according to one estimate, of 15,000 public companies. See Exchange Act Release No. 53385 (Feb. 28, 2006).

38. Section 971 of Dodd-Frank (adding subsection (2) to Section 14(a) of the Exchange Act, 15 USC 78n).

39. Rule 14a-11, 17 CFR § 240.14a-11.

40. The rule was struck down in Business Roundtable v. SEC, 647 F.3d 1144 (DC Cir. 2011). The case is discussed in J. Robert Brown, Jr., Shareholder Access and Uneconomic Economic Analysis: Business Roundtable v. SEC, 88 Denver University Law Review Online (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1917451

41. The Swiss approved a binding vote on compensation in a referendum. See Raphael Minder, Swiss Voters Approve a Plan to Severely Limit Executive Compensation, N.Y. Times, March 3, 2013, available at http://www.nytimes.com/2013/03/04/business/global/swiss-voters-tighten-countrys-limits-on-executive-pay.html

42. Government announces far-reaching reforms of directors' pay, UK Dept. for Business Innovation & Skills, June 20, 2012, available at http://news.bis.gov.uk/Press-Releases/Government-announces-far-reaching-reforms-of-directors-pay-67b96.aspx

43. See Improving Accountability on Director and Executive Remuneration Act 2011. A copy of the legislation and its Parliamentary history can be found here: http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id:legislation/billhome/R4520.

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The Challenges of Regulatory Enforcement

Brad Miller

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 internali[zed], 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 stoke 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 it's 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 flourishin' 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
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Some Examples of Shadow Banking Transactions

An independent mortgage broker takes an application for a prospective homebuyer and submits it for approval to a finance company, which finances the loan and sells it on to an industrial loan company that gathers and warehouses loans and sells them in bulk onto the financial markets. A broker-dealer subsidiary of a major bank places the loans into a bankruptcy-remote special purpose vehicle where they are structured into a mortgage-backed security underwritten by the broker-dealer. While the special purpose vehicle is a separate entity and bankruptcy remote, it is often enhanced by guarantees offered by the underwriting bank. Thanks to subordination, the senior tranches of these securities are seen as low risk and are attractive to institutional investors.

More junior tranches of mortgage-backed securities are less attractive to outside investors and accumulate in the inventory of a broker-dealer. The broker-dealer structures the tranches into a new securitization with its own subordination structure and adds credit guarantees from outside insurers. The newly structured collateralized debt obligation (CDO) is held by a special purpose vehicle, which funds the purchase using commercial paper backed by the CDO cash flows. The commercial paper is sold to entities such as money market funds or local government excess cash pools, which need a short-term investment that provides a return on their extra cash. The revenue from the CDO sale and the excess spread helps the broker-dealer purchase more loans from warehouse lenders, making loan financing more available to retail borrowers.

A bank makes a billion dollars of risky loans to shipping companies. Concerned at the amount of capital regulators require it to hold against this exposure, it sets up a trust which writes a credit default swap guaranteeing the first $100 million in losses from the loans, in exchange for periodic premium payments by the bank. Investors in the trust receive the right to the premium payments in exchange for purchasing shares of securities issued by the trust. The transfer of default risks from the loans to outside investors not subject to regulatory capital requirements allows the bank to reduce the capital backing the loans.

An insurance company invests its premiums in stocks and bonds. To earn additional returns, it loans these securities to hedge funds and asset management companies seeking to sell short and hedge their long exposures. In exchange for the loan, it receives cash collateral plus a small fee (while continuing to earn the returns on the loaned securities). This cash collateral is reinvested in short-term commercial paper backed by credit card receivables. This reinvestment is usually low risk, but if the commercial paper defaults the insurance company must sell off securities, possibly at a loss due to the forced and rapid nature of the sale, in order to return the cash collateral.

What Is Shadow Banking?

All of the examples above represent so-called "shadow banking" transactions in modern financial markets. They demonstrate several of the key characteristics of shadow banking and the way it contrasts with the canonical model of commercial or relationship banking:

- Credit intermediation chains—the series of steps that transfer cash from a saver/investor to a final consumer or borrower—are much longer, more complex, and less transparent than under the commercial banking model.

- Credit intermediation chains include both regulated banks and unregulated non-banks.

- In shadow banking, credit is market mediated—exchanged and priced in markets for traded securities—rather than held on the books for a long period at the originating institution.

- Shadow banking is collateral intensive. The extensive use of private collateral to backstop liabilities provides some of the assurance that might otherwise come from an explicit government backstop such as insurance of deposits in commercial banks.

- The shadow banking system performs extensive credit, liquidity, and maturity transformation outside of the banking system. That is, shadow bank intermediation converts illiquid, risky, long-term assets into "safe" and liquid short-term securities. This made it possible to offer wholesale investors a combination of attractive securities returns along with seemingly low-risk "deposit-like" access to liquid funds. Such transformation is enabled by the use of collateral, and also by diversification, subordination, and guarantees provided by private parties.

The market-mediated nature of shadow banking is a key contrast to relationship banking under a Glass-Steagal Act type division between commercial banking and the financial markets. In its strongest form, relationship banking eliminates market trading altogether by requiring intermediaries to hold credit to maturity on their balance sheet. In contrast, the vast global markets central to shadow banking—such as the derivatives market, the securitization market, and the securities lending market—permit the continuous disaggregation and trading of risk through exchange markets.

Shadow banking is central and significant to the modern financial system. By 2007, over 60 percent of financial sector liabilities were funding shadow banking and less than 40 percent funded "traditional" regulated liabilities such as bank deposits, checking accounts, interbank loans, and declared reserves of insurance companies.

This compares to 1970, when some 80 percent of financial sector liabilities funded traditional forms of financial intermediation.[1] Another way of looking at the growth of shadow banking is through the proportion of end user, or real economy, liabilities funded through bank deposits. In 1980, 40 percent of end user liabilities were funded through bank deposits, while by 2007 the fraction had dropped to 23.6 percent.[2] Post-crisis the size of the "traditional" sector has rebounded somewhat but still accounts for only about half of total financial sector funding.[3]

However, the new centrality of market mediation should not be taken to indicate that banking entities themselves are no longer central to the system. The markets that are vital to shadow banking are heavily dependent on banks as market makers, dealers, and guarantors. These dealer banks play a central role in the system and have been, in a sense, its private regulators and sources of liquidity. Recent research has documented that banks and their subsidiaries supported and continue to support over 75 percent of major securitizations through the use of guarantees.[4] The U.S. derivatives market is dominated by the four largest commercial banks. A few major banks dominate the market for repurchase agreements (repo) as well.[5] Thus, bank holding companies are still essential to the system, but traditional relationship banking activities appear to be growing less and less significant compared to broker-dealer activities.[6]

The financial crisis of 2008 was to a large degree a crisis of shadow banking. Supposedly separate non-bank "shadow" entities (e.g. securitization conduits, structured investment vehicles, and, in some cases, hedge funds) failed first, challenging the solvency of undercapitalized parent banks, which had to execute on guarantees to these entities. Stressed banks sold off the asset-backed securitizations used as collateral for their borrowing, driving down valuations of these securities. This triggered margin calls across the repo and credit default swap markets that continued to drive down collateral values and stress bank balance sheets. The spiraling decline in collateral values and questionable solvency or failure of key dealer institutions created a massive run on interbank lending markets and on institutions such as money market funds dependent on bank-issued liabilities such as commercial paper. As many observers have pointed out, the crisis resembled a traditional run on the banking system, mediated not through deposits but through the interrelationships created by shadow banking.[7]

Some Benefits and Costs of Shadow Banking

Shadow banking may be beneficial because it allows borrowers to access funds from a wider variety of investors with a wider variety of risk preferences. The ability to transform cash flows from relatively illiquid assets such as long-term individual loans into liquid, tradable, diversified securities benefits investors interested in holding securities that provide a return and can be converted into cash relatively easily. The ability to customize securities also allows the creation of risk-return tradeoffs that are maximally attractive to all types of investors. Demand deposit products offered through commercial banking traditionally never offered the range and scope of risk-return combinations available through market-mediated credit. Consistent with this argument, the expansion of shadow banking prior to the financial crisis coincided with and helped fuel a large increase in the sheer volume of available credit.

Another benefit of shadow banking is that it opens up possibilities for gains from specialization by credit providers, including both superior knowledge due to specialization in a single area of the market and economies of scale made possible by specializing in particular credit intermediation functions. Non-bank finance companies and credit guarantors can specialize in niche areas of the market that were not well served by banks. For example, some researchers have argued that non-bank finance companies have traditionally been superior to banks at servicing specialized consumer credit markets such as subprime auto lending and credit cards, as well as low quality corporate credits including airlines.[8]

Finally, it is important to remember that market mediated credit is not new. Traded credit instruments such as corporate bonds and forms of short-term commercial paper are at least as old as the depository banking system. More recently, some of the more sophisticated techniques used in the modern shadow banking system were pioneered in the (implicitly) government-backed housing markets, which was also designed to increase credit availability through the conversion of illiquid long-term, fixed-rate mortgages into liquid tradable securities. Entities such as the Federal Home Loan Banks, Fannie Mae and Freddie Mac have played roles similar to private sector warehouse lenders, securitization underwriters, and credit guarantors in shadow banking.

However, the growth in the size and complexity of private shadow banking over the past two decades has indisputably represented a major shift away from the commercial banking model dominant under the New Deal banking regulation. The clear relationship between the growth of shadow banking and the destructive 2008 financial crisis has highlighted the potential costs of under-regulated market mediated credit.[9] There are two broad categories of such costs. The first is the opportunity for deception and exploitation created by the long, complex credit intermediation chains characteristic of shadow banking. The second—and related—cost is a major increase in financial fragility.

The long credit intermediation chains in shadow banking made monitoring of counterparties very difficult, and eliminated incentives for any one actor in the chain to ensure quality underwriting. In each step of the chain, there were potential agency problems, or incentives for sellers to deceive buyers.[10] Under the relationship banking model, the originator of credit must hold it for an extended period, and has a strong incentive to underwrite properly. When securities are originated for sale in a market mediated system, the incentive may only be to create a product that will appear attractive to a buyer over the short term. Securities produced by the shadow banking process were misrepresented in numerous ways by multiple actors, ranging from originators who lied about the income of borrowers to underwriters and credit rating agencies that cooperated to mislead investors concerning the risks of structured securities. The "free lunch" combination of attractive returns and high short term liquidity seemingly offered to investors by shadow banking may simply have rested on concealing risks. When those risks became fully evident, liquidity vanished. Shadow banking may have channeled risk not to those best able to bear it, but to those least able to understand it.

Second, shadow banking increased financial fragility. While it was once believed that securitization and shadow banking could improve financial stability by better distributing credit risks across a range of investors, since the financial crisis economists have developed a better understanding of how much credit risk remained within financial intermediaries due to guarantees and similar off-balance-sheet relationships.[11] Shadow banking enabled massive increases in financial sector leverage that were concealed from regulators and counterparties through the complexity of the system. The ability of banks to arbitrage capital requirements through the apparent transfer of risk to outside investors has been well documented.[12] These commitments, along with the full scope of funding flows through the shadow banking system, were not visible on the bank balance sheet scrutinized by regulators.

Securitization also created vast increases in effective leverage that were embedded in structured securities. For example, by 2006, $1 of equity investment in a mezzanine CDO supported over $111 of subprime mortgages.[13] Thus, even small losses had a drastic impact on credit availability. The apparent effectiveness of shadow banking in leveraging investor capital to create high volumes of lending was catastrophically reversed when losses began to occur.

In addition to high leverage levels, the dependence of shadow banking on market intermediation and collateralized lending linked liquidity very tightly to volatile market prices. This mark-to-market (or fair value accounting) character of finance made the entire system extremely pro-cyclical—in other words, it was vulnerable to booms and busts.[14] In periods of rising asset prices, balance sheet capacity expands drastically due to increases in the value of collateral. The heavy dependence on collateralized short-term lending in shadow banking markets means that increases in market valuations of collateral enable much higher levels of borrowing, lending, and liquidity. But when market prices come under question, the process reverses and a negative price spiral ensues. Such negative price spirals are analogous to bank runs, except mediated through margin calls and market "fire sales" of securities rather than through depositor withdrawals of funds. Just as rises in collateral pricing support rapid expansion of leverage, declines in the market valuation of collateral translated almost instantly into pressures on bank liquidity and solvency.

Perhaps the clearest example is in the market for repurchase agreements, which were a key source of liquidity for broker-dealers and many buy-side investors. The funds available through these agreements were directly linked to the current market valuation of securities collateral. When the value of this collateral dropped, the funding stream of dealer banks was immediately threatened. The heavy dependence on overnight repo meant that problems in rolling over debt occurred with 24 hours, and margin calls resulted for longer-term repo commitments. The need for additional funding forced asset sales, which further depressed the value of repo collateral, causing more funding shortfalls and additional "fire sales" of securities. There was no effective government backstop to halt this process.

The financial fragility created by shadow banking can be contrasted to the situation of commercial banking. Commercial banking can be highly unstable due to depositor runs if there is no government insurance for deposits. When there is such insurance, commercial banking stability is still vulnerable to weak regulatory oversight, since access to government deposit insurance creates incentives for banks to take excessive risks. But the assumption that banks will hold credit to maturity (or at least for a long period) rather than trading it means that accounting valuations are generally based on historical cost, not current market prices. This can be problematic if regulators refuse to force banks to recognize losses on assets that are genuinely and permanently impaired. However, it also means that losses can be managed over a much longer time period, allowing much more time for planning and resolution than if bank stability was immediately threatened by volatility in market prices. Furthermore, in a commercial or a relationship banking system, the full nature of bank liabilities and assets should be much more visible to a supervisor, as there are fewer off balance sheet risk transfers and less dependence on long credit intermediation chains.

Regulating Shadow Banking

Shadow banking poses fundamental challenges to regulatory oversight of the financial system. These challenges involve the measurement and oversight of risk, the ease of regulatory arbitrage when risk and activities move easily between the regulated and unregulated entities, and the difficulty in defining the perimeter of the public safety net.

Such challenges are made even more difficult by the fragmentation of the U.S. financial regulatory system. Regulation is still shaped around a distinction between financial markets and banking entities that the repeal of the Glass-Steagal Act and the growth of shadow banking has rendered obsolete. For example, market regulators such as the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) are separate from prudential regulators of individual banking entities such as the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). The authority of the Federal Reserve to oversee bank holding companies is also essentially a prudential authority over individual banking entities. The separation between jurisdiction over markets and jurisdiction over entities divides regulation in a way that makes it difficult to oversee the relationships created by shadow banking. The Dodd-Frank Act has taken some steps toward addressing this regulatory fragmentation by creating a council of regulators—the Financial Stability Oversight Committee—to oversee systemic risk, and expanding the systemic authority of the Federal Reserve in various ways. Yet the essential division in jurisdiction remains, and it continues to pose a challenge for regulatory integration.[15]

The Dodd-Frank Act did not specifically target key elements of shadow banking. For example, the legislation contains no explicit consideration of key shadow banking markets such as securities lending and repo, or wholesale investors in the shadow banking system such as money market funds. However, many elements of the Dodd-Frank Act have profound implications for shadow banking. In addition, regulatory actions by the Federal Reserve, both independently and as part of the Basel III process, have explicitly targeted shadow banking issues.

Below, I discuss the relationship between shadow banking and three essential regulatory toolkits for addressing systemic risk: rationalizing the safety net, instituting restrictions on bank activities, and improving prudential regulation and supervision. The rise of shadow banking creates challenges for each form of regulation that have not yet been fully addressed.

Rationalizing the Safety Net

The scope of government guarantees and liquidity support—the perimeter of the safety net—is crucial to properly disciplining the financial sector and making financial regulation effective. Access to the safety net permits financial actors to behave irresponsibly by expanding in ways that increase profits but threaten financial stability. Counterparties permit this since they understand that government guarantees will be available in case of failure. When the perimeter of the safety net is aligned with the effective scope of government oversight, then regulators can at least theoretically limit this harmful behavior. When it is not, profit-motivated financial entities that are guaranteed but unregulated can increase their activities in ways that benefit them but create major negative externalities for the economy as a whole.

Yet properly aligning the scope of the safety net with the boundaries of regulation is not as simple as making a pre-commitment to support only regulated entities. Once financial stability is threatened, regulators face a powerful incentive to assist entities whose failure would seriously damage the broader economy, regardless of whether those entities are within the scope of the pre-crisis safety net. If such institutions truly are central to the economy, the failure to support continuation of their activities can greatly multiply the human suffering and economic harm created by a financial crisis. On the other hand, the ad hoc expansion of the safety net in ways that protect financial actors from the consequences of their own behavior can create moral hazard that prevents needed adjustment and plants the seeds for the next crisis.

Navigating this dilemma is not easy. The experience of the 1929 crash, driven by the "liquidationist" philosophy of Andrew Mellon and the contractionary policies of the Federal Reserve, shows the dangers of an insufficiently aggressive response to crisis. But the experience prior to and during the 2008 crisis demonstrates some dangers of an overly permissive expansion of the safety net in response to financial stress.

Prior to the crisis, the expansion of the shadow banking sector was indirectly supported by implicit or assumed expansions of the government safety net beyond commercial banking. As mentioned above, shadow banking activities were heavily dependent on private guarantees from entities such as investment banks and insurance companies. In cases where these guarantors had access to the government safety net, their private guarantees implicitly passed on the benefits of government safety net support to non-bank counterparties. Many factors contributed to uncertainty about the boundaries of the effective government backstop, including the increasing size and centrality of dealer banks important in the shadow banking system, and the intermingling of dealer and commercial bank activity. As well, there is a recent history of informal government support for the financial market as seen in the 'Greenspan put' and brokered assistance for hedge fund management firms such as Long-Term Capital Management. To highlight an example, Lehman Brothers Holdings, an investment bank, assured counterparties of its stability by claiming access to the Federal Reserve discount window through its relatively small commercial banking subsidiaries.[16]

Finally, over the decade prior to the crisis, there was an increasing subsidy to derivatives and repo markets central to shadow banking through the expansion of exemption from bankruptcy laws.[17] Bankruptcy exemptions give users of derivatives and repo a significant advantage over all other creditors, in that derivatives and repo obligations are given first priority in distributing the assets of a failing company. The bankruptcy stay is crucial to the operation of these markets and constitutes implicit public support.

During the financial crisis, government stepped in to replace private guarantors in backing a broad range of shadow banking activities. The ability of private banks to act as guarantors of the shadow banking system came under question in the early phases of the crisis. The Federal Reserve responded by using its previously dormant 13(3) authority for emergency lending to create credit facilities that acted as the "dealer of last resort," supporting the value of shadow banking collateral and shadow maturity transformation performed through the commercial paper market.[18] Later in the crisis, when these interventions appeared inadequate and Lehman Brothers demonstrated the consequences of the failure of a major investment bank, the federal government stepped in with a massive ad hoc expansion of the pre-crisis safety net. The government rescued American International Group (AIG), a major private guarantor of shadow banking collateral, guaranteed the value of money market funds previously outside the safety net, guaranteed the debt of the entire banking sector, rapidly committed to support investment banks nominally outside the pre-crisis safety net, and, of course, made Troubled Asset Relief Program (TARP) capital infusions to save failing banks from resolution. As researchers have documented, in aggregate the terms and duration of intervention went far beyond any traditional principles of "lender of last resort" support.[19]

The Dodd-Frank Act was passed while these unprecedented interventions were still ongoing. It was shaped by two conflicting imperatives. First, widespread public outrage at a seemingly indiscriminate government bailout of the entire financial sector created pressure to cut back the safety net. But at the same time, many regulators felt the experience of the financial crisis demonstrated the inadequacy of a safety net limited to commercial banking and deposits alone, and sought statutory authority for future interventions that better matched the new shape of the financial sector.

These conflicting pressures led to a complex set of changes that expand the scope of the safety net in many ways while contracting it in others. In cases where the safety net is expanded, the legislation seeks to blunt the moral hazard effect by placing additional legal limitations on public support and increasing the "cost sharing" of the financial sector in safety net interventions.

When compared to the ad hoc crisis interventions, the Dodd-Frank Act places new legal restrictions on government assistance. However, when compared to the explicit pre-crisis safety net, the legislation expands the formal safety net in several important ways:

- Title II resolution authority creates an avenue for public (Treasury) liquidity funding to systemically important failing financial institutions. The potential scope of this public support goes well beyond commercial banking and includes broker-dealer subsidiaries of investment banks, as well as non-banks designated as systemically significant.

- The Dodd-Frank Act permits derivatives clearinghouses to directly access liquidity support from the Federal Reserve discount window. At the same time, however, other sections of the Dodd-Frank Act grant regulators greater oversight over these clearinghouses.

- Section 1101 creates a new framework for Federal Reserve use of its 13(3) lending authority. Before 2007, this authority had never been used at any scale. While Title XI places new limitations on 13(3) authority—limiting its use to the creation of generally available lending facilities serving solvent institutions—these restrictions are at least nominally compatible with the "dealer of last resort" interventions used in the financial crisis. This section thus ratifies future use of this authority to support the value of collateral in shadow banking markets.

- Section 1105 authorizes an emergency guarantee of all bank debt similar to the FDIC debt guarantee programs created during the financial crisis. Unlike

Federal Reserve use of emergency lending authority under Section 1101, the Section 1105 guarantee authority requires explicit Congressional approval.

At the same time, the Dodd-Frank Act also limits the safety net in several ways, especially when compared to the ad hoc and arguably extra-legal bailout programs put in place during the crisis.

- The new resolution authority in Title II also gives regulators authority to impose losses on executives, stockholders, and creditors of a failing financial institution through a resolution and liquidation process. The broader financial sector must also eventually pay back any public losses experienced through the resolution authority.

- As discussed above, while Title XI gives explicit authority for several major crisis interventions, it also places certain new restrictions on them.

- The "swaps push out" provision in Section 716 of the Dodd Frank Act separates customized credit default swaps and other types of dealing in exotic derivatives from the depository institution, eliminating deposit insurance support for these activities.

- The Dodd-Frank Act bans the use the Exchange Stabilization Fund to insure money market funds, as was done during the crisis.

The full impact of these changes will be difficult to understand until the new safety net is tested in a crisis. Two vital questions are the use of Title II resolution authority and 13(3) authority, both of which are powerful tools that do not require Congressional approval. In both cases, the Dodd-Frank Act leaves regulators significant discretion to balance the potential need for broad assistance in order to maintain financial stability during a crisis, with the need to ensure accountability, minimize moral hazard, and properly delimit the scope of the public safety net. Even given this regulatory discretion, the statutory language clearly mandates an emphasis on accountability and strong limitations on indiscriminate assistance.[20]

Unfortunately, early signs are that regulators may be leaning toward a greater emphasis on the ability to provide liquidity assistance during a crisis than on fulfilling the accountability mandate of the Dodd-Frank Act. It is concerning that the "single point of entry" approach to resolution has at times been portrayed as involving indiscriminate support of the full range of bank subsidiaries in order to maintain the value of the institution.[21] The provisions for executive accountability under resolution authority proposals are also weak.[22] The failure of the Federal Reserve to promote the required regulations to limit emergency lending also raises serious concerns.[23]

When combined with the extremely broad exercise of safety net support during the 2008 crisis, the failure of regulators to make a strong commitment to limit indiscriminate intervention during future financial stress causes reasonable concern that extensive public support could again flow to shadow banking and related dealing activities. This undermines incentives for private market oversight and emphasizes the need to properly oversee shadow banking and align regulatory controls with the potential for public subsidy.

Activity Limitation

Shadow banking involves the expansion of bank involvement in financial market activities previously banned under Glass-Steagal Act limitations. As argued above, the fusion of financial market and banking activities is central to the increase in complexity, financial fragility, and interconnectedness created by shadow banking. The limitation of banking activities to restore a more effective separation between commercial banking and financial markets is thus an appealing response. There are an almost infinite variety of schemes for such limitation, but in this section I will focus on activity limitations under the Dodd-Frank Act, especially the Volcker Rule.

The Dodd-Frank Act does not rely heavily on activity limitations. In most cases, the legislation takes the approach of continuing to permit the full range of financial market activities that existed prior to the crisis, but instructing regulators to improve risk management, transparency, and prudential governance of those activities. For example, the Dodd-Frank Act continues to permit trading in over-the-counter or customized derivatives, but requires that those with sufficient liquidity be executed through a clearinghouse, and all must be reported.

The great exception to this approach is the Volcker Rule.[24] The Volcker Rule bans proprietary trading in banking institutions, and also requires that major banks eliminate material conflicts of interest and limit connections to off-balance sheet entities such as hedge funds and securitization vehicles. If properly implemented, these changes would significantly shift the banking business model and fundamentally change the relationship between regulated dealer banks and the shadow banking system of market-mediated credit.

Unlike the Glass-Steagall Act, however, the Volcker Rule explicitly permits financial market involvement by banks. In fact, it specifies that banks may engage in market making and underwriting to the extent that such financial market activities do not generate systemic or prudential risk or result in material conflicts of interest. Thus, the Volcker Rule challenges regulators to craft a new definition of the dealer or market maker role that is more stable and reliable due to the removal of proprietary trading incentives, but is still able to support market-mediated credit. In other words, regulators are being asked to define a reliable utility role for dealer banks in the financial markets.

This mandate makes sense. Contrary to some criticisms of the Volcker Rule, the proprietary trading incentives of dealer banks did contribute to the 2008 financial crisis.[25] For example, major dealer banks significantly overextended their capital and liquidity in chasing profits from the real estate bubble through underwriting, securitization, and other activities, and were unable to act as a stabilizing force in the market during the crisis.[26] The conflicts of interest involved in their simultaneous role as market intermediaries, proprietary traders, securitization managers, and underwriters also helped to drive exploitative and fraudulent behavior during the crisis.

Unfortunately, so far regulators appear to be somewhat paralyzed by the challenge of restructuring the dealer role of banks. More than three years after passage of the Dodd-Frank Act, and two years after publication of a Proposed Rule, the five agencies charged with agreeing on the details of the Volcker Rule have been unable to finalize a rule. Furthermore, the details of the Proposed Rule, which contains fairly conceptual and principles-based definitions of permitted activities and no actual penalties for violations, imply that, even after the rule is implemented, there will be an extended period of data gathering and calibration before forceful restrictions on bank activities emerge. Regulatory responses to the London Whale incident in 2012, as well as more recent press reports, also indicate disagreement regarding even what should be fairly straightforward Volcker Rule issues, such as the definition of permissible hedging.[27]

A major substantive criticism of the Volcker Rule has been that modern market making cannot be effectively distinguished from proprietary trading, because contemporary market making is supported by proprietary profits and not by bid-ask spreads or fee income.[28] The Volcker Rule does grant regulatory discretion to negotiate this issue. It allows banks to accommodate reasonable fluctuations in client market making demands, while imposing extra capital and liquidity requirements that address risks emerging from proprietary trading related to the market making function. Restrictions on trader compensation are also important and mandated under the Volcker Rule to limit negative effects of proprietary trading incentives.

Nevertheless, to the degree that client demands for immediate accommodation by market makers do involve extensive proprietary trading, the Volcker Rule may lead to the migration of some market making functions outside the regulated banking sector, to hedge funds or asset managers. The migration of relatively small-scale boutique market making in illiquid and customized instruments—which will be particularly difficult if not impossible to police under the Volcker Rule—may not be problematic. Indeed, to the degree such boutique market makers are subject to proper market discipline, such migration may be beneficial, and improve the diversity of dealer choices for customers.

But the 2008 financial crisis experience showed that thanks to the expanded role of market-mediated credit, large scale market making can easily become central to the economy and be pulled within the implicit public safety net. The issues regarding the scope of public support after the Dodd-Frank Act discussed in the previous section add to these concerns. Without more dramatic shifts in the structure of financial markets to displace the central role of dealers, it is important for large-scale dealing to remain regulated.

The Dodd-Frank Act does give scope to do this through designation of non-bank systemically important financial institutions (SIFIs). This authority should be used if the Volcker Rule results in migration of large-scale dealer activities out of banks. Section 13(a)(2) of the Bank Holding Company Act, added under the Volcker Rule, mandates the regulation and control of the risks of proprietary trading at non-bank SIFIs through additional capital and liquidity requirements and quantitative activity limitations. This section grants very extensive discretion, but it still requires that regulators limit the risks of proprietary trading at systemically important non-bank dealers in order to realize the benefits of the Volcker Rule.

Prudential and Capital Regulation
Prudential risk regulation is the systemic approach favored under the Dodd-Frank Act. In marked contrast to the lack of activity restrictions in the legislation outside of the Volcker Rule, Titles I, VI, and VII contain extensive directives to regulators to limit systemic risk through supervision, risk management, capital, collateral mandates, and diversification requirements such as credit exposure limits. Capital and liquidity regulation is dealt with in detail elsewhere in this volume, so this section will focus on the specific challenges to prudential supervision created by the rise of the shadow banking system.

One major such challenge is the ease of transferring financial commitments between the regulated and unregulated sector under shadow banking. As shown in the example of a "capital relief trade" in the introduction to this essay, the rise of derivatives and securitization markets have made it theoretically simple for a bank to transfer risk to an outside investor not subject to capital or prudential requirements. The same financial commitment will be capitalized and regulated differently depending where in the system it is held.[29]

There are several possible avenues to address this. First, regulators could take more steps to limit the range of entities to which credit risk can be transferred and expand the regulatory perimeter to better oversee such entities. The steps in the Basel III rules to define a category of "eligible guarantee" and "eligible risk guarantor" that could be subject to regulatory oversight are one step in this direction.[30] Notably, such eligible guarantors would not include monoline insurers (insurance companies that provides guarantees to issuers) or in general entities subject to wrong-way risk (*i.e.* entities with institutional default risk highly correlated with the default risk of the instruments they guarantee). But the requirements for eligible guarantors remain broad and are dependent on institutional credit ratings that have not been reliable in the past. Furthermore, the Basel III rules still contain numerous avenues for the reduction of credit risk through credit default swaps traded on the markets generally. These limits on risk transfer would have to be tightened significantly to fully address the problem.

Another challenge is the general migration of credit intermediation to shadow banking networks in response to increased regulation of the banking system. An important potential barrier to such migration is the dependence of the shadow banking system on private guarantees from large organizations seen as within the implicit public safety net. As discussed above, prior to the crisis many such guarantees were provided by banks. If this dependence continues, it may be possible to effectively regulate shadow banking through control of dealer banks.

A major issue in properly addressing shadow banking risk through bank regulation prior to the crisis was that linkages between regulated banks and the shadow banking system were not immediately visible on bank balance sheets. For example, most guarantees were permitted to remain off balance sheet, the lack of information on derivatives exposures concealed interconnections in the system, and, in general, regulators did not understand the length and complexity of intermediation chains.
Post-crisis some real progress has been made on this problem. Changes in accounting rules have required guarantees and previously off-balance-sheet securitization vehicles to be made visible on the balance sheet. The increased reliance on explicit stress testing, rather than simply examining balance sheet commitments, has increased regulators' understanding of bank exposures. New data on derivatives should bring much greater transparency to this market. Work by the Office of Financial Research should also help to illuminate the relationship between the banking sector and less regulated non-banks.

Nevertheless, it would be unwise to rely on the assumption that guarantees provided by large banking organizations will remain central to the shadow banking system once capital and other prudential requirements on banks are increased. Many banking entities that provided guarantees prior to the crisis were less regulated investment banks that were not within the explicit public safety net. Non-bank guarantors such as monoline insurers were also very important. There are many large insurance companies, asset managers, and even hedge and private equity funds that could grow to become important non-bank guarantors of financial intermediation. Thoughtful scholars have concluded that the main barrier to imposing the substantially heightened bank capital requirements that most observers believe are necessary is not the supposed economic cost of capital, but the possibility of extensive risk migration to the shadow banking system.[31]

One possible way to address this issue is by designating entire intermediation markets for prudential oversight, rather than focusing oversight on single institutions. This could capture migration of risk away from regulated banks through traded markets. For example, the Financial Stability Board has recommended "haircuts" in securities lending markets generally, at the level of individual securities. Such regulation would, in effect, limit the leverage available through collateralized lending generally, no matter which entity is involved. The effort to address run risk in money market funds generally also falls in this category. As well, protections in credit default swap markets have been improved through Title VII of the Dodd-Frank Act.

Conclusion: Moving Beyond the Dodd Frank Act to Better Address Shadow Banking

There are grounds for doubt that current regulatory efforts alone will properly address shadow banking risks. Below are two broad recommendations designed to contend with these risks. These are only some of the needed regulatory interventions.

End Complexity Bias and Introduce a Regulatory Preference for Simplicity and Standardization

The ideology that financial markets are efficient leads to a situation where regulators tend to permit any form of voluntary contracting between market participants. The obvious risks of arbitrage are generally addressed through ever more complex prudential requirements rather than steps to limit complex risk transfers. This tendency creates an effective bias toward complexity. Multiplied over numerous decisions, it creates extremely long and involved financial intermediation chains that conceal risks from market participants and regulators alike, and also adds to financial fragility. Regulators should address this bias and increase their willingness to actively simplify financial intermediation through limitations on risk transfer and affirmative steps to standardize and simplify the terms of financial contracts. For example, it is highly questionable whether the customization and complexity of private securitization has created more value in financial efficiency than it has subtracted in opportunities for regulatory arbitrage and outright fraud.

Take Steps to Expand the Role of Relationship Banking

While relationship banking certainly presents issues of its own, it creates significant benefits that are not present in the market-mediated and transactional relationships that characterize shadow banking. In addition, greater diversity of financial intermediation models could reduce systemic risk. This essay has already touched on some of the transparency and financial fragility issues related to the distinction between commercial banking and market-mediated credit. There is also clear evidence that relationship banking is beneficial to mid-market and smaller real economy businesses.[32] There are a range of ways to expand the role of relationship banking, from the full restoration of an updated version of the Glass-Steagall Act as proposed in "The 21st Century Glass-Steagall Act" introduced by Sen. Elizabeth Warren (D-Mass.) and Sen. John McCain (R-Ariz.), to steps that regulators can easily take without statutory change, such as favoring originate-and-hold lending over originate-and-distribute in prudential rules.

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Toward an Understanding of the Use of Derivatives by End Users

Wallace C. Turbeville

The use of derivatives has mushroomed in the past 20 years. Businesses and governments routinely enter into derivatives contracts in connection with price exposures that they experience in their ongoing operations. They "hedge" price risk. How should businesses and governments—who already use derivatives so much—evaluate the use of derivatives in their enterprises? This article provides a set of principles for this evaluation.

The core function of derivatives is to synthetically alter price consequences to a business or government. Most often, a business elects to contract for the currently expected market price consequence on a future date in lieu of experiencing the consequence of the actual price on that date. The hedger decides that the certainty of today's forward price is better than the uncertainty of future prices that may move in the hedger's favor, may move against the hedger or may simply stay the same.

Businesses and governments that employ derivatives to hedge price risk in their enterprises are exempted from many of the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act as "end users." For example, they are not required to transact over exchanges or swap execution facilities and can execute transactions using direct negotiations with a bank or other financial institutions. In addition, end users are exempt from the requirement that their derivatives be submitted to regulated clearinghouses so that credit risk can be managed. The evaluation principles discussed herein assume that the derivatives are executed directly and are not cleared.

I argue that the use of derivatives by businesses and governments is far more widespread than is objectively explainable based on obvious criteria. This article will also describe factors apart from objective criteria that encourage the use of derivatives.

The conclusion drawn is that the use of derivatives for reasons that run counter to sound objective financial criteria generates costly inefficiencies in the economy.

Key Characteristics of Derivatives

The value to a counterparty of a derivative on any given day during its life involves two central properties of the contract. The first is the expected financial value of the performance in the future by the other party to the contract. The second is the likelihood that the required performance by the other party will not occur and that the expected financial value will not be realized (giving rise to credit exposures between the counterparties, as described below).

The values of these properties can be, and typically are, measured independently, but they must be evaluated in concert. Measurement of these values and how they interact, even for a simply structured derivative, is a complex task.

Time is a critical factor in the valuation of a derivative. One party to a derivative contract is obligated to make a payment based on a reference price that is determined on a set date in the future. For example, the contractual obligation might be to pay the price on a set quantity of crude oil (*e.g.,* 100 barrels) delivered at a particular place (*e.g.,* Cushing, OK) at a set time (*e.g.,* the next succeeding June 1). This is the floating price leg of the derivative. The other party typically is required to make a fixed payment, based on the current expected (or "forward") price at inception of the contract.

Since derivatives are executory contracts, their realized value is totally dependent of performance by the counterparty. Similarly, their accrued value can evaporate if the expected performance by the counterparty vanishes as the result of a bankruptcy or similar event. It is as if the party that has accrued value had loaned the amount of that accrual to its counterparty and the counterparty then went bust. For all reasonable purposes, credit has been extended to the counterparty.[1]

Margining and Demands on Cash Liquidity
As described above, the changing accrued value of a derivative generates credit exposures during the term of its existence. These credit exposures are not capped. An exposure's size is measured by the movement of the referenced forward price during the life of the derivative. This price movement has no limit.

To protect against losses, banks generally require that credit exposures be fully or partially collateralized by their counterparties. This is referred to as "margining." If a derivative's credit exposures are fully collateralized, the bank will require that the full amount of credit exposure as of the prior day's close of business be on deposit in an account that secures the bank. If the forward price moves in the bank's favor, the amount of margin required to be on deposit the next day increases. If the forward price moves in favor of the counterparty, margin collateral can be withdrawn.

Since the amount of credit extended under a derivative is uncapped and unpredictable, margin can pose severe cash liquidity risk to the counterparty. In a volatile price environment, the challenge can be greater as prices move by relatively large amounts over short periods of time. In the real world, the threat posed by the need to access cash immediately is the most dangerous aspect of derivatives.

Generally, banks allow counterparties to accumulate credit exposure up to a cap before they must make a deposit of margin collateral. These are typically referred to as "margin thresholds." Banks treat margin thresholds like revolving loans, decrementing credit capacity to lend to the derivative counterparty on an unsecured basis.

Banks also require "credit triggers," provisions that require full margin collateralization, regardless of thresholds, if the credit of the derivative counterparty deteriorates. The most common trigger is a downgrade by a credit rating agency. The implementation of a credit trigger is the extreme form of the dreaded "margin call." One need only recall the credit default derivative margin call made on American International Group (AIG) in 2008 that precipitated its bailout in the amount of $185 billion. A margin call can be catastrophic.

A credit rating downgrade trigger means that the business or government must come up with cash at precisely the time that cash is most difficult to secure. This amplifies the cash liquidity risk posed by margining generally. The company might be pushed into a default for lack of cash, which triggers cross defaults to other financing arrangements, even though default caused by its underlying business is remote. Historically, this is the way derivatives have bankrupted businesses and governments.

An inescapable feature of derivatives—even if they are perfectly designed to offset some price risk that is absolutely going to be realized in the future—is that if the business or government cannot meet a call for margin, either because a credit threshold has been exceeded or a credit trigger has been tripped, it will likely go bankrupt. The derivatives terms will be breached and all other financial arrangements that have cross default provisions will be breached as well.

These risks are poorly understood and almost never valued when businesses and governments decide between derivative hedging and the use of simpler alternatives. Moreover, these risks are not considered in the academic literature that analyzes the use of derivatives. If a call for margin is unfunded, it is often the case that other contracts of the business or government will default because of cross-default provisions. This potential for cataclysmic insolvency of a company or government, even though its underlying financial condition may be relatively stable has not been modeled and perhaps may be impossible to model.

The un-margined derivatives credit exposures that are widespread in the economy are a form of "Ponzi " financing described by economist Hyman Minsky.[2] He states that "Ponzi" financing can not be currently repaid or even repaid from identifiable future revenues, which creates high levels of instability in the economy. Of course, not every un-margined exposure is impossible to fund with identifiable revenue. They are not precisely what Minsky described—though Minsky may have addressed them if he had the opportunity to think about them.

The problem is that many un-funded margin obligations have the potential to become "Ponzi" financing. One reason is that exposure under derivatives have no actual cap, as prices are generally uncapped. Also, a derivative is a demand obligation. The counterparty is incented to make a demand before insolvency because, once cash is deposited, the counterparty enjoys super priority over other creditors in respect to the collateral under bankruptcy law. In cases such as AIG, a margin calls cannot be funded by current cash flow. The only way to avoid default is to find financing that replaces the financing under the derivatives that has suddenly become unavailable. This is reminiscent of subprime mortgage loans that were at the center of the financial crisis. As for AIG, the replacement financing came from the U.S. taxpayers.

Finally, credit exposures in derivatives run both ways. Banks protect themselves with margins, thresholds and credit triggers. However, if a business or government transacts a derivative with a bank, the credit exposure is equally likely to involve an extension of credit to the bank. This extension of credit is almost never priced into the transaction by the business or government and they rarely benefit from margining, threshold and trigger provisions. The vast majority of derivatives are held by only four banks, so the ability of businesses and governments to negotiate favorable terms is negligible, even if they understand the risks involved. It is as if the market has concluded that no risk of bank default need be considered. The derivative counterparties of Lehman Brothers Holdings might find that conclusion particularly unpersuasive.

The Decision to Hedge with a Derivative

Financial market participants can put money into stocks bonds or derivatives seeking to profit from price moves by having superior information than other market participants. This is speculation. In contrast, businesses and governments use derivatives to offset a market price exposure that it experiences in its operations or in its capital structure. Unlike speculation, the value of hedging is not derived from market price moves. The value is in the offset between the actual price exposure and the synthetic price exposure under the derivative.

Derivatives do not eliminate risk. They are contracts that exchange one set of future consequences from a price change for another, assuming the other party performs. Picture a business whose profit and loss during a period in the future depends on price movements of a commodity or security. In order to avoid the consequences of an adverse price move, the business could establish a reserve from borrowings or earnings. Alternatively, it could enter into a derivative that (assuming performance by the counterparty) fixes the consequence of this price exposure at the current price level.

The distinctions between these alternatives—cash reserves and derivatives—should drive the decision between these two methods of managing the risk of price movement.[3] The use of derivatives is often characterized as a “risk reduction” device. Instead, it is a contract that is one of a number of devices to alter the consequences to an enterprise of an exposure to price changes. Price volatility is eliminated (assuming performance by the counterparty) as both the risk and reward of price change are passed to the counterparty. The possible cost of using a cash reserve is the capital to fund it, net of the earnings on the reserve deposits. The possible cost of a derivative is the company pays the value of a beneficial price move if it occurs. That value, plus a fee, is transferred to a bank that is its counterparty. If a reserve is used, the risk is that an adverse price move has consequences beyond the reserve. If a derivative is used, the basic embedded risk is that the counterparty fails to perform, but derivatives include many other risks as well.

The enterprise price risk that is hedged by a derivative occurs sometime in the future, presumably when the payments are required under the contract. However, the other basic property, two-way credit risk extension, comes into play from the inception of the derivative contract. A company either funds margin collateral during the term of the derivative contract or it receives an extension of credit from the counterparty, which is almost always a bank. In turn, the company also extends credit to the bank.

The company or business could set aside funds as reserves. It could save the amount it would have been putting up in margin or in the embedded extension of credit under the derivative contract if no ongoing margining is required. At the time the enterprise price risk is experienced, the company or government would be equally protected from a price shock, assuming that the derivative counterparty performs its obligations and the reserve is prudently sized and maintained. However, if it uses a reserve fund it would benefit from a favorable price movement. If it uses a derivative it would not experience a negative price shift.

Superficially, the cost of borrowing money to fund a reserve and the cost of credit extended under a derivative should be the same. As discussed above, a derivative involves an extension of credit, with many of the characteristics of a loan to fund a reserve. A bank has finite capacity to extend credit to any company or government. When it makes a loan, the bank decrements available credit capacity to keep track of how much exposure to the borrower has been taken on. Similarly, when the bank enters into a derivative, the embedded credit exposure is decremented from credit capacity. Both consume finite credit capacity, limiting what the business or government can borrow for other purposes. As well, the bank that deploys the credit under the derivative will charge an amount at least equal to the profit it would receive by issuing a loan.

The question is whether the costs and benefits are accurately reflected in the pricing of the derivative contract and the consequences to the two parties.

Since the alternative approach to managing a price exposure is to establish a reserve, derivatives can be described as a substitute for funding a reserve. The cost of funding a reserve is the cost of capital to the business or the government (net of earnings on the reserve). In this sense, a hedging derivative is a substitute for capital. In practice, the use of derivatives by businesses and governments is closely related to capital funding.

Derivatives use is closely related to capital funding in several other ways. Indeed, derivatives are often used directly in conjunction with capital raising. For instance, interest rate derivatives can allow a business or government that wants to borrow at a fixed rate fund its capital requirements by accessing floating interest rate markets. More broadly, derivatives are used to hedge in order to lower the cost of capital. Credit rating agencies, in particular, encourage the use of price hedges. After all, credit ratings are based on probability of default rather than prospects for profit. This may be at least a part of the reason that some studies have observed a positive correlation between the share prices of companies and the propensity to use derivatives to hedge.[4]

If the underlying social purpose of the financial markets is the efficient intermediation between capital sources and capital uses, the best way to evaluate the use of derivatives is to observe their efficiency in that task. To the extent the use of derivatives rather than capital reserves increases that efficiency, derivatives provide a social value. To the extent their use decreases it, they impose a social cost.

There is an important difference between the use of derivatives and capital reserves, however. The cost of borrowing under a loan is straightforward. Lenders charge interest over time. Contractually, principal and interest are distinguished from one another so that the basic costs, at least, are transparent.

The compensation charged by a counterparty, typically a bank, for entering into a derivative is very different. The first problem is that there is no certainty that the bank will incur a direct cost of entering into the transaction. As discussed above, at inception market-priced derivatives have no intrinsic financial value to either party. Value—and its mirror image, credit exposure—accrues over time as forward price expectations change. Banks must evaluate the credit exposures either using statistical probabilities based on prior price movements or adjust calculated exposures over time. The pricing of derivatives is so complex that customers almost never understand how much a bank charges them. The profit margin for the bank is baked into the pricing of a derivative.

This constitutes a massive distortion of the credit markets. In an efficient market, the same credit is priced similarly regardless of how it is deployed. Derivatives are commonly used to reconcile differences between the needs of the sources and uses of capital investment. This is an alternative to the commercial bank intermediation model in which banks loan from deposit funds and other sources and their capital absorbs the differences between sources and uses of capital. In both cases, the users of capital "rent" the balance sheets of the banks to access sources of capital investment. Large differences between the rent charged for derivatives and the rent charged in the commercial banking intermediation model for the "use" of the bank balance sheet constitute an extraction of value from the capital intermediation process in excess of the value provided.

Only the banks that overcharge are aware that the overcharging occurs. In order to examine pricing, one must compare the original pricing with the market at inception of the transaction, and data is difficult to find. However, there are rare glimpses into the practice. One was a package of London Interbank Offered Rate (LIBOR) derivatives entered into by the Denver Public Schools as part of a complex financing of its unfunded pension fund liability. LIBOR derivatives are extremely liquid, and are near commodities. Andrew Kalotay, the founder of Andrew Kalotay Associates that provides quantitative analysis of fixed income products, was asked to look into that financing after it collapsed in the wake of the financial crisis. Kalotay testified concerning his investigation before the Securities and Exchange Commission (SEC) in a general inquiry on municipal finance practices.[5]

Kalotay determined that the school district was overcharged by more than $13.5 million, an immense amount for such a commonplace derivative. Troubled by his finding, Kalotay estimated that state and local governments throughout the country had been overcharged by $20 billion by the financial sector between 2005 and 2010.

Overcharging of private companies is even more shadowy and is more likely to involve derivatives that are less liquid, having prices that are less transparent. However, practitioners believe that the evidence of general overpricing is compelling.

Why Do Businesses and Governments Overuse Derivatives

Derivatives involve costs—including risk—that often outweigh their benefits in the real world. What are the other factors that must be influencing businesses and governments to use derivatives so much?

Tax and accounting results can affect the decision. Holding cash can be inefficient from a tax perspective depending on the funding source. In addition, the accounting for debt transacted under a derivative by a company or a government that is hedging a risk is obscure.[6]

Another important factor is that the end users simply do not understand the costs and risks. They may not even have the tools to make an informed decision. This is particularly a concern with municipal users of derivatives.

However, this is not a sufficient answer since the use of a derivative requires an affirmative act so that concerns about lack of knowledge must be overcome.

One factor is that the embedded credit extension in derivatives allows an end user to synthetically borrow without having to report debt as such. The most extreme example may be the Government of Greece that entered into a currency derivative with Goldman Sachs that was out-of-the-money, meaning that the pricing was off-market at inception. From day one, there was credit extended to the Government of Greece. The credit extension under the derivative allowed Greece to transact debt without having to consume its borrowing capacity under EU rules. This form of "shadow borrowing" occurs frequently.

Another factor is the extreme emphasis that credit rating agencies place on hedging price risk with derivatives. Credit ratings are not an evaluation of how profitable a business may be. Instead, they are an evaluation of how likely default on debt is. Here is how Standard & Poor's describes ratings:

> Credit ratings are opinions about credit risk. Standard & Poor's ratings express the agency's opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time.[7]

If a price consequence is hedged with a derivative, the end user avoids adverse price consequences and foregoes positive price consequences. Thus, the risk of default is reduced in exchange for foregoing potential profit. From a credit rating standpoint, this is a sensible exchange, even though it may be sub-optimal in terms of the value of the enterprise to shareholders or, in the case of a government, to taxpayers.

Additionally, in large part because derivatives business is so profitable, banks market derivatives aggressively to end users. Often, derivative business can be tied to other bank business that the end user finds advantageous so that derivative prices are not rigorously negotiated. Also, a bank can strongly advise a treasurer or chief financial officer to enter into a derivative transaction as a hedge. If the treasurer or financial officer decides to reserve against the risk instead and if the adverse price movement occurs, he or she can be criticized for not heading the advice of the banker. The safer course for the individual, though not for the end user, may be to use the derivative.

Conclusions

Powerful innovations over the last 35 years, especially since 2000, have changed trading markets dramatically. By far the largest and most dangerous innovation is the derivatives market. Derivatives were created and marketed aggressively by the large financial institutions that dominate trading. These sophisticated market participants are very well situated to understand the distortions and inefficiencies that are embedded in derivatives.

Armed with superior technological and analytical capabilities as well as intimate knowledge of distortions and inefficiencies, these large financial institutions are able to exploit them. They understand the pricing and valuation of derivatives much better than their customers. This knowledge advantage is immensely profitable for them.

The value that they extract is large. For the most part, it exceeds the value provided by the derivatives themselves. For example, most studies indicate that the value of using derivatives to manage risk is roughly the same as the value of using a reserve for the same purpose. Yet the cost of a derivative is much higher. Unfortunately, the complexity of even the simplest derivative goes largely unaccounted for in the academic literature and in the marketplace. Complexity obscures the evaluation of efficient results. Studies that find that the use of derivatives to hedge provides little if any advantage over alternatives omit many costs that would tip the scales against derivatives.

The marketplace is biased toward complexity because it favors market participants with asymmetric information advantages and oligopolistic market power. Under these circumstances there is an inherent bias toward risk taking by large financial institutions: the larger the risk, the larger the reward. If the rewards are structurally higher, immediate profits—which translate into shareholder value and executive compensation—can be seized. The periodic catastrophic failure is worth it for traders and executives who keep their prior earnings.

Meanwhile, however, American businesses, governments and the general public suffer. Inefficiencies that transfer earnings to the financial sector are like a tax that redistributes wealth upward. This system cannot persist. Constraints on innovation, especially innovation in derivatives, based on much greater evaluation of costs and benefits, are desperately needed.

The capital intermediation system, and as a result the economy as a whole, would benefit greatly from a reduction of the derivatives markets. A number of regulatory measures have been suggested that would move in this direction.

The end user exemption from clearing and price transparency provisions of the Dodd-Frank Act could be eliminated or interpreted very narrowly. This exemption was included for political expediency in the debate over the Dodd-Frank Act. Businesses and governments with direct access to members of Congress continue to support the exemption, but the value that they perceive from it is misguided and springs from illegitimate incentives, such as obfuscation of debt in disclosure and tax technicalities.

Pricing of derivatives, especially for state and local governments, must be made more transparent and fair. Two measures would improve this situation. Generally, state and local governments employ independent advisers to evaluate derivatives. Many of these advisers are ill equipped to evaluate the transactions. Even worse, they are highly susceptible to influence by banks in direct and indirect ways. Registration and a strong set of standards would be beneficial. Further, a bureau like the Consumer Financial Protection Bureau for state and local governments—or a department within that bureau to serve these governments—is completely justified. The mispricing of financial products, particularly derivatives, to these entities imposes a heavy burden on the economy.

The problem of proper evaluation of the use of derivatives by businesses and governments is daunting. Derivatives impose dangerous and costly risks that ultimately are material to investors in the businesses and governments that use them. Comprehensive disclosure of these risks and costs would require the businesses and governments to actually examine them. The SEC should develop a template for rigorous evaluation of these risks and costs and require disclosure under its terms. Investor disclosure would improve, but even more importantly businesses and governments would be provided the tools to understand the consequences of their transactions.

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Wallace C. Turbeville

Wallace Turbeville, practiced law for seven years before joining Goldman, Sachs & Co. in 1985 as an investment banker. In his twelve years at Goldman, he specialized in infrastructure finance and public/private partnerships. From 1990 through 1995, he was posted to the London office where he was co-head of a group tasked to pursue financing of transportation, energy and environmental projects, particularly in the newly opened eastern European nations. From 1997, Mr. Turbeville managed a financial advisory firm and business specializing in the post-trade management of credit exposures in over-the-counter derivatives transactions.

Starting in 2010, Mr. Turbeville devoted his efforts to financial reform, energy and environmental policy issues. He served as Visiting Scholar at the Roosevelt Institute and authored nearly 30 articles concerning financial reform, energy, the environment and political opinion.

In October 2010, Mr. Turbeville joined Better Markets, Inc. He was the primary author of dozens of comment letters relating to proposed rules and studies implementing the Dodd-Frank Act. He resigned from Better Markets in late 2011 to devote time to interests New York City as a Senior Fellow at Demos, a national public policy research and advocacy organization, and as an Adjunct Professor of Law at the University of Maryland Law School.

Beyond Finance: Permissible Commercial Activities of U.S. Financial Holding Companies

Saule T. Omarova

This essay explains the legal basis for, and examines public policy implications of, recent expansion of large U.S. financial holding companies' non-financial business activities. Despite its potentially significant impact on economic growth and systemic stability, this phenomenon of financial conglomeration beyond finance remains poorly understood. Yet, any truly comprehensive and effective reform of financial services regulation must address public policy issues that arise when "too-big-to-fail" banks grow even bigger and more systemically significant by combining finance with commerce.

I. The Legal Wall Between Banking Commerce

One of the foundational principles underlying the entire system of U.S. bank regulation is the principle of separating banking from general commerce. Since at least 1863, federally chartered banks have been allowed to engage only in the "business of banking," and therefore prohibited from participating in purely commercial activities.[1] Congress extended the same principle to banks' parent companies and affiliates, when it adopted the Bank Holding Company Act of 1956.[2] The key policy reasons for separating banking from commerce have traditionally included the needs to preserve the safety and soundness of insured depository institutions, to ensure a fair and efficient flow of credit to productive economic enterprise (by, among other things, preventing unfair competition and conflicts of interest), and to prevent excessive concentration of financial and economic power in the financial sector.

In line with these objectives, the Bank Holding Company Act was originally conceived as an anti-monopoly statute, aimed at preventing excessive concentration of economic power in large money center banks.[3] Under the Bank Holding Company Act regime, all companies that own or control U.S. banks—bank holding companies (BHCs)—are generally restricted in their ability to engage, directly or indirectly, in any business activities other than banking, managing banks, and certain financial activities "closely related" to banking.[4]

In the 1980s, under pressure from the banking industry trying to regain competitive ground vis-à-vis securities firms, federal bank regulators began gradually relaxing legal constraints on banks' and BHCs' non-banking activities. Both the Office of the Comptroller of the Currency and the Federal Reserve engaged in aggressively expansive interpretations of the statutory language, to allow commercial banks and BHCs, respectively, to grow their businesses beyond traditional banking. Between the mid-1980s and early 2000s, the Office of the Comptroller of the Currency issued a series of interpretations allowing commercial banks to trade in a wide range of derivative instruments.[5] In a parallel effort, the Federal Reserve's orders allowed BHCs to underwrite and deal in corporate securities, subject to revenue limitations. Moving beyond pure finance, the Federal Reserve amended its regulations, for example, to permit BHCs to conduct general data processing, storage, and transmission activities, including providing related hardware and other facilities.[6]

II. The Gramm-Leach-Bliley Act of 1999: Three Doors in the Wall[7]

This era of expanding BHC-permissible activities through administrative action culminated in the passage of the Gramm-Leach-Bliley Act of 1999, which partially repealed the Glass-Steagall Act and allowed affiliation between commercial and investment banks under the new financial holding company ("FHC") structure. The Gramm-Leach-Bliley Act amended the Bank Holding Company Act to allow certain qualifying BHCs that elect an FHC status to conduct (through their non-bank subsidiaries) a much wider range of "financial in nature" activities, including unlimited securities dealing and underwriting as well as general insurance business. FHCs were envisioned as "financial supermarkets" serving as a "one-stop-shop" for their customers' financial needs. This structural reform profoundly altered the key dynamics in the U.S. financial sector, unleashing a wave of consolidations and the emergence of large, diversified financial conglomerates such as Citigroup, JPMorgan Chase, and Bank of America.

The Gramm-Leach-Bliley Act also significantly expanded the range of non-financial activities permissible for this new breed of bank-centered financial services conglomerates. By allowing FHCs to enter purely commercial business lines, the Gramm-Leach-Bliley Act quietly dealt a potentially deadly blow to the concept of separating banking from commerce. Even now, more than a decade later, it is difficult to assess fully the implications of this shift in the legal and regulatory regime governing banking institutions. Yet, its importance for understanding the sources and patterns of systemic risk in today's financial sector is becoming increasingly clear.

Three principal provisions of the Bank Holding Company Act, as amended by the Gramm-Leach-Bliley Act, enable FHCs to engage in commercial activities on a much broader scale than before 1999. First, an FHC may make passive private equity investments of any size in any commercial company under the "merchant banking" authority.[8] Second, an FHC may directly engage in any non-financial activities, if the Federal Reserve determines such activities are "complementary" to a financial activity.[9] Finally, the statute contains a grandfather clause to allow entities that become subject to the Bank Holding Company Act after the Gramm-Leach-Bliley enactment to run physical commodity businesses.[10] An FHC may use any one of these statutory authorizations to conduct a particular commercial activity.

Each of these three statutory exemptions from the general ban on banking organizations' non-financial operations—or three "doors" into previously inaccessible sphere of pure commerce—is subject to various conditions and limitations. However, a closer look at the language, origins, and subsequent implementation of these provisions reveals how weak these formal protections can be in practice.

A. Door No. 1: Merchant Banking

Prior to 1999, a BHC was generally permitted to make passive private equity investments in any commercial company only if such investments did not exceed 5 percent of such company's voting securities.[11] In the 1990s, banks viewed this as a major competitive disadvantage that kept them from making potentially lucrative private equity investments in start-up Internet and high-tech companies. Section 4(k)(4)(H) of the Bank Holding Company Act, added by the Gramm-Leach-Bliley Act, sought to remedy that situation by permitting FHCs to acquire or control, directly or indirectly, up to 100 percent of ownership interest in any commercial entity under the "merchant banking" authority.

The statute does not define the term "merchant banking." In 2001, the Federal Reserve and the Department of Treasury jointly issued the Merchant Banking Rule, which defines merchant banking as a catch-all authorization for FHCs to invest in commercial enterprises, as long as any such investment meets several requirements.[12] Thus, the investment cannot be held through an FHC's bank-subsidiary and must be sold within 10 to 15 years after the acquisition (barring any special circumstances). The investment must be made "as part of a bona fide underwriting or merchant or investment banking activity" (i.e. it must be a financial investment for the purpose of appreciation and ultimate resale). Furthermore, an FHC cannot "routinely manage or operate" any portfolio company in which it made the investment, except as may be necessary in order to obtain a reasonable return on investment upon resale.

These requirements were designed to ensure that FHCs use the merchant banking powers to facilitate their financial intermediation activities, as opposed to getting involved in the commercial businesses of companies in which they invest. Although an FHC is permitted to acquire full ownership of a commercial firm, the principal purpose of its investment must remain purely financial: making a profit upon subsequent resale or disposition of its ownership stake.

The real question is whether, in practice, FHCs comply with the rule's formal requirements while circumventing its intended purpose—that is, to what extent they are able to use merchant banking authority as a means of engaging in impermissible commercial activities. For instance, in general discussions of FHCs' merchant banking activities, the statutory prohibition on "routinely managing" portfolio companies is often understood as a requirement—and an effective assurance—of a purely passive "arm's length" relationship between an FHC and commercial entities it controls under that authority. Yet, this is not necessarily the case. The regulators interpreted the term "routinely managing" narrowly, leaving ample opportunities for FHCs to exercise decisive managerial control over their portfolio companies. Under the Merchant Banking Rule, the indicia of impermissible "routine management" of a portfolio company include certain kinds of management interlocking and explicit contractual restrictions on the portfolio company's ability to make routine business decisions (e.g., hiring non-executive personnel or entering into transactions in the ordinary course of business).[13] Examples of permissible arrangements that do not constitute "routine management" include contractual agreements restricting the portfolio company's ability to take actions not in the ordinary course of business; providing financial, investment, and management consulting advice to, and underwriting securities of, the portfolio company; and meeting with the company's employees to monitor or advise them in connection with the portfolio company's performance or activities.[14] FHCs can also elect any or all of the directors of any portfolio company, as long as the board does not directly run the company's day-to-day operations.[15]

Thus, unwrapping regulatory interpretation of the statutory language reveals that FHCs enjoy considerable flexibility in directing business affairs of portfolio companies in which they invest pursuant to merchant banking authority. In practice, it is not difficult to structure an FHC's relationship with any particular commercial entity in a way that avoids formal indicia of "routine management" but gives it effective control over important substantive aspects of that entity's business.

B. Door No. 2: Complementary to Finance

The Gramm-Leach-Bliley Act also authorizes FHCs to conduct commercial activities determined by the Federal Reserve to be "complementary" to a financial activity. The Federal Reserve must also determine that any such complementary activity does not "pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[16] Once again, however, the statute does not define what complementary means.

Procedurally, the Federal Reserve makes these determinations on a case-by-case basis. Any FHC seeking to engage in any commercial activity it believes to be complementary to a financial activity must apply for the Federal Reserve's prior approval and provide detailed information about the proposed activity.[17] In making its determination, the Federal Reserve is required to make a specific finding that the proposed activity would produce public benefits that outweigh its potential adverse effects.[18] The statutory list of such public benefits includes "greater convenience, increased competition, or gains in efficiency."[19] The Federal Reserve must balance these benefits against such dangers as "undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the United States banking or financial system."[20] This list of potential dangers directly channels the policy concerns underlying the principle of separation of banking from commerce, which indicates Congress's intention to limit FHCs' potential expansion into the commercial sphere. Yet, the statutory language leaves too many opportunities for interpreting public benefits too broadly and potential risks too narrowly.

The legislative history of this provision shows that the industry deliberately sought the inclusion of the complementary clause as an open-ended source of legal authority for banking organizations to engage in any commercial activities that may become feasible or profitable in the future. Again, banks' real goal was to be able to invest in Internet and high-tech companies. Yet, the industry framed the congressional debate on complementary activities as a debate primarily about low-risk, low-profile activities, such as publishing travel magazines and using back-office over-capacity to offer telephone help lines.[21]

After 1999, the banking industry found other, less innocuous uses for this complementary power, such as physical commodity and energy trading.[22] Beginning in 2003, the Federal Reserve issued several orders allowing Citigroup, JPMorgan, Bank of America, and other FHCs to trade in a wide range of physical commodities as an activity complementary to their commodity derivatives businesses. In making its determinations, the Federal Reserve routinely equated the public benefits of proposed activities with the primarily private benefits to individual FHCs—their enhanced competitiveness and profitability.[23] With respect to potential adverse effects, the orders typically briefly noted the absence of any substantial risks to the safety and soundness of the FHC or the U.S. financial system.

The main safety and soundness limitation the Federal Reserve imposed on these activities was the prohibition on FHC ownership or operation of facilities for the extraction, storage, processing, or transportation of physical commodities.[24] In response, FHCs developed ways to obtain effective operational control of power plants and oil refineries through contractual arrangements. In the wake of the recent crisis, when three large FHCs – Goldman Sachs, Morgan Stanley, and JPMorgan – emerged as major commodity merchants and owners of oil pipelines and metals warehouses, the Federal Reserve's original line drawing began to seem even less relevant in practice.

More generally, this selective expansion of large FHCs into commodities and energy—vitally important and volatile sectors of the economy that are inherently vulnerable to market manipulation and speculative bubbles—raises fundamental questions as to whether the vague regulatory concept of complementarity imposes meaningful limits on banking organizations' commercial activities.

C. Door No. 3: "Grandfathered" Commodity Activities

The third source of authority for FHCs to enter commerce is section 4(o) of the Bank Holding Company Act, which authorizes any company that becomes an FHC after November 12, 1999, to continue "activities related to the trading, sale, or investment in commodities and underlying physical properties," if that company "lawfully was engaged, directly or indirectly, in any of such activities as of September 30, 1997, in the United States."[25]

Thus, section 4(o) seems to allow a qualifying FHC to conduct virtually any kind of commodity trading and any related commercial activities (for example, owning and operating oil terminals and metals warehouses), if it happened to conduct any commodities business—even if on a very limited basis and/or involving different kinds of commodities—prior to the 1997 cut-off date. Potentially, so broadly stated an exemption may open the door for large financial institutions to conduct sizeable commercial activities of a kind typically not allowed for banking organizations.[26]

Grandfathering of pre-existing commodities operations was originally proposed in 1995 by Congressman Jim Leach as part of a broader set of provisions establishing a new charter for "wholesale financial institutions" ("WFIs") that could conduct a wide range of banking activities but could not take federally-insured retail deposits.[27] The proposal sought to create a "two-way street" for investment banks, enabling them to acquire commercial banks and offer wholesale banking services to institutional clients, without becoming subject to the full range of activity restrictions under the Bank Holding Company Act.[28] Because WFIs and their parent-companies—"woofies"—would not have access to federal deposit insurance and, therefore, were not likely to pose any significant potential threat to the deposit insurance fund, the proposal authorized them to engage in a broader set of non-financial activities than regular FHCs backed by FDIC insurance. One of these explicit trade-offs involved the grandfathering of woofies' pre-existing commodities trading.

Initially, several big banks and securities firms strongly pushed for the passage of the woofie charter.[29] Unlike the House bill, the Senate version of the reform legislation did not contain woofie provisions. In April 1999, Senator Phil Gramm introduced an amendment replicating the commodity grandfathering provision for woofies in the House bill, but without any reference to woofies.[30] Ultimately, the entire subtitle of the House bill dealing with the new woofie charter was eliminated from the legislation. The Senate's broader version of the commodity grandfathering clause, however, became the current section 4(o) of the Bank Holding Company Act. Thus, an initially limited concession to financial institutions that were explicitly denied access to federal deposit insurance became an open-ended exemption available to all newly-registered FHCs fully backed by the federal government guarantees.

This commodity grandfathering provision remained largely unnoticed until Morgan Stanley and Goldman Sachs, which became BHCs in September 2008, claimed it as the legal basis for keeping and expanding their vast operations in physical commodities and energy markets. The controversy over this issue brought section 4(o) to the forefront of the public debate on the proper limits of banking institutions' non-financial activities and the dangers of failing to police these limits in practice.

III. From Financial Conglomerates to Financial-Industrial Conglomerates? Potential Public Policy Implications

As the preceding discussion shows, the post-Gramm-Leach-Bliley Act regime governing FHCs' commercial activities does not provide effective constraints on such activities. It is not surprising that, since the early 2000s, large U.S. bank-centered financial conglomerates—such as JPMorgan, Goldman Sachs, and Morgan Stanley—have been gradually morphing into financial-industrial conglomerates. This trend is especially visible in physical commodity and energy markets, in which these FHCs conduct significant operations producing, processing, transporting, storing, and marketing oil, gas, electricity, coal, uranium, aluminum, etc. But large U.S. FHCs may also be acquiring stakes in airports, railroads, telecommunications, or defense companies, we simply don't know.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the centerpiece of the U.S. financial regulation reform, does not directly address the question of whether, or to what extent, financial institutions should engage in commercial activities. While the Dodd-Frank Act generally endorses the continuing significance of the foundational principle of separation of banking and commerce, its main focus remains on financial activities and markets. Establishing effective regulatory boundaries for financial firms' non-financial activities and eliminating the current disconnect between legal principles and reality is a task for future reforms.

In the absence of full and reliable information on FHCs' commercial activities and their impact on financial and commercial markets, it is difficult to offer specific policy prescriptions for such reforms. However, as an initial matter, it is helpful to define the range of potential public policy implications of large, systemically important FHCs' large-scale involvement in commercial enterprise and to articulate key policy objectives that should guide our search for solutions.

There are several policy reasons to revisit the existing legal framework for allowing banking entities to conduct non-financial activities. Some of these reasons reflect the heightened relevance of the traditional policies behind the principle of separating banking from commerce in the complex and interconnected world of modern finance. These are concerns about safety and soundness of financial institutions and systemic risk associated with their commercial activities, potential leakage of the public subsidy beyond the banking sector, market integrity and consumer protection, and excessive concentration of economic and political power in the hands of financial conglomerates. In addition, there are serious reasons to doubt the actual capacity of financial institutions and their regulators to monitor and effectively control potential risks posed by such institutions' ever-expanding activities.

These theoretical concerns may be more or less pronounced in the context of a particular commercial activity. It is also worth noting that banks' involvement in certain non-financial activities may—and often does—produce tangible financial benefits to their clients and, indirectly and perhaps less tangibly, to society as a whole. Yet, after decades of unquestioning acceptance of private firms' self-interested depiction of such benefits, it is critical that policy makers fully address potential social costs of mixing banking and commerce.

A. Safety and Soundness of Financial Institutions and Systemic Risk

It is often asserted that separating banking from commerce undermines banking institutions' safety and soundness by preventing them from diversifying their sources of income. This argument, however, is meaningless if stated in the abstract, as a generally applicable principle. Some forms of diversification may, in fact, produce desired economic benefits for an FHC, while others may have the opposite effects by exposing it to too much risk, often in unfamiliar ways. The task, therefore, is to determine which types of commercial investments and activities are likely to generate significant diversification benefits without, at the same time, undermining the safety and soundness of the individual FHC or the entire financial system.

Large FHCs' involvement in physical commodities and energy markets provides a useful example of how certain commercial activities may raise potentially significant safety and soundness concerns and exacerbate systemic risk. Let us assume that owning or operating oil pipelines and metals warehouses generates profits for an FHC that are both independent from, and significant enough to offset serious downturns in, its core financial-market business. This diversification effort also exposes the FHC to a broader range of risks, many of which are qualitatively different from risks posed by its traditional financial activities. It's easy to imagine, for example, that an accident or explosion on board an oil tanker owned or operated by one of JPMorgan's subsidiaries causes a large oil spill in an environmentally fragile area of the ocean. The news of the disaster may lead JPMorgan's counterparties in the financial markets to worry about the firm's financial strength and creditworthiness. The full extent of JPMorgan's clean up costs and legal liabilities would be difficult to estimate upfront, so it would be reasonable for the firm's counterparties to worry about its financial strength and creditworthiness. This could trigger a run on the firm's assets and bring JPMorgan to the verge of a major liquidity crisis. Without some form of a bailout, its failure is nearly certain to cause a major systemic disturbance in the financial markets.

This hypothetical illustrates how FHC's expansion into physical commodity and energy businesses creates new sources of, and transmission channels for, systemic risk in the financial sector. Systemic vulnerability is likely to increase whenever FHCs enter, on a sufficiently large scale, any commercial business and, as a result, become exposed to financial, operational, and market risks specific to such business. Therefore, any potential benefit from diversifying an FHC's portfolio beyond finance must be weighted against potential costs of increasing the overall level of institutional and systemic risk.

B. Leakage of Public Subsidy

By taking deposits and serving as the main channel for the flow of payments and credit throughout the economy, banks perform a "special" public service. For this reason, the federal government subsidizes banking institutions by guaranteeing their deposit liabilities and providing them with liquidity support through dedicated Federal Reserve facilities. Big, systemically important banks and their affiliates also enjoy implicit subsidy, based on the market expectation that the government would bail out any such entity in order to avoid financial meltdown.[31] As a result of this public support, explicit or implicit, banking organizations have lower cost of funding than ordinary commercial companies, which potentially gives FHCs a crucial advantage over their non-bank competitors in any non-financial market.

Commodities markets, again, provide a classic example. The financial industry often asserts that banks' entry into commercial sectors provides public benefits by increasing competition and by enabling them to provide better, more efficient services to their clients. What these claims leave out, however, is the potential competitive advantage that the federal subsidy of banking institutions gives them when they act in commodity markets. An oil refinery may very well benefit from a lower cost of its crude inventory supplied entirely by Morgan Stanley, but is Morgan Stanley able to offer the lower price because its own cost of funding is partly subsidized by the taxpayer? If it is so, the taxpaying public is indirectly subsidizing the refinery's costs of doing its business—something Congress has never endorsed or even contemplated.

To protect the taxpayers from unknowingly supporting private firms' profit-generating activities, it is critical to impose strict limitations on the ability of banking institutions to leverage their access to federal subsidy. Despite the existence of laws attempting to do just that, in practice, it remains a difficult task.[32] Once banks venture beyond finance, the market-distorting effects of the subsidy leakage become even harder to detect and control.

C. Conflicts of Interest, Market Manipulation and Consumer Protection

One of the key policy reasons for separating banking from commerce is the fear of banks unfairly restricting their commercial-market competitors' access to credit, the lifeblood of the economy. Banks can also use their financial power to influence prices in commercial markets in which their affiliates operate. The relatively recent growth of global derivatives markets, in which large U.S. FHCs are key participants, raises these concerns with potential conflicts of interest and market manipulation to a qualitatively new level. If the same FHC trades derivatives linked to the price of some underlying asset and, at the same time, through its commercial operations, can influence the supply of, or demand for, that asset, that FHC can intentionally move the underlying asset's price to maximize gains from its derivatives positions.

This structural market power from combining derivatives trading with direct participation in related commercial activities creates both incentives and opportunities for new, more subtle, and harder to detect forms of manipulative conduct across different markets. Furthermore, FHC affiliates acting in various commercial markets in pursuit of their parents' complex trading strategies may fundamentally alter the dynamics within those markets, creating sudden price changes not explained by the traditional supply-and-demand factors. These destabilizing effects of "financialization" of commercial markets often translate into higher consumer prices. Recent revelations about Goldman Sachs' role in artificially inflating aluminum prices, through its metals warehousing operations, provide one example of this troubling trend.

D. Political Economy

Writing almost a century ago, Justice Brandeis famously warned against the dangers of allowing financial institutions to accumulate direct control over industrial enterprises.[33] The recent financial crisis underscored the continuing salience of Brandeis's political-economy concerns. One of the central themes in post-crisis regulatory reform is the prevention of future bailouts of "too big to fail" financial institutions. Yet, if large U.S. financial institutions successfully transform themselves into financial-industrial conglomerates, it would make the reformers' task even less enviable. Not only will these giant firms become even bigger and more complex, they will acquire additional sources of leverage over the economy—and, consequently, the polity—in their new role as providers of vital commercial products and services.

E. Firm Governability and Regulatory Capacity

Significant expansion of FHCs' commercial businesses presents serious challenges for these firms' internal governance and risk management. Large U.S. financial conglomerates are already complex in terms of their corporate structure, risk management, and the breadth and depth of financial services and products they offer. Allowing these firms to run extensive commercial operations that require specialized technical and managerial expertise adds to their internal complexity. Firm-wide coordination and monitoring of operations, finances, risks, and legal and regulatory compliance become all the more difficult in that context.

Furthermore, mixing banking with commerce creates potentially insurmountable challenges from the perspective of regulatory efficiency and capacity. The U.S. system of financial services regulation is already fragmented and ill suited to detect and reduce systemic risk across different financial markets and products. The expansion of FHCs' activities into new areas subject to extensive regulation under very different regulatory schemes—environmental regulation, workplace safety regulation, consumer safety regulation, etc.—lays the foundation for jurisdictional conflicts on an unprecedented scale. In addition to the several federal financial regulators, banking organizations may become subject to direct regulation by the Environmental Protection Agency, the Federal Trade Commission, the Department of Transportation, and numerous other federal and state agencies. Yet, none of these many overseers will see the whole picture, leaving potentially dangerous gaps in the regulation and supervision of these companies.

Non-financial regulatory schemes are not designed to address the unique risks—enterprise-wide and systemic—posed by the activities of systemically important financial institutions. Financial regulators, in turn, lack the necessary expertise and legal authority to exercise meaningful oversight of FHCs' commercial businesses and the risks they generate. This natural limit on regulatory capacity is a critical factor in the discussion of financial institutions' entry into non-financial lines of business.

IV. What Should Be Done? Potential Avenues for Reform

At present, there is surprisingly little public information on the nature and scope of banking organizations' commercial assets and activities. FHCs' public filings do not provide a sufficiently detailed picture, and it is not clear whether the Federal Reserve collects enough data to give it a comprehensive view of their merchant banking and complementary activities. Thus, the first step toward developing a coherent regulatory approach to commercial activities of banking organizations is to demand more specific and targeted public disclosure of all relevant information. Once we have a better idea of how involved our banking institutions are in non-financial businesses, we can decide whether such involvement warrants any particular policy intervention.

As a general matter, intervention could proceed along three lines: (1) strengthening the existing regime by imposing additional regulatory controls on FHC's ability to enter commerce; (2) eliminating specific authorizations of FHCs' commercial activities; and (3) folding this issue into a broader structural reform of financial services regulation.

A. "Policing the Doors"

The least radical policy response would seek to improve practical efficacy of the existing regime by imposing stricter and more meaningful regulatory controls on FHCs' commercial activities.

<u>Size and concentration limits</u>

One possible step in this direction would be to impose additional size and concentration limits on FHCs' permissible merchant banking and complementary activities. The relevant measures and thresholds may vary, and the Federal Reserve should have flexibility to determine whether the size, scope, or relative significance of any individual FHCs' commercial holdings and/or activities—as represented by any single or multiple metrics—reach potentially worrisome levels. In order to be meaningful, these limitations would have to target all of the substantive policy concerns outlined above.

Given the breadth of what constitutes commerce, it may be desirable to identify specific sectors or areas of activity, which are critically important to economic growth and/or potentially vulnerable to speculation-induced instability, and to craft additional limitations and conditions on FHCs' expansion into such areas. For example, additional safeguards could be imposed on FHCs' activities in physical commodities, real estate, telecommunications, as well as infrastructure and transportation. The list of such "special concern" activities, and activity-specific limitations, may be adjusted by policy makers, if necessary.

Redefining supervisory objectives

The Federal Reserve should be required to (1) collect more granular quantitative and qualitative data on each FHC's merchant banking investments and complementary activities, and (2) monitor compliance with the statutory and regulatory requirements much more closely. The agency's principal supervisory goal should be to understand and evaluate not only each FHC's full commercial-activity profile but also the overall pattern and potential effects (internal and external) of combining its commercial and financial activities.

In evaluating compliance, Federal Reserve examiners must not rely on review of FHCs' corporate documents and formal "policies and procedures." For instance, with respect to merchant banking, examiners should scrutinize the actual relationships between each FHC and its portfolio companies, in order to ensure that the FHC's merchant banking portfolio contains only financial-in-nature investments. The examiners' task would be to monitor the relationship between an FHC and each of its merchant banking portfolio companies for the indicia of de facto operational influence that potentially cross the line between financing commerce and engaging in commerce.

Portfolio-level reporting

To this end, the Federal Reserve could require that each commercial company controlled by an FHC pursuant to merchant banking authority regularly provide quantitative and qualitative information detailing all of its business dealings with the FHC or its clients (e.g., percentage of the company's revenues generated from such dealings, lists of business contracts with the FHC or its clients, specific information on FHC's participation in the management and business decisions of the company). To ease the administrative burden, this portfolio-level reporting requirement may be applied selectively to portfolio companies engaged either in any "special concern" activity (as outlined above) or an activity in which the FHC's investment exceed certain concentration thresholds.

The same type of reporting may be mandated with respect to FHCs' commercial subsidiaries engaged in complementary activities. While the specific purpose of supervisory scrutiny in this context is somewhat different than in the case of FHCs' merchant banking portfolio, the overall goal is fundamentally similar: to ascertain the extent to which an FHC's commercial activities indicate any potentially troubling micro- or macro-trends.

Procedural safeguards

The existing scheme for complementary activities can be further strengthened by imposing additional procedural requirements on the Federal Reserve's decision making.

For example, the Bank Holding Company Act can be amended to require the Federal Reserve to provide a more detailed substantive justification of its determination that the public benefits—which are not to be equated with profitability and competitive gains of FHCs—of allowing a particular FHC to engage in a specific complementary activity outweigh all of the potential adverse effects specified in the statute (and not only those directly related to individual institutions' safety and soundness). Putting these implicit requirements directly into the words of the statute would make it more likely that the Federal Reserve fulfills its responsibilities as the guardian of the public interest.

It is also desirable to mandate periodic regulatory reviews and re-authorizations of each order granting individual FHCs' requests to conduct commercial activities complementary to finance. In effect, this requirement would create an automatic "sunset" period (e.g., every five years) for complementary power grants, which would force the Federal Reserve to reconsider its decisions in light of new information. Again, in issuing re-authorization orders, the Federal Reserve should be required to lay out in full the substantive reasoning behind its decision.

B. "Closing the Doors"

A more radical policy response would be to repeal specific statutory authorizations of FHCs' commercial activities created by the Gramm-Leach-Bliley Act. In contrast to the option outlined above, this option is less complicated and does not create significant compliance and administrative costs.

The easiest case for such outright repeal is section 4(o) of the Bank Holding Company Act. This commodity grandfathering provision has outlived its original purpose and does not serve any real function today.

There is also a potentially strong argument for repealing the statutory authorization of FHCs' merchant banking activities. As discussed above, the banking industry sought the inclusion of this authority in the Gramm-Leach-Bliley Act to enable it to invest in Silicon Valley start-ups. Today, long after the dotcom boom ended, FHCs can use this provision to conduct commercial activities that go far beyond the vague statutory concept of "bona fide merchant banking." Given the practical difficulty of ensuring compliance with the spirit and purpose of this provision, it would make sense to reassess whether the real public benefits of allowing banking organizations to act as private equity funds outweigh potential risks such activities pose from the public policy perspective.

C. "The Wall is the Problem!"

Finally, the most radical approach to resolving the existing tension between the legal principle of separation of banking from commerce, on the one hand, and its inconsistent implementation, on the other, would be to reconsider the principle itself.

This approach could support abandoning the legal fiction of separating banking from commerce and legalizing financial-industrial conglomeration under the rubric of "universal banking." Alternatively, it could support a call for broader structural reforms seeking more effective separation of finance from commerce. The former version of this paradigm shift, while potentially restoring doctrinal consistency, is not likely to address policy concerns discussed above. The latter version, however, might ultimately hold the key to resolving many a regulatory dilemma in modern finance. Developing a coherent system of new regulatory categories that reflect today's market realities better than old-style "walls" and "silos" could enable new solutions tailored more precisely to specific policy problems.

One of the fundamental questions in this respect concerns the social functions and boundaries of financial intermediation. Financial institutions' growing involvement in commercial activities blurs these boundaries, so that it is not clear any more where financial intermediation ends and trade intermediation begins—and what regulatory implications should follow. The recent growth of derivatives markets intensified this conceptual ambiguity by enabling the rise of new, hybrid intermediaries that seamlessly combine financial risk management services with large-scale commercial enterprise, often without being subject to full-blown regulation as financial intermediaries.

Resolving this fundamental ambiguity, however, is a difficult task. Much work needs to be done before we can outline a realistic path toward a new structural paradigm in financial regulation. Understanding where we are today and how we got here is the necessary first step on that path.

Endnotes

1. 12 U.S.C. § 24 (Seventh).
2. 12 U.S.C. §§ 1841 et seq.
3. For a discussion of the origins and subsequent changes in the primary policy focus of the Bank Holding Company Act, see Saule T. Omarova & Margaret E. Tahyar, That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States, 31 Rev. Banking & Fin. L. 113 (2011-12).
4. 12 U.S.C. § 1843. The list of activities "closely related" to banking can be found in the Federal Reserve's Regulation Y, 12 C.F.R. 225.28(b). Many financial activities (securities dealing and underwriting, general insurance underwriting, private equity investing) and commercial activities (real estate brokerage, land development, manufacturing and trading in physical goods) do not qualify as "closely related" to banking and, therefore, are generally impermissible for BHCs.
5. For a full discussion of the history and implications of the OCC's decisions in this area, see Saule T. Omarova, The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking," 63 U. Miami L. Rev. 1041 (2009).
6. 12 C.F.R. 225.28(b)(14).
7. Parts II and III of this essay are based on Saule T. Omarova, The Merchants of Wall Street: Banking, Commerce, and Commodities, 98 Minn. L. Rev. (forthcoming 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180647.
8. 12 U.S.C. § 1843(k)(4)(H).
9. 12 U.S.C. § 1843(k)(1)(B).
10. 12 U.S.C. § 1843(o).
11. 12 U.S.C. § 1843(c)(6),(7).
12. 12 C.F.R. § 225.170(a). The Merchant Banking Rule provides the following definition:
 Section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) and this subpart authorize a financial holding company, directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act. For purposes of this subpart, shares, assets or ownership interests acquired or controlled under section 4(k)(4)(H) and

this subpart are referred to as "merchant banking investments."
13. 12 C.F.R. § 225.171(b)(1).
14. 12 C.F.R. § 225.171(d)(2),(3).
15. 12 C.F.R. § 225.171(d)(1). This means merely that the portfolio company must employ officers and employees responsible for routinely managing and operating its affairs.
16. 12 U.S.C. § 1843(k)(1).
17. 12 C.F.R. § 225.89(a).
18. 12 C.F.R. § 225.89(b)(3).
19. 12 U.S.C. § 1843(j)(2)(A).
20. Id.
21. H.R. 10—The Financial Services Modernization Act of 1999: Hearings Before the Comm. On Banking and Fin. Servs., 106th Cong. 294-95 (1999) (prepared testimony of Michael E. Patterson, Vice Chairman, J.P. Morgan & Co., Inc., on behalf of the Financial Servs. Council).
22. As of mid-2013, the Federal Reserve approved only one other type of activity – certain disease management and mail-order pharmacy services – as complementary to a financial activity of underwriting and selling health insurance. Wellpoint, Inc., 93 Fed. Res. Bull. C133 (2007).
23. See, e.g., Citigroup, Order Approving Notice to Engage in Activities Complementary to a Financial Activity, 89 Fed. Res. Bull. 508 (2003).
24. Id. at 6-7.
25. 12 U.S.C. § 1843(o)(1). In addition, the statute requires that the aggregate consolidated assets of the company attributable to commodities or commodity-related activities, not otherwise permitted to be held by an FHC, not exceed five percent of the company's total consolidated assets (or such higher percentage threshold as the Board may authorize) and prohibits cross-marketing of products and services between any of its subsidiaries engaged in the grandfathered commodities activities and any affiliated U.S. depository institution. 12 U.S.C. § 1843(o)(2),(3).
26. On its face, the statutory 5-percent limit on the FHC's total consolidated assets attributable to grandfathered commodities activities seems to operate as a built-in brake on a new FHC's purely commercial activities in various markets for physical commodities. In absolute terms, however, even such a small fraction of total consolidated assets of a large FHC (with a trillion-dollar balance sheet) may allow for a considerable expansion of its commercial business of owning, producing, transporting, processing, and trading physical commodities.
27. Financial Services Competitiveness Act of 1995,104 H.R. 1062 (Version 1), Sec. 109.
28. This is how an American Bankers Association report described the proposal:

To allow for two-way affiliations between banks and securities firms, a new type of holding company would be permitted. This would be the investment bank holding company. These companies would have still wider powers than the new bank holding company format would bring, but the separation between banking and commerce would still be retained. These special holding companies could own wholesale financial institutions (WFIs, also known as "woofies") which would be uninsured but also not subject to standard bank holding company firewalls.

Steve Cocheo, Outlook Brightens for New Banking Laws, ABA Banking Journal, Feb. 27, 1997, at 10.
29. Goldman Sachs lobbied for specific inclusion of the commodity grandfathering clause in the "woofie" provisions of the House bill because of its existing investment in J. Aron, a commodity trading company. The commodity grandfathering provision was "widely viewed as the "Goldman" exception." Martin E. Lybecker, Financial Holding Companies and New Financial Activities Provisions of the Gramm-Leach-Bliley Act, in BACK TO THE FUNDAMENTALS: INSURANCE REGULATION, BROKER-DEALER REGULATION, AND INVESTMENT ADVISER REGULATION (ABA CENTER FOR CLE NAT'L INSTITUTE, NOV. 8-10, 2001), fn. 11.
30. S. Rep. 106-44 (Apr. 28, 1999), at.3.
31. For a recent study attempting to quantify such implicit subsidy of large financial institutions, see Viral Acharya, Deniz Anginer, & A. Joseph Warburton, "The End of Market Discipline? Investor Expectations of Implicit State Guarantees" (2013).
32. Thus, section 23A of the Federal Reserve Act, which imposes quantitative and qualitative limitations on transactions between federally insured depository institutions and their affiliates, should theoretically prevent the leakage of this public subsidy from banks to their commodity-trading non-bank affiliates. 12 U.S.C. § 371c. As the recent crisis demonstrated, however, the practical effectiveness of this statutory firewall is subject to considerable doubt. See Saule T. Omarova, From Gramm-Leach-Bliley to Dodd-Frank: the Unfulfilled Promise of Section 23A of the Federal Reserve Act, 89 N. C. L. Rev.1683 (2011).
33. Louis D. Brandeis, Other People's Money: And How The Bankers Use It (1933), at 3.

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