
Saule Omarova’s inquiry into whether Wall Street could be regulated—or self-regulated—as a “community of fate”\(^1\) is one way of asking how much we should reform the financial system after the recent financial crisis.

Perhaps, she suggests, strong command-and-control regulation is not the answer—or at least not the only part of the answer. After all, Wall Street had a long preregulatory tradition of acting in concert to prevent financial panics. Concerted action was not always successful, to be sure, but it was something that the original J.P. Morgan—not to mention today’s JPMorgan Chase—would find familiar.

Can Wall Street be induced to act in concert to forestall the next crisis? Here, I think Omarova’s creative exploration of how self-regulation might work offers promise, though I accept it with qualifications. A self-regulated industry might work particularly well in the context of powerful, though not always prophetic, regulators that oversee finance, especially the Treasury Department and the Federal Reserve.\(^2\) Regulators like these—agencies that possess “shotguns be-

---

\(^{1}\) Assistant Professor of Legal Studies, The Wharton School of the University of Pennsylvania.

hind the door” for use in emergencies \(^3\) but also face real problems in keeping up with the latest innovations in financial engineering—could have the right combination of abilities and needs to make industry self-supervision realistic and useful.

In this brief evaluation of Omarova’s article, I situate the piece in the emerging literature of financial crisis fixes; I explore what, exactly, regulation through a community of fate—her vision of a precondition for effective self-regulation—might mean for the industry; and I offer a modest critique of the argument that moderate self-regulation can solve the modern problems of global panics. Creating the ideal form of a community of fate would be challenging. \(^4\) But the task is not insuperable, and if done right and in conjunction with some of the traditional substantive reform that Omarova herself thinks may be useful, \(^5\) then it could minimize the pain of the next panic.

A number of proposals to fix the financial system have been introduced in the media and literature, and some of them have involved quite stringent regulation. Jeffrey Gordon and Christopher Muller, for example, suggest creating a $1 trillion bailout fund that would be funded by the banks themselves to deal with the next crisis—a forced insurance scheme. \(^6\) Simon Johnson and others go even further; they believe that the banks should be broken up through antitrust or hard-asset caps. \(^7\) Paul Volcker, the former Federal Reserve chair and Ob-

---

\(^3\) The metaphor belongs to former SEC Chair (and later Supreme Court Justice) William O. Douglas, who said of self-regulation that “[g]overnment would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.” William O. Douglas, Democracy and Finance 82 (J. Allen ed. 1940). For a discussion of this “shotgun,” see Toni Anne Puz, Note, Private Actions for Violations of Securities Exchange Rules: Liability for Nonenforcement and Noncompliance, 88 COLUM. L. REV. 610, 611, 612 n.19 (1988).

\(^4\) As Omarova states, “[i]ndividual firms within the industry must realize the importance of assuring collective survival through voluntary limitation of their otherwise unconstrained profit-seeking activities.” Omarova, supra note 1, at 446.

\(^5\) See id. at 483 (noting that “for an effective self-regulatory system to emerge and thrive, there must be a strong regulatory and supervisory framework in whose shadow such self-regulation operates”).

\(^6\) See Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund, 28 YALE J. ON REG. 151, 155 (2011) (“The initial fund should be $1 trillion, indexed to an appropriate measure of financial sector growth. The Fund should be partly pre-funded by risk-adjusted fees charged to large or systemically important financial firms.”).

ama advisor, has urged Congress to rationalize financial regulation by, among other things, consolidating it in one or two market regulators—a proposal former Treasury Secretary Henry Paulson also pushed, but the Dodd-Frank Financial Reform Act of 2010 eschewed. And although those who believe that we should learn to live with a boom-and-bust financial system have kept relatively quiet in propounding proposals for fixing the system of financial regulation, retaining the old way of doing things is an alternative that cannot be discounted either, given the apparent success and even the profitability of the ad hoc bailouts administered during the last financial crisis.

I view Omarova’s approach as one that, at its most rigorous, might serve as a force multiplier for fans of stringent oversight, but also as one that is quite consistent with a laissez-faire approach. Omarova argues that the financial industry may be well suited to police itself against crisis, especially if the alternative is a constant battle with a command-and-control government regulator. Moreover, she contends that self-regulation might be able to do the job that the Dodd-Frank Act assigned to a council of senior regulators—regulation de-

---


11 After all, it could be that the highs of unconstrained American finance are worth the loss of busts and bubble bursts when compared with heavily regulated and sleepy financial sectors that drive much less growth—a model adopted in Canada, for example.

12 Omarova decries the “self-perpetuating dynamic, putting the state and the industry on opposite sides of a regulatory arbitrage game” as “likely to increase complexity in the financial markets and exacerbate potential systemic risk.” Omarova, supra note 1, at 435-36.
signed to forestall systemically unsafe practices. In her view, the sine qua non of such self-regulation would be the creation of a “we feeling,” the belief that if the financial industry participants do not hang together, then they will hang separately. In competitive industries such communities of fate are difficult to find, but Omarova has found a couple: the nuclear power industry is surpassingly interested in ensuring that every nuclear power plant operator meets high safety standards, and by the same token, the chemical manufacturing industry after the Bhopal disaster has tried to ensure that none of its members causes similarly terrible releases of toxins.

Could Wall Street police itself in the same way? As Omarova notes, “[t]he global financial industry has a significant history of self-regulation.” She plausibly argues that finance, rather than its regulators or its customers, is the regulatory least-cost avoider. Financial institutions understand market complexity. They can assess risks quickly. If they took their “we feeling” seriously enough, they might even be willing to pool together to create some kind of self-insurance fund, obviating the need for Gordon and Muller’s regulatory solution.

Moreover, Wall Street regulates itself quite a bit today, suggesting that the move from competitive industry to a “we feeling” might not be a very long one. The SEC has branded exchanges and other capital-market-clearing institutions as self-regulatory organizations, or SROs, and for decades these organizations have been pressed into market-oversight service. This experience, to be sure, has not put the exchanges at the front and center of guaranteeing systemic stabili-

---

13 See Alvin C. Harrell, Teaching Consumer Law Part Five, 14 J. CONSUMER & COM. L. 87, 95 (2011) (“The Dodd-Frank Act also provides for a separate Financial Stability Oversight council (FSOC), with authority over the safety and soundness of the financial system (S&S) (and authority to overturn a [Bureau of Consumer Financial Protection] rule if that rule threatens that S&S].”).

14 Omarova points to the Three Mile Island and Bhopal accidents as triggers that made the nuclear power and chemical manufacturing industries . . . [the] targets of intense public criticism and attacks by environmentalists and other social groups. It is under conditions of extreme uncertainty and mounting pressure from the outside that private industry actors perceive the greatest need to relate their industry’s norms to its broader, and changing, context.

Omarova, supra 1., at 451.

15 Id. at 464.

16 See Gordon & Muller, supra note 6 and accompanying text (explaining the authors’ proposal for a $1 trillion bailout fund).

17 Omarova, supra note 1, at 465-68.
ty, the issue that Omarova believes self-regulation might also be able to address, but the experience surely counts for something.\footnote{18}{Omarova also notes that the financial industry has self-regulated derivatives for many years through the International Swaps and Derivatives Association. \textit{Id.} at 444.}

For these reasons, Omarova’s account is plausible. It is consistent with a movement in regulation toward enhancing regulatory capacity by using a private sector multiplier that extends the reach of public sector policing.\footnote{19}{See, e.g., Cary Coglianese & David Lazer, \textit{Management-Based Regulation: Prescribing Private Management to Achieve Public Goals}, 37 \textit{LAW \\& SOCY REV.} 691, 692 (2003) (“[A] management-based approach requires firms to engage in their own planning and internal rule-making efforts that are supposed to aim toward the achievement of specific public goals.” (citations omitted))).} The hope is that by encouraging the adoption of internal controls, by requiring the use of gatekeepers like lawyers and accountants, and so on, the private sector can do much more to ensure that regulations enjoy compliance than can publicly employed inspectors and enforcement officers alone.

Furthermore, from a scholarly perspective, Omarova’s account makes the occasionally evanescent New Governance scholarship tangible. New Governance “views regulation as a reflexive, iterative, and dialogical process and ‘identifies ongoing deliberation as the most legitimate and most effective mechanism for making decisions in complex organizational structures.’”\footnote{20}{Omarova, \textit{supra} note 1, at 427 (quoting Cristie L. Ford, \textit{New Governance, Compliance, and Principles-Based Securities Litigation}, 45 AM. BUS. L.J. 1, 27-28 (2008)).} It is often difficult to understand what this means, amid all the iterative processes and dialogic benchmarking. Omarova’s suggestions show the way for New Governance to actually take root.

But I still worry about the potential of the community of fate, especially given the costs of cooperation in a purportedly competitive industry. I offer five critiques.

\textit{First}, self-regulation can lead to anticompetitive cartelization, a particular concern in the financial markets. After all, NASDAQ brokers and dealers fixed bid-ask spreads for decades in the heart of a purportedly liquid and competitive market.\footnote{21}{“[N]ot only did private plaintiffs awake the federal government to . . . price collusion that the government had previously ignored, but also pulled the principal laboring oar in advancing this case.” Arthur M. Kaplan, \textit{Antitrust as a Public-Private Partnership: A Case Study of the Nasdaq Litigation}, 52 CASE W. RES. L. REV. 111, 112 (2001) (internal quotation marks omitted)).} Industry-generated compliance efforts create barriers to entry no matter what industry is involved. But in finance, which has been accused of less-than-clearly
procompetitive cooperation many times in the past few decades, a blessing of self-regulation warrants some trepidation.

Second, if the impetus for the creation of a community of fate in a competitive industry is the threat that a single accident at a single business might destroy an entire sector, then we must ask whether finance is well analogized to such an industry. The welfare of firms in the financial industry may, in fact, be far more correlated than that of firms in the nuclear power and chemical production industries. In finance, one panic will affect many companies, as has been the case for centuries. The paradigm is not that bad news for one firm makes it hard for others to do business, regardless of their fundamental business plan; it is that bad news can make one, one hundred, or many hundreds of firms insolvent at once. This is contrary to a situation in which the litigation, compensation, and political risk at one firm will create public relations—but not necessarily real—problems in comparable institutions. Because panics result in real insolvency for many financial intermediaries, rescues have often followed these panics. And if the correlation and centrality of finance make rescue likely, it is possible that, rather than acting as a community of self-policing fate, the incentives and structure of finance will lead the industry to act as a community of moral hazard. Creating the desired incentive structure is difficult because there are real differences between the correlation of risks in finance and in industries facing terrible industrial accidents, such as the nuclear power and chemical production industries.

Third, it is difficult to reconcile the story Omarova tells about regulatory capture—where regulators often do the bidding of the finance industry—with a story that the industry will begin to police itself because of the in terrorem effect of the regulator. Financial regulators unquestionably have the power to destroy recalcitrant or inept members of the industry. But they have often been unwilling to act.

---


23 Omarova, supra note 1, at 463-64.

24 Id. at 486.

25 See David Zaring, A Lack of Resolution, 60 Emory L.J. 97, 100 (2010) (noting that “in the wake of the crisis, [Congress and President Obama] passed and signed
Despite the Dodd-Frank Act’s efforts to ban bailouts in the future, in a crisis it is very hard for the government to leave the financial community to its own protections.\textsuperscript{26} And if the shotgun behind the door is so rarely employed, will the incentives to self-regulate really add up?

\textit{Fourth}, one of Omarova’s preconditions for self-regulation is a Glass-Steagall-like cabining of the wholesale industry (which trades market instruments of varying complexity) and the retail industry (which funds itself through individual deposits).\textsuperscript{27} Such a separation is not New Governance, although Omarova herself admits that the best self-regulatory schemes are paired with command and control by effective regulators.\textsuperscript{28} But perhaps this admission is a useful caution about the power of the community of fate model.

\textit{Fifth}, will pooled insurance, one of the mechanisms that, Omarova proposes, a self-policing effort might create,\textsuperscript{29} actually work? Firms can write off insurance as a cost of doing business and pass that cost along to customers, after which financial intermediaries may get involved with more and more hazardous activities because of the prospect of insurance. Nor is moral hazard the only problem. In financial markets, counterparties present risk—the possibility that the counterparty will be unable to meet its contractual obligations because of insolvency. That risk, one would think, would give market participants incentives to carefully monitor one another for long-term stability. But the very real incentives of counterparty risk, which in many ways already created its own community of fate for financial intermediaries, failed to preclude the most recent financial crisis. One wonders whether more of a Wall Street “we feeling” would be more likely to do any better.

I nonetheless find Omarova’s suggestions to be thoughtful. The financial industry is familiar with some degree of internal cooperation, after all. And furthermore, I am unconvinced by the strongest proponents of capture. The Treasury Department, for all its problems during the last financial crisis, seriously punished one of the five larg-

\textsuperscript{26}See Kim Krawiec, \textit{On Second Doses and Delegations}, THE CONGLOMERATE (July 21, 2010), \url{http://www.theconglomerate.org/2010/07/on-second-doses-and-delegations.html} (arguing that Dodd-Frank does not completely tie the executive branch’s hands).

\textsuperscript{27}Omarova, supra note 1, at 475-82.

\textsuperscript{28}See id. at 416, 445-46.

\textsuperscript{29}Id. at 481 (“The introduction of a mandatory system of mutual self-insurance among these firms is another measure likely to incentivize private firms in the wholesale financial services industry to see themselves as a community of fate.”).
That means that two of the five largest investment banks in the United States were killed under close government oversight. Omarova recognizes that “we feelings” are created by threats and the prospect of industry-wide devastation, absent high, self-enforced industry standards of safety. While collapsing financial market bubbles do not provide the same sort of threats of industry-wide devastation (at least not threats unaccompanied by bailouts), it is possible that government regulation here is a bit more of a daunting prospect.

Finally, there is historical precedent for Omarova’s approach to financial reform. She may be reinvigorating an old approach to dealings with financial panics, as well as outlining a new one. J.P. Morgan, after all, led an industry rescue to forestall the banking crisis of 1907. Morgan learned his craft in a banking industry that, of its own accord, adopted regional clearinghouses in an effort to avert the regular banking panics of the nineteenth century. Morgan led the 1907 rescue with assistance from the Secretary of the Treasury, but not with a government bailout. Although Omarova bases the theoretical underpinnings of her approach on the recent New Governance literature, she is also reaching back to reinvigorate a long-standing model of financial regulation. And that approach—new ideas, but with a track record—is a pretty good basis for reform.


30 See Davidoff & Zaring, supra note 2, at 480, 493 (characterizing the Bear Stearns sale as a punishment and the Lehman Brothers collapse as an intentional move to send a message).


32 Id.; see also Robert F. Bruner & Sean D. Carr, The Panic of 1907: Lessons Learned from the Market’s Perfect Storm 57-64 (2007) (describing the development and significance of clearinghouses in the 1907 crash).