THE NEW MACROPRUDENTIAL REFORM PARADIGM: CAN IT WORK?

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"Macroprudential policies focus on risks to the financial system as a whole. Such risks may be crosscutting, affecting a number of firms and markets, or they may be concentrated in a few key areas. A macroprudential approach would complement and build on the current regulatory and supervisory structure, in which the primary focus is the safety and soundness of individual institutions and markets." [1]

This article addresses whether the implementation of new macroprudential reform policy can work to control systemic risk across the capital and financial markets given the current regulatory infrastructure in the U.S. The passage of the Wall Street Reform and Consumer Protection Act (Reform Act) signaled a major change in the current regulatory and supervisory infrastructure from a microprudential model to a "big picture" or macroprudential approach to systemic risk in two significant ways. First, while addressing systemic risk has historically been within the realm of financial or prudential regulation, the new paradigm of macroprudential policy expands prudential regulation into the securities markets as a new stop gap measure to control "crosscutting" systemic risk. Second, the

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1. Benjamin Bernanke, Chairman, Fed. Res. Bank, Financial Reform to Address Systemic Risk, Address to the Council on Foreign Relations, (March 10, 2009) (emphasis added), *available at* http://www.federalreserve.gov/newsevents/speech/bernake/20090310a.htm http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

Reform Act also creates a hybrid reform model designed to wed the new macroprudential systemic risk management policy, under the oversight of a super regulator, with the current supervisory "functional oversight" model implemented by existing federal agencies. The article focuses on whether the hybrid reform model will work given the limitations and weaknesses of the current regulatory infrastructure upon which it is built. To address this question, the article examines four federal agencies responsible for supervising some material aspect of financial transactions in the securities and banking sectors. Understanding the U.S model offers a ground for comparison with similar macroprudential policies recently implemented in other global financial markets.

INTRODUCTION

The Glass–Steagall Act of 1933[2] provided for the separation of commercial and investment banking as part of the 1933 Banking Act.[3] The Gramm-Leach-Bliley Act, also known as the Financial Modernization Services Act of 1999,[4] repealed part of Glass-Steagall, removing barriers in the market among banking companies, securities companies, and insurance companies that prohibited any one institution from acting as any combination of an investment bank, a commercial bank, and an insurance company.[5] The change was viewed as a welcome deregulation of the banking and financial services market. The theory was that the market is the best possible facilitator of economic coordination and rationality, even superior to central planning and regulation. Deregulation became the mantra of global capital markets in the race to become more competitive in global financial centers.[6]

2. The Glass-Steagall Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933).

3. The Glass-Steagall Act technically refers to two separate federal laws: the Glass-Steagall Act of 1932 and the Glass-Steagall Act of 1933, the latter known as the Banking Act of 1933. *See* J. Gorman, General Counsel, Conference of State Bank Examiners, *Summary of Provisions*, (2012), *available at* http://www.csbs.org/bankinglaw101/BL101%20PDF/Glass-Steagall_Act.pdf. (describing how the Act "effectively separated commercial banking from investment banking"); The 1933 Act "also amended the Federal Reserve Act to institute the system of federal deposit insurance on a temporary basis, and created the Federal Deposit Insurance Corporation ("FDIC")." *Id.*

4. The Gramm-Leach-Bliley Act, Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified at 15 U.S.C. § 6801 et seq.).

5. The Gramm-Leach-Bliley Act, *Summary of Provisions*, http://www.banking.senate.gov/conf/grmleach.htm.

6. *See generally* PETER KOSLOWSKI, THE ETHICS OF BANKING: CONCLUSIONS FROM THE FINANCIAL CRISIS 167-76 (Springer ed., 2010).

The dominance of deregulation greatly facilitated the recent financial crisis and the trillion dollar bailouts of the banking and financial services system.[7] The resulting destruction of capital through big bank deregulation has had enormous political, economic, and social consequences. The singular consequence examined in this article focuses on the change in the regulatory and supervisory model aimed at the banking and securities markets in an effort to ease systemic risk and prevent future melt downs.[8] Specifically, the article examines the movement from microprudential regulation to macroprudential regulation,[9] not only in the banking and financial services market but also in the extension of the model to the securities market in an effort to address the threat of "crosscutting" systemic risk.

This idea of integrating prudential or financial risk regulation into the securities laws is relatively new and mostly untested.[10] Securities regulation has traditionally focused on securing market efficiency and preserving the trust and confidence of investors in the marketplace, whereas regulatory monitoring of prudential systemic risk has been confined to financial sector regulators and done at a microprudential level.[11]

The specific question to be addressed is whether the new model of macroprudential regulation, envisioned by the Wall Street Reform and Consumer Protection Act (Reform Act),[12] can successfully interface with the actual regulatory apparatus in place. The answer to the question lies to a great degree in understanding how the U.S. regulatory system works. The issue here is not one of design, but rather the probable success of agency implementation.

Systemic risk has been defined as, "the potential for the financial

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7. *Id.* at 167.

8. "The idea that macroprudential policy is needed to correct market failures, rather than to smooth financial cycles is important. . . . The identification and correction of market failures is a clearer, uncontroversial objective for a macroprudential regulator." Giovanni Favara & Lev Ratnovski, *Macroprudential Policy: Economic Rationale and Optimal Tools*, VOX (Aug. 6, 2012), http://www.voxeu.org/article/macroprudential-policy-economic-rationale-and-optimal-tools.

9. *See* Claudio Borio, *Towards a Macroprudential Framework for Financial Supervision and Regulation*, 49 CESIFO ECON. STUD. 181 (2003) (providing in-depth finance discussion regarding the distinction between microprudential and macroprudential models of regulation).

10. *See* Anita I. Anand, *Is Systemic Risk Relevant to Securities Regulation?*, 60 U. TORONTO L.J. 941, 942 (2010) [hereinafter Anand] (stating that very few countries have integrated systemic risk into their securities laws).

11. *Id.* at 943.

12. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Reform Act].

distress of a particular firm or group of firms to trigger broad spillover effects in financial markets, further triggering wrenching dislocations that affect broad economic performance."[13]

By analogy, systemic risk can be thought of as an illness that becomes uncontrollably contagious.[14] "Crosscutting" systemic risk can be described as a risk of default by one market participant that will have repercussions on other market participants in different markets due to the interlocking nature of financial markets both domestically and globally.[15]

The passage of the Reform Act, aimed at addressing systemic risk, signaled a major change in the current regulatory and supervisory infrastructure from a microprudential model to a "big picture" or macroprudential approach in two significant ways.[16] First, while addressing systemic risk has historically been within the realm of financial or prudential regulation, the new paradigm of macroprudential policy expands prudential regulation into the securities markets as a new stop gap measure to control "crosscutting" systemic risk.[17] Second, the Reform Act also creates a hybrid reform model designed to wed the new macroprudential systemic risk management policy, under the oversight of a super regulator, with the current supervisory "functional oversight" model implemented by existing federal agencies.[18] Chairman Bernanke recently observed, regarding the relative benefits of this hybrid model, that "[b]oth regulation and market discipline have important roles to play in constraining risk-taking in financial markets; the best outcomes are

13. Emil Henry, Assistant Secretary for Treasury for Financial Services, U.S. Treasury, Address Before the House Policy Council of the Financial Services Roundtable (June 26, 2006), *available at* http://www.treasury.gov/press-center/press-releases/Pages/js4338.aspx.

14. *Id.*

15. CHRISTOPHER LAURSEN ET AL., , PCI WHITE PAPER, WHY TOO BIG TO FAIL IS TOO SHORT SIGHTED TO SUCCEED: PROBLEMS WITH RELIANCE ON FIRM SIZE FOR SYSTEMIC RISK DETERMINATION, (2010), http://www.pciaa.net/web/sitehome.nsf/lcpublic/379/$file/pci_whitepaper_toobigtofail.pdf

16. *See* Ben S. Bernanke, Chairman, Fed. Res. Bank, Address Before 47th Annual Conference on Bank Structure and Competition, Chicago, Ill. Conference on Bank Structure and Competition (May 5, 2011) [hereinafter Bernanke] (highlighting the changes and goals of the Reform Act).

17. *See* Letter from Ben Bernanke, Chairman, Fed. Res. Bank, to Bob Corker, U.S. Senator (Oct. 30, 2009) (discussing the new paradigm for addressing systemic risk); *See* Ben S. Bernanke, Chairman, Fed. Res. Bank, Address Before 2012 Federal Reserve Bank of Atlanta Financial Markets Conference, Stone Mountain Georgia (April 9, 2012) (explaining the government's overhaul of the financial system and how it takes systemic risk into account).

18. Annette Nazareth, *New Paradigms for Financial Regulation in the United States and the European Union*, 35 BROOK. J. INT'L L. 845, 847 (2010) [hereinafter Nazareth].

achieved when these two forms of oversight work effectively together."[19]

I. THE CONNECTION BETWEEN FINANCE THEORY AND LEGAL REGULATION

The Reform Act effectively integrates finance theory and the law but not much is written about that process. The connection between macroprudential policy and regulatory implementation is clear given that the failure of credible regulatory oversight in the regulatory and supervisory infrastructure is recognized as one major contributing factor to the rise of systemic risk.[20] Thus, it is difficult to understand the new vision of regulatory reform in the marketplace brought about by the Reform Act without first understanding the underlying finance and economic theories that explain the new direction of the law.[21] However, current literature fails to address the important question of whether new financial reform is indeed in lockstep with the existing regulatory infrastructure needed to implement its goal of stabilizing the market economy. Arguably, the success of financial reform depends in great measure upon the actual legal authority of regulators to implement real economic reforms. The analysis of the four federal agencies below illustrates that it is a mistake to assume that such broad legal authority resides with the regulators.

A. Implementation of the Financial Model

An economic study by Hanson, Kashyap & Stein, focusing on the model of macroprudential regulation, addresses the financial crisis in private sector banking institutions and how the movement from microprudential regulation to a new regulatory paradigm of macroprudential regulation could better control systemic risk.[22] In

19. Ben S. Bernanke, Chairman, Fed. Res. Bank, Remarks at the Squam Lake Conference, Remarks on "The Squam Lake Report: Fixing the Financial System" (June 16, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20100616a.htm.

20. David Lieberg & Michaela Posch, *Macroprudential Regulation and Supervision: From the Identification of Systemic Risk to Policy Measures*, FIN. STABILITY REP., June 2011, at 68, http://www.oenb.at/en/img/fsr_21_special_topic_02_tcm16-235512.pdf [hereinafter Lieberg & Posch].

21. *See generally* Bernanke, *supra* note 16 (discussing the goals and reasoning behind reform regulation).

22. Samuel G. Hanson, Annil K. Kashyap, & Jeremy C. Stein, *A Macroprudential Approach to Financial Regulation*, 25 J. ECON. PERSP. 3 (2011), *available at* http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.25.1.3 [hereinafter Hanson et al.].

expanding the "field of vision" from safety- and-soundness regulations that focus on individual financial institutions in isolation to the financial market as a whole, Hanson, Kashyap and Stein argue that specific changes to monetary policy and capital requirements can ease systemic risk.[23] At the conclusion of the article, the authors pose a critical but unanswered question "about how such regulation might be implemented."[24] Noting that macroprudential oversight has been delegated to large councils populated by the heads of many diverse regulatory agencies such as the Financial Stability Oversight Committee (FSOC), a creature of the new Reform Act, and the European Systemic Risk Board, the article asks whether the existing weaknesses in the regulatory system itself can be addressed "sensibly."[25] The concern is not isolated. For example, Davis and Karim worry that new regulation does not merely lead to substitution capital flows toward the remaining unregulated or less regulated sectors.[26] Milne cautions that it is necessary to grasp not only the new contours of macroprudential policy (envisioned by the UK Financial Services Authority), but also how those new policies will be implemented to achieve the intended reform objectives.[27]

Thus, the Hanson, Kashyap & Stein article leaves open two important albeit unanswered questions.[28] First, is macroprudential regulation merely a function of shifting the focus from a particular banking institution in isolation to the financial market as a whole, or is the new model of macroprudential regulation, as envisioned by the Reform Act, a regulatory model that expands the field of vision to include both the financial and capital markets? In short, what are the parameters of macroprudential reforms? The second unanswered question is whether a macroprudential reform model can be successfully implemented in the U.S. based upon limitations in the current regulatory infrastructure?

B. Credible Regulatory Oversight

The second unanswered question was partially addressed in Weismann's article, which specifically focuses on how to achieve credible regulatory oversight, given the current U.S. regulatory apparatus that

23. *Id.* at 4.
24. *Id.* at 23.
25. *Id.*
26. Phillip Davis, & Diruba Karim, *Macroprudential Regulation - The Missing Policy Pillar*, 211 NAT'L INST. ECON. REV., 11 (2010), http://ner.sagepub.com/content/211/1/67.
27. Alstair Milne, *Macroprudential Policy: What Can It Achieve?,* 25 OXFORD REV. OF ECON. POL'Y 608, 611 (2009) [hereinafter Milne].
28. *See* Hanson et al., *supra* note 22 (discussing macroprudential regulation).

provides meaningful control of a nation's financial infrastructure and at the same time preserves innovation and growth in the marketplace.[29] Weismann observes that the oversight question is generally framed in terms of identifying a corporate or market disaster and then reflecting upon what factors are needed to make oversight work.[30] However, this framing usually is "without any real understanding of the boundaries of regulatory authority and the systemic problems impacting the probable success of oversight."[31] While a valuable exercise in scholarship, its shortcoming is comparable to trying to fix a watch without first understanding all of the moving parts.[32] The article then examines several questions in the context of the current regulatory structure, including: What is regulatory oversight? How does regulation work? What is the actual legal jurisdiction of the regulatory agencies in the financial sector? What is the standard for determining whether the oversight exercised by a particular federal agency is "credible"? Who makes the decisions in government, if anyone? Given the current slow pace of passing enabling regulations, does the new Reform Act signal real change in financial oversight?[33]

C. Integrating Theory and Practice to Achieve Reform

To determine whether the new macroprudential reform model can be successfully implemented in the U.S. given its current domestic regulatory infrastructure, four federal agencies, responsible for supervising material aspects of financial transactions in the securities and banking sectors, are considered, including: the Securities and Exchange Commission (SEC); the Commodity Futures Trading Commission (CFTC); Federal Reserve Board

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29. *See* Miriam F. Weismann, *Achieving the goal of 'credible' regulatory oversight*, 15 J. LEGAL ETHICAL AND REGUL. ISSUES 1, 1 (2012) [hereinafter Weismann] (focusing on "the difficult and unresolved question of how to achieve credible regulatory oversight that provides meaningful control of the nations' financial infrastructure and at the same time preserves innovation and growth in the marketplace").

30. *Id.* at 3.

31. *Id.*

32. *Id*.

33. Weismann concludes: "In short, it is fair to conclude that law makers, regulators and the private sector, ostensibly in partnership with the regulators, must all accept responsibility for the current state of the financial markets. However, this should not become just an exercise in assessing blame. Instead, the goal should be to focus on accountability for the failure of the regulatory system to identify systemic risk. The Reform Act, like SOX before it, is reactive legislation enacted not only to solve this nagging problem of achieving financial stability in the marketplace but also to send a remedial message in the hope of coaxing 'gun-shy' investors back into the markets." *Id. a*t 45. The article then suggests several regulatory drafting "best practices" to increase the level of credible oversight. *Id.* at 42.

(FRB); and the Federal Deposit Insurance Corporation (FDIC). The important changes made by the Reform Act, including the creation of the umbrella regulator the FSOC[34] to implement the new macroprudential policy, is likewise considered in this context.

The regulatory analysis first considers whether a particular agency has operated in compliance with its congressional mandate in accordance with the agency's regulatory model. Several conclusions about oversight are provided based upon the relative success or failure of a particular agency's oversight activities. Then, changes to the respective agency's authority and jurisdiction implemented by the Reform Act are also reviewed. Finally, the article concludes that achieving the goal of credible oversight and reform through the implementation of macroprudential policy reform is complicated and cannot be cured simply by piling on more rules and regulations. Even achieving a baseline of credible supervision under macroprudential reforms may not necessarily result in credible oversight. Inadequate regulatory oversight embraces a multitude of external deficiencies, including a lack of resources, an agency's lack of focus, pressure from outside political forces, legal and policy limitations on agency authority, regulatory gaps created by policy decisions, and concealment of dishonest business practices in the private sector. These externalities directly impact the probable success of implementing the macroprudential model of systemic risk management embedded in the Reform Act in the domestic and global venues currently considering the problem.

II. UNDERSTANDING THE MACROPRUDENTIAL REGULATORY MODEL: A HYBRID BY DESIGN

A. Macroprudential Regulation: A Hybrid Model

The new model of regulatory policy and oversight envisioned by the Reform Act is a hybrid between the existing regulatory structure, referred to as "functional regulation," and macroprudential systemic risk management, addressing both crosscutting risks and risks that flow across

34. *See generally*, EDWARD V. MURPHY AND MICHAEL B. BERNIER, CRS REPORT TO CONGRESS, FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK, R42083 (2011), *available at* http://assets.opencrs.com/rpts/R42083_20111115.pdf (describing the purpose and scope of the FSOC). The Financial Stability Oversight Council (FSOC) was created by the Reform Act as part of a comprehensive reform of the banking and securities market regulators. *Id.* The FSOC both monitors systemic risk in the financial system and coordinates several federal financial regulators. *Id.*

multiple markets.[35] Financial experts tend to agree that systemic risk regulation and functional regulation "are closely interconnected and highly complementary."[36] Separation of systemic risk regulation and functional regulation creates a risk that nether performs satisfactorily in isolation.[37]

There are, however, several variants of the macroprudential risk management model. Indeed, a clear consensus on the definition, parameters and focus of macroprudential regulation has yet to be reached.[38] Generally, macroprudential policy has been defined as the "use of regulatory and other instruments to reduce the risk of financial instability."[39] In the case of the Reform Act, the new paradigm of systemic risk regulation is broadly designed, blurring the traditional distinction between financial and securities markets regulation and joins the two in a more unified system of supervision.[40] Instead of focusing on components of the financial system, macroprudential policy addresses the system as a whole and, in conjunction with microprudential regulation and supervision, is gauged to achieve financial stability.[41]

One main feature of macroprudential regulation in the global financial services industry has been an effort to control the social costs associated with economic downturns and excessive balance sheet shrinkage on the part of multiple financial institutions facing a common shock.[42] Federal

35. Nazareth, *supra* note 18, at 847; Weismann, *supra* note 29, at 8.

36. Nazareth, *supra* note 18, at 847.

37. *See generally* Bruce Arnold et al., *Systemic Risk, Macroprudential Policy Frameworks, Monitoring Systems and the Evolution of Capital Adequacy*, 36 J. BANK. & FIN. 3125, 3125-32 (2012)(discussing systemic risk's advancement, measurement and implementation difficulties as a result of policy reform).

38. *Id.* at 3126; Lieberg & Posch, *supra* note 20, at 68.

39. Milne, *supra* note 27, at 611.

40. Bernanke, *supra* note 16.

41. *Id.*

42. *See generally*, BANK OF ENGLAND, THE ROLE OF MACROPRUDENTIAL POLICY (2009), *available at* http://www.bankofengland.co.uk/publications/Documents/other/financialstability/roleofmacroprudentialpolicy091121.pdf ("Whatever its structure, the prudential regulatory framework will need to be re-oriented to have a system-wide focus. And improvements need to be made to allow financial institutions to fail without imposing unacceptable costs on the rest of society."); Stephen Cecchetti, Econ. Adviser and Head of Monetary and Econ. Dep't, Bank for Int'l Settlements (BIS), Remarks Prepared for the Second Conference of the European System of Central Banks: The Future of Financial Intermediation and Regulation, (Oct. 30, 2012), *available at* http://www.bis.org/speeches/sp121030.pdf ("As recent events have shown yet again, the fundamental links between the real economy and the financial system make it difficult if not impossible, to isolate the former from shocks originating in the latter . . . the reason to proscribe certain activities, to constrain certain actions, and to require certain behaviors is to not to protect individuals from facing the consequences of their own actions. Rather, it is to keep the negligence, miscalculations, and errors of one individual or institution from affecting the system as a whole").

Reserve Chairman Ben Bernanke, recognizing that such adverse shocks and systemic risk may be crosscutting, namely, risk affecting a number of firms and markets, concluded that macroprudential regulatory reforms should extend beyond the financial markets into the securities markets as well.[43] The crosscutting effect is likewise a global concern.[44] As noted previously, securities regulation has traditionally focused on securing market efficiency and preserving the trust and confidence of investors. On the other hand, regulatory monitoring of prudential systemic risk has been confined to financial sector regulators and done at a microprudential level. This notable separation between microprudential regulatory goals for the financial and securities markets is also common in other developed economies in the world.[45] It is the movement from microprudential regulation to macroprudential regulation[46] and its integration with the current U.S. regulatory system of functional regulation that has created complexity and challenges in implementing the Reform Act.

B. Functional Regulation

The oversight model of "functional regulation" remains relatively unchanged by the Reform Act.[47] This regulatory system embraces both the banking sector and the securities and futures sector and assigns supervisory

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43. Bernanke, *supra* note 16.

44. *See generally*, Oliver DeBandt & Philipp Hartmann, *Systemic Risk: A Survey* (European Cent. Bank, Working Paper No. 35, 2009) (exploring systemic risk as the basis in economic crises), *available at* http://www.pedz.uni-mannheim.de/daten/edz-ki/ezb/00/w-paper/ecbwp035.pdf.

45. Anand, *supra* note 10.

46. *See generally*, Erlend Nier, *Macroprudential Policy-Taxonomy and Challenges*, 216 NAT'L ECON. REV. R1, R1 (2011) [hereinafter Nier] (exploring questions and strategies to effectively implement macroprudential regulation)..

47. Weismann, *supra* note 29, at 8. ("The current regulatory oversight model in the securities and futures financial marketplace can best be described as a hybrid of government and private sector governance. Federal agencies, authorized to regulate within legal boundaries set by Congress, are bound in a governance partnership with private sector organizations including SROs (self-regulatory organizations), which ostensibly operate in lockstep with government regulation. Congress crafted this hybrid model of financial oversight with the passage of the 1934 Securities and Exchange Act. The original SEA regulatory model was aptly described by former SEC Chair Arthur Leavitt: 'Our securities markets operate under a 'self-regulatory' system. Markets serve an important public interest, and deserve public oversight; but markets are also innovative and fast moving, and easily stifled by the heavy hand of government. So Congress arrived at a formula in which the industry polices itself, with SEC oversight. This keeps us out of most day- to-day affairs, and allows us to keep our hands off, but our eyes open. And on those rare occasions when self-regulation goes off track, the SEC must act in the public interest'")..

authority based upon "functional" operations.[48] Thus, financial products or activities are regulated and supervised according to their function, no matter which market or firm offers the product or participates in the activity.[49] This also means that more than one federal agency may be responsible for supervision at the same time.[50] Broker-dealer activities, for instance, are generally subject to the SEC's jurisdiction, whether the broker-dealer is a subsidiary of a bank holding company subject to Federal Reserve supervision or a subsidiary of an investment bank.[51] According to the Government Accounting Office (GAO), "[t]he functional regulator approach is intended to provide consistency in regulation, focus regulatory restrictions on the relevant functions area, and avoid the potential need for regulatory agencies to develop expertise in all aspects of financial regulation."[52]

The relative benefits of the functionality model are two-fold. First, specialization by regulators allows them to better understand the risks associated with particular activities or products. Second, competition among regulators helps promote regulatory innovation, providing businesses with a method to move to regulators whose approaches better match the businesses' operations.[53] However, the Federal Reserve has admitted that although the model is effective in design, it is ineffective in its "execution."[54] This inefficiency has resulted in an "institution-by-institution supervisory approach," which fails to identify overall systemic instability.[55] The solution to this problem is somewhat addressed by the Reform Act through the FSOC and its new role in bringing together the functional regulators to supervise big picture systemic risk posed by Wall Street and the banking industry.[56] The functionality characteristic of the oversight model, however, remains in place and is not changed by the Reform Act.[57]

48. *Id.* at 9.

49. *Id.*

50. *Id.*

51. *Id.*

52. U.S. GOV'T ACCOUNTABILITY OFFICE REPORT, GAO-08-32, INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE (2007), *available at* http://www.gao.gov/assets/270/267957.pdf.

53. *Id.*

54. Ben S. Bernanke, Chairman, Fed. Res. Bank, Fostering Financial Stability, Address Before 2012 Federal Reserve Bank of Atlanta Financial Markets Conference, Stone Mountain Georgia (April 9, 2012).

55. *Id.*

56. *Id.*

57. Weismann, *supra* note 29, at 9.

C. The Financial Services Oversight Council (FSOC)

Notably, the Reform Act does not change this model of empowering and limiting agency regulatory authority despite the creation of the new systemic risk overseer, the FSOC.[58] The FSOC consists of ten voting members including, nine federal financial regulatory agencies and an independent member with insurance expertise and five nonvoting members.[59]

In enacting the Reform Act, Congress responded to various criticisms of the functional regulatory model.[60] Congress recognized that the then existing regulatory structure focused regulators narrowly on individual institutions and markets, which allowed supervisory gaps to grow and regulatory inconsistencies to emerge, which in turn, permitted arbitrage and weakened standards.[61] No single entity held responsibility for monitoring and addressing risks to financial stability posed by different types of financial firms operating in and across multiple markets.[62] As a result, important parts of the system were left unregulated.[63] The federal regulatory agencies' analyses selected in this article will aptly illustrate this point. The Reform Act is an attempt to fix the flaws, not eliminate the

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58. Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1001, 4 Stat. 1376 (2010), *available at* http://www.govtrack.us/congress/bill.xpd?bill=h111-4173.

59. *Id.* at § 111(b)(1)(A-j). The voting federal regulatory agencies include: the Secretary of the Treasury, who serves as the Chairperson of the FSOC, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the newly created Consumer Financial Protection Bureau, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency (FHFA), the Chairman of the National Credit Union Administration Board (NCUA), and an independent member with insurance expertise that is appointed by the President and confirmed by the Senate for a six-year term. H.R. 4173,111th Cong. § 111(2010). The FHFA was added by the Reform Act to replace the now dissolved OTS. Nonvoting regulatory members are selected from various state agencies and serve only in an advisory capacity. The state nonvoting members have two-year terms. *Id.* at § 111(b)(2).

60. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-1049T, FINANCIAL REGULATION: RECENT CRISIS REAFFIRMS THE NEED TO OVERHAUL THE U.S. REGULATORY SYSTEM 2 (2009), *available at* http://www.gao.gov/new.items/d091049t.pdf. ("The current U.S. financial regulatory system is fragmented due to complex arrangements of federal and state regulation put into place over the past 150 years . . . . Today, almost a dozen federal regulatory agencies, numerous self-regulatory organizations, and hundreds of state financial regulatory agencies share responsibility for overseeing the financial services industry").

61. FIN. STABILITY OVERSIGHT COUNCIL, TREAS., BUDGET OF THE PRESIDENT, FISCAL YEAR 2014 (2002), at FSOC-3, *available at* http://www.treasury.gov/about/budget-performance/CJ14/14.%20FSOC%20CJ%20Final%20ok.pdf.

62. Bernanke, *supra* note 16.

63. *Id.*

model, and to provide business with a "strong incentive to avoid becoming systemically significant" or "too big to fail."[64]

As Chairman Ben Bernanke explained, the purpose of the FSOC is to provide a forum for agencies with differing responsibilities and perspectives to share information and approaches and facilitate identification and mitigation of emerging threats to financial stability.[65] It is intended "that the lines of accountability for systemic oversight be clearly drawn, [but that] the council should not be directly involved in rule-writing and supervision.[66] Rather, those functions should remain with the relevant supervisors, with the council in a coordinating role."[67] Thus, the FSOC can be characterized as more of a "looker" rather than a "doer" with a significant exception where the marketplace is "imperiled," a situation still to be defined by implementing regulations.[68]

The creation of the FSOC also responds to the risk that the information relied on by a systemic risk regulator, and supplied by a functional regulator, is merely derivative in nature and may lag behind real time events due to coordination efforts.[69] This issue is problematic in times of crisis as evidenced by the recent subprime mortgage debacle. In this situation, a council of regulators, such as the FSOC, is conducive to information aggregation.[70] To identify emerging stress and imbalances and then address them through timely and efficient regulatory calibration, the systemic regulator must have close connections to the functional regulator and regular and close contacts with multiple market representatives and intermediaries.[71] To achieve calibrated regulation, the macroprudential model is designed to ensure that all systemically important markets are subject to consolidated supervision.[72] This complex task requires coordination, timely information sharing, and policy coordination at both the domestic and international levels.[73]

64. David Moss, *An Ounce of Prevention*, HARVARD MAG., Sept.-Oct. 2009, at 5, *available at* http://harvardmagazine.com/2009/09/financial-risk-management-plan.

65. Bernanke, *supra* note 16.

66. *Id.*

67. *Id.*

68. Weismann, *supra* note 29, at 13.

69. Nazareth, *supra* note 18, at 847.

70. Bernanke, *supra* note 16.

71. PAUL VOLCKER, THE GROUP OF THIRTY THE STRUCTURE OF FINANCIAL SUPERVISION APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE, 14 (2008), *available at* http://www.group30.org/images/PDF/The%20Structure%20of%20Financial%20Supervision.pdf.

72. Bernanke, *supra* note16.

73. *Id.*

III. IMPLEMENTATION OF THE REFORM MODEL THROUGH THE REGULATORY INFRASTRUCTURE

Can the hybrid macroprudential reform model work effectively and efficiently within the boundaries and limitations of the current U.S. federal regulatory system? Erlend Nier, Senior Financial Sector Expert at the International Monetary Fund (IMF), postulates that, critical to the success of the implementation of any macroprudential oversight model, are four key factors: information collection powers, designation powers, rulemaking and calibration powers, and a strong mandate.[74] Information collection starts with an assessment of systemic risk for the financial sector as an integrative whole.[75] The macroprudential authority should have designation powers or the authority to create policy for all systemic institutions.[76] Rule-making should be calibrated across time and industry sectors.[77] Finally, a strong mandate should constrain the discretionary use of powers and, through legal regulation, define the primary objectives of the macroprudential authority.[78]

Nier's ideal model of the system of macroprudential oversight does not completely coalesce with the existing U.S. regulatory model. As noted above, the FSOC is more of a "looker" rather than a "doer" with the critical aspects of credible regulatory oversight remaining within each federal agency whose powers are strictly mandated by Congress. However, Nier's framework, along with an understanding of how the current U.S. regulatory infrastructure operates, does provide a starting point to evaluate whether the U.S. regulatory system and the Reform Act's macroprudential model can successfully interface to achieve real economic and market reforms.

A. The U.S. System of Regulatory Oversight

Credible regulatory oversight is a central component in achieving the goal of good corporate governance. In the Enron hearings, Congress credited the absence of credible oversight as one of the principle causes of the corporate debacle.[79] It concluded that both the regulators and the

74. Nier, *supra* note 46, at R3.
75. *Id.* at R6.
76. *Id.* at R7.
77. *Id.*
78. *Id.*
79. *See* STAFF OF S. COMM. ON GOV. AFFAIRS, REPORT ON THE FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, S. Prt. 107-75, at 2 (2002), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT82147/pdf/CPRT-107SPRT82147.pdf. ("In looking at the array of purported checks on financial misbehavior, what Committee staff

traditional "corporate watchdogs" in the private sector "failed to bark." More recently, the FCIC Report of investigation of the current financial crisis echoes the same sentiment, noting that the regulators were simply not "at their posts."[80]

Credible oversight is also important in its breach. Particularly where markets lack transparency or are otherwise unregulated, as with derivatives and hedge funds, such unregulated, unsupervised financial markets can all too easily suffer catastrophic failure. If a market center gains a reputation as having lax oversight and surveillance, that market will suffer the consequences. Those consequences include "the harsh reality that where there is no market, there is no value."[81] The recent collapse of capital markets resulting from inadequate or absent credible oversight underscores the true importance of the discussion.

In simple terms, credible regulatory oversight is, at a minimum, a function determining whether the agency is doing the job that it is charged by law to do. Simply put, credible regulatory oversight is at least a function of whether the agency is doing the job that it is authorized by law to do.[82] In 1993, Congress passed the Government Performance and Results Act (GPRA) to "improve the confidence of the American people in the capability of the Federal Government, by systematically holding federal agencies accountable for achieving program results."[83] The Office of Management and Budget (OMB) is responsible for the implementation of the GPRA.[84] The OMB typically examines the overall effectiveness of the entire federal apparatus and/or its various parts.[85]

Additionally, the Inspector General Act of 1978 was enacted to

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discovered was deeply disturbing not so much because they uncovered malfeasance or intentional wrongdoing on anyone's part (although that seems to have been present in some cases as well), but because what emerged was a story of systemic and arguably catastrophic failure, a failure of all the watchdogs to properly discharge their appointed roles. Despite the magnitude of Enron's implosion and the apparent pervasiveness of its fraudulent conduct, virtually no one in the multilayered system of controls devised to protect the public detected Enron's problems, or, if they did, they did nothing to correct them or alert investors. Not one of the watchdogs was there to prevent or warn of the impending disaster . . . .").

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

81. William Bodine & Christopher Nagel, *Quants Gone Wild - the Subprime Crisis*, WALL ST. J., March 2008, *available at* http://247wallst.com/2008/03/27/quants-gone-wil/ [hereinafter Bodine].

82. Weismann, *supra* note 29, at 5.

83. Government Performance and Results Act of 1993, Pub. L. No. 103-62 §2(b)(1) (1993).

84. *Id.* at § 3(a).

85. *Id.* at § 3.

conduct and supervise audits and investigations relating to the programs and operations of numerous federal agencies.[86] Functionally, the IG focuses on the operations of a specific agency,[87] whereas the OMB examines the overall effectiveness of the regulatory apparatus, or some part thereof, in connection with a particular systemic issue or problem.[88] The Reform Act also creates the Council of Inspectors General on Financial Oversight (CIGFO), which consists of all of the IGs assigned to audit the performance of the federal regulators serving on the FSOC.[89] The regulators are now ostensibly more highly regulated.

Ideally, when the audit results reveal that the agency has satisfied its congressional mandate, it acts credibly. When the agency does not, it fails. The problem is that averting crisis through adequate supervision is often difficult to document. When something does not go wrong, it is hard to prove that the system is functioning because the regulators are supposedly fulfilling their respective jobs.

B. Externalities Impacting Credible Regulatory Oversight

Oversight may also be credible in the sense that it satisfies its congressional mandate; however, oversight may still be unable to prevent corporate misconduct where the circumstances are beyond the regulator's

86. Inspector General Act of 1978, Pub. L. No. 95−452, 92 Stat. 1101, H.R. 8588 (1978). .

87. *Id.* §§4(a)(4); 6(a)(2); 6(c); *See also* Robert Longley, *About the Office of the Inspector General*, http://usgovinfo.about.com/od/thepresidentandcabinet/a/oig.htm. ("Within the federal agencies are politically independent individuals called Inspectors General who are responsible for ensuring that the agencies operate efficiently, effectively and legally").

88. *The Mission and Structure of the Office of Management and Budget*, WHITEHOUSE.GOV, *available at* http://www.whitehouse.gov/omb/organization_mission. ("The management side of OMB is comprised of five offices, four of which are statutory, that oversee and coordinate the Administration's procurement, financial management, e-government, performance and personnel management, and information and regulatory policies. In each of these areas, OMB's role includes not only administrative management functions, but also program and policy management (e.g., program delivery and outcomes). This role encompasses oversight of how agencies devise, implement, manage, and evaluate the statutory programs and policies for which they are responsible. This responsibility is central to OMB's efforts to assist in agency strategic planning, goal-setting, performance measurement, information management, evaluation, and policy research. These functions are essential parts of the policy and program direction advice that OMB provides.").

89. *See generally* COUNCIL OF INSPECTORS GEN. ON FIN. OVERSIGHT, ANNUAL REPORT OF THE COUNCIL OF INSPECTORS GENERAL ON FINANCIAL OVERSIGHT, (2011), http://www.federalreserve.gov/oig/files/CIGFO_Annual_Report_July_2011.pdf.
(explaining the creation and composition of the Council of Inspectors General on Financial Oversight).

sphere of control. In short, credible supervision may not necessarily result in credible oversight where outside forces prevent or interfere with the regulatory oversight function.

First, even assuming that the regulatory agency is functioning according to its legal mandate, the congressionally authorized degree of supervision may be inadequate to detect and prevent corporate and financial misconduct.[90] Thus, the agency may be doing precisely what it is authorized to do but lacks congressional authority to prevent the problem.[91] Case in point: the CFTC, through its former chair Brooksley Born, requested and was refused the congressional authority to regulate derivatives.[92]

Even more problematic are those policy decisions made outside of the control of a particular regulatory agency that may impact the agency's ability to control the consequences in the marketplace.[93] Indeed, John Taylor of Stanford University makes a compelling argument that government intervention and conscious economic policy decisions designed to protect consumers actually created, worsened, and prolonged the current financial crisis.[94] Also, not to be forgotten is the wave of deregulation during the Reagan era, referred to as "the cure that killed" and crippled regulatory oversight.[95]

Next, market innovations may simply outpace regulatory control.[96]

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90. Brooksley Born, Chairperson, U.S. Commodity Futures Trading Comm'n, Regulatory Responses to the Risks in the OTC Derivatives Market, Address to ABA Section of Business Law (Nov. 13, 1998), *available at* http://www.cftc.gov/opa/speeches/opaborn-40.htm. ("Notably, no reporting requirements are imposed on most OTC derivatives market participants. This lack of basic information about the positions held by OTC derivatives users and about the nature and extent of their exposures potentially allows them to take positions that may threaten our regulated markets or, indeed, our economy without the knowledge of any federal regulatory authority.") [hereinafter Born].

91. *Id.*

92. *Id.*; *See also* DVD: Frontline: The Warning (PBS 2009), *available at* http://www.pbs.org/wgbh/pages/frontline/warning/view/ (describing the requests of Chairperson Brooksley Born) [hereinafter Frontline].

93. *See generally*, JOHN TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED AND WORSENED THE FINANCIAL CRISIS (Hoover Inst. Press 2009) (describing the problem of policy decisions made without control of particular agencies).

94. *Id.*

95. *See generally*, KITTY CALAVITA & HENRY N. PONTELL, *Heads I Win, Tails You Lose: Deregulation, Crime And Crisis In The Savings and Loan Industry*, *in* CRIMES OF PRIVILEGE (Shover & Wright eds., Oxford University Press 2001) (describing deregulation during the Reagan era).

96. *See* Henry Hu, *Misunderstood Derivatives: The Causes of Informational Failure and The Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993) [hereinafter Hu] (describing market innovations); *The Modern Process of Financial Innovation and the*

Henry Hu demonstrated in his landmark article in 1993 that the very design of a financial product has the ability to impede regulatory oversight and control.[97] Hu's point is aptly illustrated by Thomas Donaldson's example of unregulated hedge funds, which he argues are, by design, made up of "intractable conflicts that cannot be resolved through government regulation."[98]

Additionally, concealed fraudulent behavior may impede oversight.[99] For example, the fraudulent use of earnings by management is typically invisible to the naked regulatory eye even upon audit of the books and records.[100] The resulting collapse of trust, described by Greenspan as the cornerstone of the marketplace, some argue, cannot be repaired by regulation at all.[101] Indeed, certain financial behaviors are just "bad to the bone" and cannot be fixed until some form of internal corporate governance addresses the inherent conflicts of interest inbred in corporate culture.[102] Thus, the problem may not be one of failed credible regulatory oversight but instead, one caused by other outside forces, externalities, that can overtake the oversight function and control the outcome.

Inevitably, the responsibility for oversight failure must be shared with the private sector, which has strenuously insisted on preserving a self-regulatory model. As part of that self-regulatory model, the private sector has certain delineated oversight duties to the public, such as those performed by self-regulatory organizations (SROs).[103] At its most basic level, self-regulation is the manner by which all firms self-police their own

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Regulation of OTC Derivatives: OTC Derivatives: Modernizing Oversight to Increase Transparency and Reduce Risks: Hearing Before the U.S. Senate Banking Com.: Subcomm. on Securities, Insurance, and Investment, 111th Cong. (2009) (statement of Henry T. C. Hu), *available at*
http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=a89592d9-cbaa-4930-8ce4-de1291688474.

97. Hu, *supra* note 96.

98. *See generally* Thomas Donaldson, *Hedge Fund Ethics*, 18 J. Bus. Ethics 405 (2008) [hereinafter Donaldson] (exampling the inability of government to resolve the conflicts of unregulated hedge funds).

99. *See* MIRIAM WEISMANN, CORPORATE CRIME AND FINANCIAL FRAUD, THE LEGAL AND FINANCIAL IMPLICATIONS OF CORPORATE MISCONDUCT (American Bar Association Press, Chicago 2012) [hereinafter CORPORATE CRIME].

100. *Id.*

101. Alan Greenspan, Chairman, Fed. Res. Bank, Address to the Conference on Bank Structure and Competition, Chicago, Illinois (May 8, 2003), *available at* http://www.federalreserve.gov/boarddocs/speeches/2003/20030508/.

102. Donaldson, *supra* note 98, at 415.

103. *See* BrokerCheck Glossary, FIN. INDUS. REG. AUTH. (June 28, 2010), http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/P015176. (defining an SRO as "[a]n entity, such as FINRA or the New York Stock Exchange, responsible for regulating its members by adopting and enforcing rules that govern its members' business conduct");

activities to ensure that they are meeting all fiduciary and other duties to their clients.[104] In fact, the old "Shingle Theory" was founded on the principle that, if you hold yourself out to the public as offering to do business, you are implicitly representing that you will do so in a fair and honest manner."[105] In many instances, the private sector has failed to live up to its part of the bargain as envisioned by Congress.[106] Thus, the regulatory oversight model is clearly a shared function in the marketplace where the federal regulatory infrastructure does not and is not intended to unilaterally control all aspects of oversight. Indeed, as history has shown, the private sector must frequently be held accountable by regulation infused with financial disincentives to avoid the failure to credibly self-regulate.[107]

Finally, the passage of the Reform Act signals an attempt by Congress, in lockstep with the economic policy of macroprudential regulation heralded by the Federal Reserve Bank, to deal with a bigger problem; namely, the desperately needed overhaul of an outdated regulatory infrastructure that is ill-suited to the task of financial regulatory oversight.[108] Achieving credible regulatory oversight is less likely where the adeptness of federal agencies anointed with supervisory responsibility critically lags behind innovative financial products and activities in the marketplace.

C. Overview: The Divided Roles of the Banking and Security Regulators

The two primary and intrinsically interrelated financial sectors identified by the Reform Act include the banking industry and the

104. The SEC requires self-regulatory organizations to register with the SEC. *Registration Under the Securities Act of 1933*, SEC (2013), http://www.sec.gov/answers/regis33.htm; *See also Other Links*, SEC (2013), http://www.sec.gov/links.shtml#selfreg (providing a listing of other SROs).

105. Lori Richards, Director, Office of Compliance Inspections and Examinations, U.S. SEC. AND EXCH. COMM'N, Speech at NRS Fall 2000 Compliance Conference: Self-Regulation in the New Era (Sept. 11, 2000), *available at* http://www.sec.gov/news/speech/spch398.htm [hereinafter Richards].

106. *The Watchdogs Didn't Bark: Enron and The Wall Street Analysts: Hearing Before the Comm. On Governmental Affairs*, 107th Cong. (2002) (statement of Sen. Lieberman, Chairman, Sen. Comm. Governmental Affairs).

107. ACHARYA, V, L. PEDERSEN, T. PHILLIPON AND M. RICHARDSON, N.Y.U. STERN WHITE PAPERS PROJECT, REGULATING SYSTEMIC RISK, 283-304 (2008).

108. U.S. GOV'T ACCOUNTABILITY OFFICE REPORT, GAO 09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009) [hereinafter ACCOUNTABILITY OFFICE REPORT].

securities and futures markets.[109] With some new additions and modifications created by the Reform Act, the federal regulatory structure is as follows. In the banking sector, under the functional regulatory model, multiple federal and state agencies may regulate the same entity based upon the functionality model described above.[110] However, the primary supervisor of a domestic banking institution is determined by the type of institution and the regulator responsible to license its operations.[111] In the banking industry, that regulatory configuration depends on the type of charter under which the banking institution operates.[112] State regulators charter institutions and participate in the oversight of those institutions. However, all of these institutions have a primary federal regulator if they offer federal deposit insurance.[113] Additionally, these federal regulators establish capital requirements for the depository institutions, supervise and conduct onsite examinations and offsite monitoring to assess an institution's financial condition, and monitor and enforce compliance with banking and consumer laws.[114] The regulators issue regulations, take enforcement actions, and close institutions determined to be insolvent.[115]

The other primary financial sector, the securities and futures sector, is regulated under a combination of SRO's, subject to oversight of the appropriate federal regulator, and direct oversight by the SEC and/or the CFTC. It is a system grounded upon self-regulation. SROs, such as the New York Stock Exchange and the AMEX, have responsibility for oversight of the securities markets and their participants by establishing the standards for their members; monitoring business conduct; and bringing disciplinary actions against their members for violating applicable federal statutes, SEC rules, and SRO rules.[116] The SEC supervises SROs by inspecting their operations, reviewing SRO rule proposals and appeals of final disciplinary proceedings.[117] In the futures industry, SROs include the futures exchanges and the National Futures Association.[118] Futures SROs

109. Reform Act, *supra* note 12.
110. Reform Act, *supra* note 12.
111. Reform Act, *supra* note 12.
112. Reform Act, *supra* note 12.
113. Reform Act, *supra* note 12.
114. Reform Act, *supra* note 12.
115. Reform Act, *supra* note 12.
116. *See* Richards, *supra* note 105 (holding the private sector accountable via financial disincentives).
117. U.S. GOV'T ACCOUNTABILITY OFFICE REPORT, GAO-05-61, FINANCIAL REGULATION INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 34 (2004).
118. *See generally*, Self-Regulation and Self-Regulatory Organizations in the Futures Industry, 70 Fed. Reg. 71090 (Nov. 25, 2005)(describing self-regulatory organizations in general).

are responsible for establishing and enforcing rules governing member conduct and trading; providing for the prevention of market manipulation, including monitoring trading activity; ensuring that futures industry professionals meet qualifications; and examining members for financial strength and other regulatory purposes.[119] The CFTC independently monitors, among other things, exchange trading activity, large trader positions, and certain market participants' financial conditions.[120]

Thus, one limitation under current macroprudential policy, viewed under Nier's ideal model of information gathering and calibration, is that functional regulation requiring timely information sharing among numerous regulators of the same institution remains intact.[121] Additionally, the policy does not directly impact the system of self-regulation that is a major component of risk control management in the private sector.[122] The private sector remains an outsider in terms of stakeholder membership in the FSOC. Nor does the new policy address in pragmatic terms the impact of externalities on the ability of various regulatory agencies to engage in credible oversight.[123]

D. The Sources and Limits of Divided Regulatory Oversight Authority

Regulatory agencies have limited powers.[124] Understanding these limitations on the exercise of agency regulatory authority is critical to evaluating the likely success of implemented policy that applies Nier's model with respect to rulemaking authority and calibration. The Supreme Court has made clear that regulatory authority to act must always be based on a specific grant of congressional power.[125] "Regardless of how serious the problem an administrative agency seeks to address . . . it may not exercise its authority 'in a manner that is inconsistent with the administrative structure that Congress enacted into law.'"[126]

There are also legal limitations on the acceptable breadth of agency interpretations of statutes in the course of drafting implementing

119. U.S. GOV'T ACCOUNTABILITY OFFICE REPORT, GAO-05-61, FINANCIAL REGULATION INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE (2004).

120. U.S. GOV'T ACCOUNTABILITY OFFICE REPORT, GAO-08-32, INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE (2007).

121. Nier, *supra* note 46, at R1.

122. *Id.*

123. *Id.*

124. *See* FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 125 (2000) (quoting ETSI Pipeline Project v. Missouri, 484 U.S. 495, 517 (1988)).

125. *Brown & Williamson Tobacco Corp,*, 529 U.S. at 125

126. *Id.*

regulations.[127] "The power of an administrative agency to administer a congressionally created and funded program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress."[128] If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to implement a specific provision of the statute by regulation.[129] The courts will accord such legislative regulations "controlling weight" unless they are "arbitrary, capricious, or manifestly contrary to the statute."[130] In short, regulators do not have carte blanche to regulate to prevent harm even if the result is desirable to protect the health, safety, and welfare of the public. Nor can an agency create corporate governance standards for business or pass regulations that result in a substantial economic impact in the marketplace unless Congress accords the rule and policy making authority to that agency through legislative grant. The agency also has no independent power to detect and prevent wrongdoing. Here, credible oversight is restricted to Congressional will and not agency whim.

Thus, the first step in the agency analysis examines the enabling legislation to determine the scope of each agency's powers in their respective oversight roles. The analysis also reviews the seminal court cases that restrict the boundaries of agency authority under the congressional mandate. Returning to the definition of credible oversight, this data illustrates that the operation of the regulatory infrastructure is at least a function of whether the regulatory agency is doing the job that it is authorized by law to do. The agency may be doing precisely what it is authorized to do by law, but may still lack the real authority to prevent a particular problem. Concomitantly, policy decisions made outside of the control of a particular regulatory agency may impact the agency's ability to control the consequences in the marketplace and create regulatory gaps. Both situations may interfere with agency supervision and the implementation of macroprudential policy by federal regulators.

127. *See infra* notes 128-130 and accompanying text (discussing the scope of regulations).

128. Morton v. Ruiz, 415 U.S. 199, 231 (1974).

129. *Id.*

130. Chevron U.S.A. v. Natural Res. Def. Council, 467 U.S. 837, 844 (1984).

IV. UNDERSTANING THE RELATIONSHIP BETWEEN THE REGULATORS AND THE RULES

A. *The Securities and Exchange Commission*

1. Regulatory model and authority

With the creation of the SEC in 1934, a conscious policy decision was made about the character of oversight that the new regulatory body was to exercise over issuers in the marketplace.[131] The model was premised on self-regulation by issuers, through a system of self-reporting under the supervision of the regulator.[132] Here, supervision did not vest responsibility in the regulator to perform internal corporate auditing functions or other "hands-on" supervision.[133] It was never intended that the SEC would become the issuer's accountant.[134] Instead, it was the job of the issuer to hire credible third party professionals, such as accountants and lawyers, to perform audits, issue opinion letters, and assist in full and fair disclosure through a system of documentary reporting to the SEC.[135]

Simply, the regulator was to review and inspect only the issuer's mandated disclosures, to confirm that it was abiding by the rules.[136] Critical to the model of self-regulation was trust. The regulator was supposed to be able to rely upon the reporting disclosures of the issuer.[137] That model also required the regulator to actually look at the materials being submitted by the issuer at least every three years to make such a determination.[138] Credible oversight in this context meant a hands-off approach to issuers with, as former SEC Chairman and Supreme Court Justice William O. Douglas described, the "shotgun behind the door," in the event an issuer engaged in improper or unlawful behavior.[139] The SEC intended barebones agency regulation to avoid interference with natural

131. CORPORATE CRIME, *supra* note 99.
132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. STAFF OF S. COMM. ON GOV. AFFAIRS, REPORT ON THE FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, S. Prt. 107-75, at 2 (2002), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT82147/pdf/CPRT-107SPRT82147.pdf.
137. *Id.*
138. *Id.*
139. WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE: THE ADDRESSES AND STATEMENTS OF WILLIAM O. DOUGLAS AS MEMBER AND CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION 82 (James Allen ed., 1940).

market forces.[140] The notion that respected third party professionals would not maintain their independence was not accorded much weight.[141] In this way, private sector issuers were burdened with the obligation to provide corporate transparency and the regulator was entitled to rely on the watchful eye of third party professionals ensuring that the issuer satisfied his burden.[142] These third party professionals were thought of as part of a class of "corporate watchdogs," providing actual review and oversight.[143] Indeed, the belief was that the marketplace had a pack of such watchdogs, including not only accountants and lawyers, but also the self-regulatory organizations (SRO's), such as the stock exchanges, investment advisors, banks and market appraisers.[144] Assuming each watchdog performed its functions in a conflict-free environment, the risk or opportunity for corporate wrongdoing would diminish.[145]

There is nothing in this legislative model that contemplates anything more than a supervisory role played by regulators with reliance on information supplied by the issuer, combined with the reactive power to punish in the event of a breach of trust.[146] The federal agencies are bound in a governance partnership with the private sector.[147] This regulatory philosophy is echoed in the agency philosophy espoused on its website: "The SEC facilitates the exchange of reliable and necessary information to enable investors to make informed investment choices."[148] It is this legislative model that defines Nier's key factor, collection of information directly from the firm to the macroprudential regulator.[149]

Periodically, Congress considered increasing the powers of the SEC and various statutes were added to the arsenal of regulatory enforcement tools.[150] Yet, the SEC and Congress have steadfastly remained at a

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140. STAFF OF S. COMM. ON GOV. AFFAIRS, REPORT ON THE FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, S. Prt. 107-75, at 2 (2002), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT82147/pdf/CPRT-107SPRT82147.pdf.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

146. CORPORATE CRIME, *supra* note 99.

147. *Id.*

148. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity and Facilitates Capital Formation*, SEC, *available at* http://www.sec.gov/about/whatwedo.shtml [hereinafter *The Investor's Advocate*].

149. Nier, *supra* note 46, at R1.

150. *See generally How Investigations Work*, SEC, *available at* http://www.sec.gov/News/Article/Detail/Article/1356125787012#.UioX-D9gHmM (providing an overview of the historical development of the SEC's role and law enforcement powers).

respectful distance to avoid undue interference in the marketplace. That philosophy is embedded in the federal regulations which require the SEC to consider, in addition to protection of the investors, whether the proposed regulatory action will promote efficiency, competition, and capital formation in the market.[151] As noted below, the IG has recently chastised the SEC for its failure to follow this mandate in its current efforts to create new implementing regulations under the Reform Act.[152] As such, the model creates a need for the SEC to serve two masters in the marketplace, investors and an efficient market. However, those interests do not always coincide.

Thus, the regulator is intended to supervise a system of self-regulation and enforce reactively in response to self-regulatory failure. This model of "credible oversight" was created by Congress based upon a myriad of policy considerations and political interests. Indeed, trust as the cornerstone of marketplace regulation is still urged as the best regulatory model today.[153] This philosophy may directly impact the scope and breadth of regulation designed to manage risk under the Reform Act. In short, macroprudential regulation is not intended to supplant the "hands-off" economic philosophy that has historically characterized the congressional response to market failure.

2. Recent oversight initiatives

In the wake of the Enron debacle, the SEC was severely criticized for its failure to have provided credible oversight.[154] Responding to the crisis, Congress enacted several new oversight provisions in the Sarbanes-Oxley Act (SOX) increasing both the supervisory powers and responsibilities of the SEC and the disclosure obligations of the private sector, including: 1) annual reports to the SEC must include an assessment of management's internal controls and must be attested to by the auditing firm; 2) the SEC must conduct enhanced review of certain issuer disclosures in periodic reports issued on a regular and systematic basis for protection of investors;

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151. *The Investor's Advocate*, *supra* note 148.

152. SEC INSPECTOR GENERAL REPORT, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER RISK ASSESSMENT PROGRAM (2008), http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf.

153. Donaldson, *supra* note 98.

154. STAFF OF S. COMM. ON GOV. AFFAIRS, REPORT ON THE FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, S. Prt. 107-75, at 5 (2002), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-107SPRT82147/pdf/CPRT-107SPRT82147.pdf ("[T]he SEC's interactions with Enron reveal the downside to the Commission's largely reactive approach to market regulation and should provide an impetus for the Commission to reorient some of its activities toward more proactive anti-fraud measures").

and, 3) directors and officers must certify financial information contained in their own periodic reports submitted to the SEC.[155]

Was this change in oversight initiatives perceived as enough to fix the problem? There is no unified response to that question. Instead, there exists a difference of opinion among the concerned stakeholders about how to define the real problem in the first instance. Lynn Turner, former SEC chief auditor, saw the problem differently.[156] He concluded that current unbridled lending practices contributing to the mortgage crisis reflected a failure of all of the operative parts of the current regulatory model.[157] In a statement before the Senate Committee on Banking, Housing and Urban Affairs on Enhancing Investor Protection and Regulation of the Securities Markets in 2009, Turner concluded: "While lenders were making bad loans in exchange for an upfront fee, and gatekeepers were falling down on the job, federal government agencies were failing to supervise or regulate those under their oversight, as well as failing to enforce laws."[158] He also noted that the lack of regulation of new products also contributed to the failure.[159] For Turner, however, the problem is not necessarily solved by promulgating more rules.[160] Instead, the problem is solved by getting the stakeholders to comply with existing rules.[161]

Finally, some observers question whether the regulatory partnership model between the government and the private sector has any validity and view this partnership with great cynicism.[162] They argue that the partnership model of self-regulation and government oversight breeds an incestuous relationship between government regulators and the private sector, which dilutes credible oversight.[163] There is no set of rules designed to fix this public perception.

155. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

156. *See generally Enhancing Investor Protection and Regulation of the Securities Markets: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs, 111 Cong.* (March 10, 2009) (statement of Lynn Turner, former S.E.C. Chief Auditor) ("There are really three root causes of this problem: people made bad loans, gatekeepers sold out, and a lack of regulation or regulators missing in action, quite frankly. And it is not the first time.").

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. HARRY MARKOPOLOS, NO ONE WOULD LISTEN: A TRUE FINANCIAL THRILLER (John Wiley & Sons, Inc. 2010).

163. *Id.*

3. Evaluating the regulator

It is worth revisiting SEC Director Richard's argument that risk-based examination programs were in place and suitable to prevent and detect risk during the most critical periods of economic failure.[164] Was the SEC's voluntary risk-based oversight program, developed post-Enron, a success or part of a failed oversight paradigm? Concededly, the programs missed Bernard Madoff's simplistic Ponzi scheme but they did manage to "catch" Bear Sterns. However, the 2008 Report issued by the IG, in connection with the SEC oversight of Bear Sterns under the Consolidated Supervised Entity (CSE) Program, questioned the real efficacy of CSE program in view of the fact that Bear Stearns was found to be in compliance with most of the regulations but still became insolvent.[165] The SEC promulgated the regulations, Bear Stearns complied with the regulations, and Bear Stearns failed.[166]

A second IG report addressing SEC oversight of Bear Stearns under the Broker-Dealer Risk Assessment Program concluded that the SEC's Division of Trading and Markets was not fulfilling its oversight obligations under the program and that concerns raised by the IG's audit of the program in 2002 had not been adequately addressed by the SEC.[167] Nearly one third of the firms under the Broker-Dealer Risk Assessment program had not even filed the required documents.[168] The division had not adequately reviewed the filings made by others.[169] The IG concluded that the failure to carry out the purpose and goals of the broker-dealer risk assessment program "hinders the Commission's ability to foresee or respond to weaknesses in the financial markets."[170] However, these conclusions fueled not only a difference of opinion but also precipitated an angry outburst by the SEC.

In response to the IG criticism, then SEC Chairman, Christopher Cox, conceded that the CSE program, created in 2004 in response to the lobbying efforts from the investment banking industry, was "fundamentally flawed from the very beginning" because investment banks could opt in or out of supervision voluntarily.[171] But Cox blamed Congress for the failure

164. Richards, *supra* note 105.

165. SEC INSPECTOR GENERAL REPORT, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER RISK ASSESSMENT PROGRAM (2008), http://www.sec.gov/about/offices/oig/reports/audits/2008/446-b.pdf.

166. *Id.*

167. *Id.*

168. *Id.* at v.

169. *Id.*

170. *Id.*

171. Stephen Labaton, *SEC Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES,

of the program.[172] The fact that investment bank holding companies were intentionally excluded from regulation by Congress by allowing them to withdraw from voluntary supervision at their discretion diminished the perceived mandate of the program and weakened its effectiveness.[173] Subsequently, Cox disbanded the CSE program, but only after the demise or reorganization of the five biggest Wall Street firms, including Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs.[174]

Cox's view that the supervisory debacle was the direct result of a "regulatory gap" created by Congress has support in the legislative history of deregulation.[175] Some hindsight is useful here. In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA) reversing the earlier restrictions between investment banks and commercial bank activities.[176] The law authorized the SEC to regulate only the securities and brokerage operations of the investment banks, but not their holding companies.[177] A gaping regulatory loophole hampered the SEC's ability to control holding company financial activities.[178] In 2002, the European Union, sensing an impending crisis in the unregulated holding company arena, sought to impose its own rules on unregulated holding companies unless they were otherwise regulated domestically.[179] To avoid being subjected to the reach of European Union oversight, the investment banks lobbied the SEC to promulgate the voluntary CSE program.[180] The program was arguably a sham designed to protect the political interests of the investment banking community and avoid government regulation where there was otherwise no clear intention to self-regulate.

While disbanding the CSE program, Cox publicly warned that the same regulatory gap existed in the unregulated credit default swap

Sept. 26, 2008 at A1 (quoting SEC Chairman, Christopher Cox) [hereinafter Labaton].

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

173. *Id.*

174. *Id.*

175. *See* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified at 15 U.S.C. § 6801 et seq.) (summarizing the provisions of the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act, including the Community Reinvestment Act (CRA) amendments).

176. *Id.*

177. *Id.*

178. *Id.*

179. Labaton, *supra* note 171.

180. ACCOUNTABILITY OFFICE REPORT, *supra* note 108.

industry.[181] Later, in testimony before Congress, then FDIC Chair Born recommended that Congress close the same regulatory gap.[182] Both warnings were preceded by the earlier efforts of the GAO, which reported that the large financial interconnections between derivatives dealers posed risk to the financial system and recommended that Congress and financial regulators take action to ensure that the largest firms participating in the OTC derivatives markets be subject to regulatory oversight.[183] Those repeated agency demands were vehemently opposed by Alan Greenspan, then FRB chairman, Lawrence Summers, and Robert Rubin in testimony before Congress.[184] The argument of the "Greenspan bloc" was straightforward: policymakers need to ensure that systemic regulation is balanced with other national goals, including facilitating capital raising and fostering innovation.[185] Booming economic prosperity solidified Congressional agreement with Greenspan.[186] Now, the massive market failure has bred increased suspicion of an incestuous relationship between government regulators and the private sector.[187]

The sustained but unheeded efforts of the SEC, the FDIC and the GAO also aptly illustrate that the agency may be doing precisely what it is authorized to do, but may still lack the real authority to prevent the problem by virtue of regulatory gaps existing in the regulatory framework. The agency may not unilaterally act beyond the scope of its legislative grant of authority to solve an obvious and dangerous problem. Concomitantly, policy decisions made outside of the control of these regulatory agencies; namely, Congressional deference to the "Greenspan bloc," clearly impacted the agencies' ability to control the consequences in the marketplace.[188]

4. Reform Act remediation

In an effort to remediate the problem, the Reform Act has added two oversight "loop closing" features for previously unregulated derivatives

181. Press Release 2008-230, SEC, *supra* note 172; STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG. 2ND SESS., REP. ON THE FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS, 31-36 (Comm. Print 2002).

182. Born, *supra* note 90.

183. U.S. GOV'T ACCOUNTABILITY OFFICE REP., GAO/GGD-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (1994).

184. *See* Frontline, *supra* note 92 (examining early warnings and failures concerning the financial crisis of 2007).

185. *Id.*

186. *Id.*

187. *Id.*

188. FIN. CRISIS INQUIRY COMM'N, FINAL REP. OF THE NAT'L COMM'N. ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE U.S. (2011), http://www.fcic.gov/report.

and hedge funds.[189] First, private equity and hedge funds with assets of $150 million dollars or more must register with the SEC.[190] Venture capital funds remain exempt from full registration.[191] Second, the "Volcker rule" bars proprietary trading unrelated to customer's needs at government backed banks.[192] Additionally, credit exposure to banks from derivative transactions must now be added to banks' lending limits.[193]

In 2012, the IG performed a cost-benefit analysis of the SEC's rule making activities under the Reform Act.[194] The IG concluded in the audit report that:

> [S]ome SEC Dodd-Frank Act rulemakings lacked clear, explicit explanations of the justification for regulatory action. Specifically, some of the rulemakings that were premised on market failure alluded to market failure but did not explicitly cite it as a justification or fully discuss it. Other rulemakings included language that erroneously suggested a market failure justification and contained no compelling alternative rationale in support of the action. OMB Circular A-4 identifies market failure as one of several possible justifications for federal agency regulation. In discussing this point, the circular provides that an agency must demonstrate that proposed action is necessary before recommending regulatory action.[195]

Thus, a disconnect between the proposed regulations and the causes of the market failure may contribute to a flawed implementation of macroprudential policy in the future if court review concludes that the agency has failed to follow the limitations of its rulemaking authority. In any case, piling more regulations on to the industry without a direct impact on the specific causes of market failure fails to achieve the goal of macroprudential reform.

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189. *See* Reform Act, *supra* note 12 (providing links to summaries of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the full text, related bills and other information regarding the Act's legislative history).

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.*

194. SEC INSPECTOR GENERAL REPORT NO. 499, FOLLOW-UP REVIEW OF COST BENEFIT ANALYSIS IN SELECTED SEC DODD-FRANK RULEMAKINGS (2012), *available at* http://www.sec.gov/about/offices/oig/reports/audits/2012/rpt499_followupreviewofd-f_costbenefitanalyses_508.pdf.

195. *Id.*

B. Commodity Futures Trading Commission

1. Regulatory model and authority

Under the Grain Futures Act of 1922, trading of futures contracts was supervised by the Department of Agriculture through the Grain Futures Administration.[196] As part of the legislative fix to the financial crisis resulting in the "Great Depression," Congress passed the Commodity Exchange Act (CEA) in 1936 and created the Commodity Exchange Commission (CEC).[197] The CEC established the Grain Futures Administration.[198] More than forty years passed until 1974 when Congress reorganized the CEC into the modern day CFTC under the Commodities Futures Trading Act (CFTA).[199] The CFTA is generally crafted to regulate futures trading.[200] Futures contracts allow purchasers to buy or sell a specific quantity of a commodity for delivery in the future.[201] While traders are required to register with the CFTC and maintain certain minimum capital requirements, the registration functions were delegated to the National Futures Association, a SRO, by regulation.[202]

The CFTC regulatory oversight model tracks the SEC model.[203] The regulations are crafted to protect the public interest through a system of "effective self-regulation" of trading facilities, clearing systems, market participants and market professionals under the CFTC oversight.[204] The CFTC has jurisdiction over most futures and options contracts, whether traded on an exchange or over the counter (OTC trading).[205] However, the authority to regulate the securities markets is divided between the SEC and the CFTC in conformity with the functionality model described above.[206] The SEC regulates the functions of the securities and securities options

196. Grain Futures Act of 1922, 42 Stat. 998 (1922) (codified at 7 U.S.C. § 1 et seq.).

197. Commodities Exchange Act, Pub. L. No. 74-675, 49 Stat. 1491 (1936); *History of the CFTC,* U.S. COMMODITIES FUTURES TRADING COMM'N, *available at* http://www.cftc.gov/index.htm [hereinafter *History of the CFTC*].

198. *History of the CFTC*, *supra* note 197.

199. Commodities Futures Trading Commission Act, Pub. L. No. 93-463 (1974); *Mission & Responsibilities* U.S. COMMODITIES FUTURES TRADING COMMISSION, http://www.cftc.gov/index.htm [hereinafter *Mission & Responsibilities*].

200. Commodities Futures Trading Commission Act, Pub. L. No. 93-463 (1974).

201. *Id.*

202. *Who We Are*, NATIONAL FUTURES ASSOCIATION, http://www.nfa.futures.org/ (last visited April 25, 2014).

203. *See Mission & Responsibilities*, *supra* note 199.

204. *Id.*

205. *Id.*

206. *Id.*

markets. The CFTC regulates the functions of most other markets.[207]

Moreover, there are numerous regulatory gaps created by law in regard to the OTC regulatory function. The CEA excludes from CFTC regulatory oversight most over the counter (OTC) financial derivatives, including credit default swaps.[208] In 2000, the Commodities Futures Modernization Act "clarified" that some off-exchange trading would be permitted and remain largely unregulated, including hedge funds.[209] Both forms of trading, now excoriated as the culprits of the current financial crisis, were thus intentionally excluded from regulatory oversight by Congress.[210] The CFTC was denied the authority by Congress to supervise these financial products.[211] This statutory model has been amended in some measure by recent changes made by the Reform Act.[212] However, until the enabling regulations are in place, the meaning of those changes will remain somewhat of an unknown. This is particularly true where the system of parallel regulation between the SEC and the CFTC remains in place after the passage of the Reform Act.

Section 3 of the CFTA authorizes three supervisory activities under the CFTC regulatory structure: 1) to protect the price discovery function; 2) to prevent the manipulation of commodities through trading schemes; and, 3) to assure an effective vehicle for risk transference.[213] While the financial futures market includes both sophisticated and unsophisticated investors, the OTC market is comprised mostly of professional broker dealers and institutional investors.[214] Also, the challenge of overseeing the regulation of financial futures is considered functionally different than regulating metals futures, energy futures, or agricultural futures.[215] So, the agency has

207. U.S. COMMODITY FUTURES TRADING COMMISSION, Report on Oversight of Trading on Regulated Futures Exchanges and Exempt Commercial Markets (2007), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/pr5403-07_ecmreport.pdf.

208. Commodities Exchange Act, Pub. L. No. 74-675, 49 Stat. 1491 (1936).

209. Commodities Future Modernization Act of 2000, H.R. 4541, 106th Cong. (2000).

210. *See Id.* (explaining the significance of exchange-traded and OTC derivative instruments to our economy due to their risk-transferring attributes).

211. *History of the CFTC*, *supra* note 197. *See also Mission & Responsibilities*, *supra* note 199.

212. *See* Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Title X, 124 Stat. 1376 (2010) [hereinafter Reform Act] (expanding the joint rule-making authority of the Securities and Exchange Commission and the Commodities Futures Trading Commission in consultation with the Board of Governors of the Federal Reserve System).

213. Commodities Futures Trading Commission Act, Pub. L. No. 93-463 (1974) [hereinafter CFTC ACT].

214. William Rainer, Chairman, U.S. Commodity Futures Trading Comm'n, Remarks at the Twenty Second Annual Chicago-Kent College of Law Derivatives and Commodities Institute (Oct. 28, 1999), http://www.cftc.gov/opa/speeches/oparainer-2.htm.

215. *Id.*

been required to reject a "one-size fits all" regulatory approach in its oversight function.[216]

2. Recent oversight initiatives

In 1998, the CFTC attempted to regulate derivatives.[217] Under the leadership of its Chair, Brooksley Born, the CFTC issued a "Concept Release" aimed at market reform through the regulation and oversight of the OTC derivatives market.[218] Born believed that this unregulated "dark market" could pose grave dangers to the economy.[219] Alan Greenspan, Robert Rubin and Larry Summers testified before Congress in opposition to the attempt at regulation.[220] The Greenspan bloc was successful in derailing regulatory efforts with the passage of the Commodities Future Modernization Act passed in 2000.[221] The CFMA, which exempted most OTC derivatives from regulation, often referred to as the "Enron loophole," is now also blamed for the current financial crisis.[222]

Significantly, the explosive growth of trading in unregulated hedge fund portfolios and OTC derivatives during the period 1999-2004 was preceded by the near catastrophic failure of Long Term Capital Management (LTCM). In fact, the LTCM failure proved that Born had accurately predicted the crisis. LTCM experienced large losses related to its $100 billion trading position in hedge funds.[223] Viewed as a precursor to a global meltdown, the Clinton administration and the FRB pressured the financial institutions with large exposure to the hedge funds to provide $3.6 billion as a cushion until the fund could be liquidated in an orderly fashion.[224] Despite the attempts of Born, the SEC's Christopher Cox and others, the regulatory gap has persisted until the recent passage of the

216. *Id.*

217. Born, *supra* note 90.

218. Over-the-Counter Derivatives, 63 Fed. Reg. 26114, 26115 (May 12, 1998), http://www.cftc.gov/opa/press98/opamntn.htm.

219. *See id.* (asserting that OTC derivatives "can present significant risks if misused or misunderstood by market participants" and that "well publicized, financial losses over the last few years have focused the attention of the financial services industry [and] its regulators. . .on potential problems and abuses in the OTC derivatives market").

220. *See* Frontline, *supra* note 92 (discussing how the statements of the "Working Group," including Alan Greenspan and Robert Rubin, ultimately dissuaded leaders from supporting Born's attempts to regulate the "risky derivatives market" prior to the 2008 financial crisis).

221. Commodities Future Modernization Act of 2000, H.R. 4541, 106th Cong. (2000).

222. *Id.*

223. ACCOUNTABILITY OFFICE REPORT, *supra* note 108.

224. *Id.*

Reform Act.[225] The meltdown that was predicted, experienced in the LTCM debacle, experienced in the energy trades conducted by Enron, and repeated by Bear Sterns, Lehman Brothers, Goldman Sachs, most major U.S. and foreign financial institutions, and many others, is a main contributor to the current financial crisis.[226] In short, Federal Reserve Bank economic policy, supported by Congress, directly impacted the regulator's ability to engage in credible regulatory oversight of an entirely unregulated dark market creating risk exposure in the trillions.[227] This was directly contrary to the original agency oversight purposes envisioned by Congress under the CFTA.[228]

3. Evaluating the regulator

The IG issued an audit report covering the period October 2009-March 2010 evaluating the performance of the CFTC.[229] The IG identified three "most serious" management challenges: Congressional demand that the CFTC and SEC harmonize their regulation of overlapping financial products; a decision on the CFTC's regulatory model for the swaps derivatives market; and expansion of CFTC's regulatory responsibilities over the potential carbon emission trading markets.[230]

Yet, neither the IG nor the GAO has much to say about the CFTC. The agency's struggle over the last twenty years to take its place in the formal regulatory structure was effectively extinguished in 2000 with the passage of the Commodities Futures Modernization Act permitting off-exchange trading that would remain largely unregulated.[231] The CFTC's struggle underscores the potency of externality impact on credible oversight. The culprit is arguably Congress. Not only did Congress refuse to heed the CFTC's warning, it passed affirmative legislation shutting the door on any regulation at all.

4. Reform Act remediation

The Reform Act authorizes the SEC and the CFTC to form a joint

225. Weismann, *supra* note 29 at 26.
226. ACCOUNTABILITY OFFICE REPORT, *supra* note 108..
227. *Id*.
228. CFTC ACT, *supra* note 214.
229. U.S. COMMODITY FUTURES TRADING COMM'N, OFFICE OF THE INSPECTOR GENERAL, Semiannual Report of the Office of the Inspector General (April 30, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oigsar033110.pdf.
230. *Id.*
231. Commodities Future Modernization Act of 2000, H.R. 4541, 106th Cong. (2000).

commission to identify emergency issues and regulatory risks, assess their implications for market participants and recommend solutions.[232] Modernization of the regulatory infrastructure has begun with the expansion of CFTC regulatory authority under the Reform Act, also known as "Derivative Markets Transparency and Accountability Act of 2009."[233] Along with the SEC, the CFTC is authorized to commence rulemaking with regard to swaps and the swap related entities and participants.[234] Specifically, the SEC has the authority to regulate security-based swaps.[235] The CFTC now has primary regulatory authority over swaps, the majority of the overall market for the over-the-counter derivatives.[236] Regulatory changes will be recommended to Congress for implementation in the derivatives market.[237] The agencies will also recommend legislative changes to federal insolvency laws.[238] The Act further extends the CFTC's authority to regulate derivatives and repeals numerous legislative prohibitions.[239] Accordingly, the Reform Act continues to maintain a parallel system of regulatory authority or functional regulation as part of the new plan.[240]

Most significantly, the Reform Act repeals the Gramm-Leach-Bliley Act prohibition against the regulation of security based swap agreements.[241] The CFTC initiated the rule making process by dividing thirty proposed topic areas into eight groups including comprehensive regulation of swap dealers and major swap participants; clearing; trading; enforcement; position limits; and, others.[242]

The expansion of the CFTC's rulemaking authority does address Nier's factor of sending a stronger mandate to the agency than was heretofore characterized by the CFMA, which was enacted to intentionally emasculate the agency.[243] Despite the current reform mandate, however,

232. Reform Act, *supra* note 12.

233. Derivative Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009).

234. Reform Act, *supra* note 232.

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.*

242. *Rule Making Areas*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/index.htm.

243. *See* NIER, *supra* note 46, at 216 (exploring questions raised by the "strong effort to make a new macroprudential orientation operational" in response to the "recognition that prior to the global financial crisis financial regulation had lacked a macroprudential perspective").

Congress has sent mixed signals to the agency and the private sector market participants over the last decade.[244] That confusion has interfered with information collection and calibration.[245] Even the best rules cannot quickly overcome the legislative practices of the past.

Parenthetically, the Congressional Budget Office previously estimated that up to 235 additional employees would be needed by the CFTC by fiscal year 2011 to regulate central counterparty clearing of swaps.[246] This estimate required a forty percent increase over existing staffing levels.[247] The estimate provided a window into the sheer magnitude of the agency's new regulatory role under the Reform Act and illustrates the massive hurdles faced by the CFTC in its continuing efforts to comply with its new obligations without adequate staffing.

C. Federal Reserve Board

1. Regulatory Model and Authority

In 1913, the Federal Reserve System, which serves as the nation's central bank, was created by federal law.[248] The law requires that the FRB report on at least an annual basis to Congress.[249] It provides a list of specific responsibilities, which includes: the formulation of monetary policy; setting the discount rate; regulating and supervising member banks; suspending, liquidating or restructuring troubled banking institutions; and setting standards for reserve requirements and worthless assets.[250] The Federal Reserve shares functional supervisory and regulatory responsibilities for domestic banking institutions with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, now merged into the OCC.[251] Banks are often owned or controlled by bank holding companies.[252] Here, the

244. *Id.*
245. *Id.*
246. GARY GENSLER, U.S. COMMODITY FUTURES TRADING COMMISSION, INSPECTOR GENERAL'S FISCAL YEAR 2009 ASSESSMENT (Nov. 16, 2009), http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/oigmgmtchall2009.pdf.
247. *Id.*
248. Federal Reserve Act, Pub. L. No. 113-31, § 226, 38 Stat. 251 (1913), http://www.federalreserve.gov/aboutthefed/section1.htm.
249. *Id.*
250. *Id.*
251. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSE AND FUNCTIONS 59 (9th ed., 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.
252. *Id.*

FRB has supervisory authority for all bank holding companies, regardless of whether the subsidiary bank of the holding company is a national bank, state member bank, or state nonmember bank.[253]

The history of the FRB rulemaking authority illustrates the point made earlier – that the regulatory authority of federal agencies is limited to the investiture of express powers by Congress and where the agency attempts to expand its supervisory power, even in the interests of preventing a societal harm caused by increased systemic risk, it will be prohibited from doing so.[254] This may result in a regulatory gap that hinders credible regulatory oversight.[255] Case in point: In 1986, the Supreme Court struck down a federal regulation promulgated by the FRB under the Bank Holding Company Act, which gave the Board regulatory authority to supervise nonbank financial institutions offering the "functional equivalent" of banking services provided to customers by banks.[256] The Court observed that the Act gave a simple and broad definition of a bank as "any national banking association or any State bank, savings bank, or trust company" and exempted from regulation *all* institutions that did not engage in the business of making commercial loans.[257] The message was clear: all other nonbank financial institutions not included in the statutory definition were simply outside of the FRB's rulemaking authority.[258] Thus, insurance institutions providing functionally equivalent banking services, like AIG, escaped FRB oversight.[259] By virtue of the passage of the Reform Act, the statute was not expanded to permit nonbank financial companies to come within the regulatory purview of the FRB until after the AIG debacle.[260]

2. Evaluating the Regulator

The FRB was one of the federal agencies not technically subject to the audit and reporting requirements of the GPRA.[261] Nonetheless, it chose to voluntarily comply with the Act. In any case, the Reform Act now requires a special audit by the GAO of "FRB governance."[262] Specifically, the

253. *Id.*
254. Bd. of Governors of the Fed. Res. Sys. v. Dimension Fin. Corp. et. al., 474 U.S. 361 (1986).
255. *Id.*
256. *Id.*
257. *Id.*
258. *Id.*
259. *Id.*
260. *See* Reform Act, *supra* note 12.
261. FED. RESERVE BOARD, 2011 GPRA PERFORMANCE REPORT 1 (2011), http://www.federalreserve.gov/publications/gpra/files/2011-gpra-performance-report.pdf.
262. *Id.*

auditors must determine the extent to which FRB governance adequately represents the public and whether there are any conflicts of interest when member banks elect the members of the FRB.[263]

A recent IG Report for the period April 1, 2010 through September 30, 2010 omits any reference to public criticism that FRB economic policy may have fueled the current economic crisis.[264] Yet, many others have criticized the Board, including the FCIC, for facilitating the credit crisis through its promulgation of loose monetary policy and low interest rates in the period post 9/11, which was characterized by the undetected corporate failures of Enron and WorldCom.[265] As a consequence, the financial system was flooded with available cash.[266] Banks, mortgage companies, institutional investors, and the unregulated hedge funds engaged in increased risk to generate ever higher returns in a weak dollar/low interest rate/cheap asset environment.[267] Notably, the Board also opposed regulation of derivatives in opposition to the demands of another federal agency, the CFTC.[268] Thus, lax economic policy combined with limited regulatory authority over nonbank financial institutions has fueled the claim that the Board failed to act in the public interest. More recently, the Financial Crisis Inquiry Commission Report, released on January 27, 2011, targeted the FRB for its failure to avert the crisis: "The prime example is the Federal Reserve's pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not."[269]

The GAO report issued in January 2009 provided a different twist regarding the perceived failure of financial regulatory oversight.[270] It is not so much a critique of the FRB, or any other federal regulator for that matter, but instead focuses on the absence of macroprudential coordination between regulatory agencies and the externalities that impede credible

263. *Id.*

264. *See* Semiannual Report of the Office of the Inspector General, *supra* note 229.

265. *Id.*

266. *See* Bodine, *supra* note 81 (commenting on the subprime mortgage crisis).

267. *Id.*

268. Concerning Regulation of the Over-the-Counter Derivatives Market and Hybrid Instruments: House Comm. on Banking and Fin. Servs. (July 24, 1998) (testimony of Richard R. Lindsey, Director, Division of Market Regulation, Securities and Exchange Commission), http://www.sec.gov/news/testimony/testarchive/1998/tsty0898.htm#body4.

269. THE FIN. CRISIS INQUIRY COMMISSION, FINAL REPORT OF THE NAT'L COMM. ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE U.S. (2011), *available at* http://www.fcic.gov/report.

270. ACCOUNTABILITY OFFICE REPORT, *supra* note 108.

regulatory oversight.[271] Those externalities include the "too big to fail" scenario that characterized the collapse of AIG, the demise of the investment bank model where investment banks utilized publicly traded holding companies with broker-dealer subsidiaries dealing in largely unregulated markets due to the regulatory gaps created by the GLBA, and the failure of the private sector to self-regulate and exercise restraint.[272] In short, the GAO report describes a runaway market not subject to sound regulation and able to evade oversight.[273]

3. Reform Act Remediation

During congressional hearings in 2008, FRB officials acknowledged a failure of big picture regulatory supervision.[274] It observed that under the pre-Reform Act regulatory structure consisting of multiple agencies, difficulties can arise in assessing risk profiles of large, complex financial institutions which operate across financial sectors, particularly given the increased use of sophisticated financial products that can generate risk across various entities.[275] In addition to the creation of the FSOC under the Reform Act to coordinate agency supervision, a newly created position of Vice-President of Supervision has been added to the regulatory infrastructure. This requires the FRB to make recommendations to Congress regarding the supervision and regulation of financial institutions.[276]

Likewise, the solution to the "too big to fail problem," where the very size and nature of the nonbank financial institutions insulated them from regulatory oversight and market discipline, may now be a function of government regulation.[277] Under the Reform Act, the FSOC may subject a "US nonbank financial company" to FRB supervision and to "prudential standards."[278] The FSOC must first determine by a two-thirds vote, including an affirmative vote by the Chairperson, that "material financial distress" exists at the nonbank financial company, or the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" could pose a threat to U.S. financial stability.[279] It is important to note that

271. *Id.*
272. *Id.*
273. *Id.*
274. Senate Comm. on Banking, Hous., and Urban Affairs: Condition of the Banking System, 110th Congres 2nd Sess. (2008).
275. *Id.*
276. *Id. supra* note 252.
277. *Id.*
278. *Id. supra* note 252.
279. *Id.*

nonbank financial companies still remain effectively outside of regulatory supervision unless the FSOC exercises its discretion as provided for under the Act.[280] It remains to be seen whether this model will effectively remediate the regulatory gap.

The Reform Act may close the regulatory gap created by Congress' previous intransigence in excluding from FRB oversight large nonbank financial institutions, including insurance companies like AIG, even if they have no bank or thrift subsidiary.[281] Here, the impact of externalities, namely Congress and economic policy, undoubtedly impacted credible regulatory oversight and the successful implementation of macroprudential policy. The FRB argues that it was doing its job according to its legal mandate.[282] It simply lacked the authority to effectively supervise systemic risk.[283]

D. Federal Deposit Insurance Corporation

1. Regulatory Model and Authority

The Banking Act of 1933 created the FDIC to administer a federal program insuring bank deposits of participating banks.[284] As such, the FDIC was another regulatory brainchild of the Great Depression. In 1989, with the abolition of the Federal Savings and Loan Corporation (FSLIC), the now defunct Office of Thrift Supervision (OTS) assumed FSLIC's regulatory function over thrifts.[285] With the advent of the Wall Street Reform Act, OTS was summarily abolished and the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) assumed the duties of the OTS.[286] Thrifts are savings and loan financial institutions, primarily engaged in the home mortgage business.[287] The FDIC provides two oversight functions referred to as

280. *Id.*
281. *Id.*
282. MARC LABONTE, CONGRESSIONAL RESEARCH SERVICE SYSTEMIC RISK AND THE FEDERAL RESERVE, 6-7 (2009), , http://www.voltairenet.org/IMG/pdf/Systemic_Risk_and_the_Federal_Reserve.pdf.
283. *Id.*
284. The Glass-Steagall Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933).
285. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989).
286. *Id. supra* note 251.
287. *See generally* Steven Pilloff & Robin Prager, *Thrift Involvement in Commercial and Industrial Lending*, FEDERAL RESERVE BULLETIN, Dec. 1998, http://www.federalreserve.gov/pubs/bulletin/1998/199812lead.pdf (considering the weight that should be given to thrift institutions as actual or potential competitors of commercial banks in providing financial services).

primary and "backup" or secondary oversight.[288] The FDIC is responsible for primary oversight of any state-chartered bank that is not a member of the Federal Reserve System.[289] In this capacity, it serves as the primary federal regulator for over 5,200 state-chartered institutions.[290] Similar to other insurers, the FDIC monitors and assesses risks at all insured financial institutions and determines each institution's insurance risk category and premium rate.[291] The FDIC regulations then assign each risk category a specific insurance assessment rate that is used to compute an institution's insurance premium, which is added to the Deposit Insurance Fund (DIF).[292]

The FDIC Improvement Act of 1991 (FDICIA) required the FDIC to establish a risk-based assessment system.[293] A risk-based system is one based on an institution's probability of causing a loss to the DIF due to the composition and concentration of the institution's assets and liabilities, the amount of loss given failure, and the revenue needs of the fund.[294] To implement that requirement, the FDIC categorized institutions into risk categories based on two regulatory criterion: (1) capital levels; and, (2) supervisory ratings as calculated by the primary regulatory agency sharing functional oversight of the institution.[295] With the passage of the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Act Conforming Amendments of 2005, the FDIC was statutorily required to set institutional risk assessments semiannually.[296] The new provisions continued to require that the assessment system be risk-based, however, risk was more broadly defined.[297] Yet, the integrity of the FDIC's oversight evaluation still rested upon the supervisory ratings calculated by the primary regulatory agency.

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288. *See generally* EDWARD MURPHY, CONGRESSIONAL RESEARCH SERVICE, WHO REGULATES WHOM AND HOW? AN OVERVIEW OF U.S. FINANCIAL REGULATORY POLICY FOR BANKING AND SECURITIES MARKETS, , (2013) http://www.fas.org/sgp/crs/misc/R43087.pdf [hereinafter MURPHY] (breaking down the regulation scheme of banks and securities markets).

289. *Id.*

290. *2013 Annual Performance Plan: Insurance Program*, FED. DEPOSIT INS. CORP., *available at* http://www.fdic.gov/about/strategic/performance/insurance.html.

291. *Id.*

292. *Id.*

293. FDIC Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified at 12 U.S.C. § 1811).

294. *Reform of Deposit Insurance*, FED. DEPOSIT INS. CORP. http://www.fdic.gov/deposit/insurance/reform.html#rbas.

295. MURPHY, *supra* note 288.

296. Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, 110 Stat. 9 (2005); Federal Deposit Insurance Reform Act Conforming Amendments of 2005, Pub. L. No. 109-173, 119 Stat. 3601 (2005).

297. *Id.*

The focus here is on the secondary or backup examination and enforcement authority of the FDIC over all of the institutions it insures in order to prevent or mitigate losses to deposit insurance funds. It is here where the FDIC's regulatory authority has been most limited. This explains, in large measure, the reasons that the FDIC was unable to effectively prevent major bank failures during the recent financial crisis as a result of these regulatory restrictions. As the word back-up implies, the bank in question has a primary regulator other than the FDIC in charge of examination and supervision. This is part of the system of functional regulation. Along with the primary regulator, the FDIC as the insurer has authority to perform its own examination of a federally insured bank and impose enforcement actions to protect the DIF, provided statutory and regulatory procedures are followed.[298]

Parenthetically, the interagency agreement between the FDIC and the primary regulator was "intended to balance the needs of FDIC against the regulatory burden on an institution of having two regulators duplicating examinations."[299] Another critical aspect of the interagency "agreement is that the FDIC must rely, "to the fullest extent possible, on the work of the primary regulator."[300] Additionally, "the terms of the interagency agreement governing information sharing and back-up examinations require that the FDIC prove a requisite level of risk at an institution – heightened risk, material deteriorating conditions, or adverse developments – in order for the primary regulator to grant the FDIC access to the institution's information."[301] Accordingly, where the primary regulator is not doing its job, the FDIC must still establish the requisite level of risk to obtain access to critical internal information.[302] Strangely, that access is limited to the audit results of the primary regulator that has failed to do its job in the first instance.[303] A clear breakdown under Nier's model of information gathering and calibration.

This regulatory paradigm was reviewed in detail by the IG during its audit of the FDIC and the OTS in its "evaluation of the federal regulatory oversight" immediately preceding the failure of Washington Mutual Bank

298. MURPHY, *supra* note 288.

299. *Role of Regulators Exercising Their Supervision of Washington Mutual Bank from 2004-2008: Hearing Before the Perm. Sen. Subcomm. on Investigations Comm. On Homeland Security and Governmental Affairs,* (2010) (statement of John Rymer, Inspector General, Federal Deposit Insurance Corporation).

300. *Id.*

301. OFFICES OF THE INSPECTOR GENERAL, U.S. DEP'T OF THE TREASURY FED. DEPOSIT INS. CORP., EVAL-10-002, EVALUATION OF REGULATORY OVERSIGHT OF WASHINGTON MUTUAL BANK (2010), http://www.fdicoig.gov/reports10/Eval-10-002-508.shtml.

302. *Id.*

303. *Id.*

(WaMu). The IG concluded that the procedures governing the FDIC's backup authority were unduly restrictive and prevented the FDIC from adequately performing its regulatory function.[304] An absence of "big picture" focus contributed to a regulatory gap.[305]

2. Recent oversight initiatives

The story of the failure of Washington Mutual (WaMu) perhaps best illustrates the importance of macroprudential regulation.[306] The failure of FDIC oversight initiatives as a result of regulatory compartmentalization supports the IG's conclusion that the FDIC's hands were tied by regulations which prevented it from effectively doing its job of credible regulatory oversight and preventing WaMu's downfall.[307]

WaMu's primary federal regulator was the OTS.[308] As such, OTS was responsible for conducting full-scope examinations to assess WaMu's safety and soundness and compliance with consumer protection laws.[309] Unfortunately, OTS relied in large measure on WaMu's own internal audit system to track the thrift's progress.[310] Parenthetically, the reliance on the private sector's own judgment effectively replaced the independent role of the primary regulator.[311] Later facts revealed that WaMu's management pursued an unreasonably high-risk lending strategy to enable it to compete with its main competitor, Countrywide Mortgage, one of the first major lenders to fail in the string of mortgage company failures to follow.[312] WaMu's strategy included liberal underwriting standards and inadequate risk controls.[313] That high-risk strategy combined with the housing and mortgage market collapse in mid-2007 left WaMu with loan losses, borrowing capacity limitations, and a falling stock price.[314] To compound the problems, in Fall 2008, depositors made a run on the bank and withdrew significant funds after WaMu's problems were made public.[315] Thereafter, WaMu was unable to raise capital to cover depositor withdrawals, forcing the OTS to close the institution on September 25,

304. *Id.*
305. *Id.*
306. *Id.*
307. *Id.*
308. *Id.*
309. *Id.*
310. *Id.*
311. *Id.*
312. *Id.*
313. *Id.*
314. *Id.*
315. *Id.*

2008.[316]

The IG concluded that the FDIC properly conducted its required monitoring of WaMu from 2003 to 2008.[317] As a result of this monitoring, the FDIC identified risks with WaMu's lending strategy and internal controls.[318] However, the risks noted in the FDIC's monitoring reports did not result in an increase in WaMu's deposit insurance premium payments.[319] This discrepancy occurred because the deposit insurance regulations rely on the safety and soundness ratings and regulatory capital levels determined by the primary regulator to gauge risk and assess related deposit insurance premiums, in this case the OTS.[320] Since the OTS examination results were satisfactory, based upon OTS' misguided reliance on WaMu's own tracking system, increases in deposit insurance premiums were not triggered.[321]

3. Evaluating the regulator

The IG concluded that the interagency agreement did not provide the FDIC with the access to information that it needed to assess WaMu's risk to the DIF.[322] Additionally, it found that the interagency agreement then in effect did not allow the FDIC sufficient flexibility to obtain information necessary to assess risk in order to protect the DIF.[323] Finally, the IG also concluded that FDIC deposit insurance regulations are too restrictive in prescribing the information used to assign an institution's insurance category and premium rate.[324] In short, the regulatory paradigm designed by Congress failed to achieve the intended goal of credible regulatory oversight.

4. Reform Act remediation

As a consequence of the WaMu failure, the OTS was dissolved and merged into the Office of the Comptroller of the Currency and the duties were then split between the OCC and the FDIC.[325] Additionally, the

316. *Id.*
317. *Id.*
318. *Id.*
319. *Id.*
320. *Id.*
321. *Id.*
322. *Id.*
323. *Id.*
324. *Id.*
325. *OTS Integration*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, http://www.occ.gov/about/who-we-are/occ-for-you/bankers/ots-integration.html.

Reform Act now includes the Dissolution Authority for Large, Interconnected Companies Act of 2009.[326] Under this Act, the FDIC is authorized to make a written recommendation regarding systemic risk to U.S. economic stability posed by a financial institution in default or in danger of default.[327] Remarkably, at that point, the FDIC may be appointed as a receiver of a financial institution for a one-year period to take "certain discretionary actions to stabilize or dissolve the institution."[328]

CONCLUSION: CAN MACROPRUDENTIAL REFORMS WORK?

Federal Reserve Chairman Bernanke argues that "a macroprudential approach would complement and build on the current regulatory and supervisory structure, in which the primary focus is the safety and soundness of individual institutions and markets."[329] However, there are two problems that must be overcome before accepting this argument as a proven assumption.

First, the existing regulatory and supervisory infrastructure failed to demonstrate the ability to forecast, much less even recognize, the severity of systemic risk until it had seized the markets. By the time regulators, risk managers, and central bankers understood that systemic risk had penetrated the markets, it had already spread into full-scale global systemic distress. In short, there was a failure of credible regulatory oversight.

Concomitantly, externalities including the legal limits on regulatory powers, political interests, private sector self-regulation, regulatory gaps and inefficiency in information sharing among competitive federal agencies all combined to inject greater complexity into the regulatory system. The failure of regulatory and supervisory oversight results in part from these weaknesses illustrated by the analysis of the five federal agencies.

Second, the regulatory and supervisory infrastructure was incapable of reining in the market participants or proposing remedial measures to temper the disaster. Instead, the government sponsored bail-out, described as "the most profound system shift over the course of recovery," resulted in the massive transfer of risk from the private institutions to governments and central banks.[330] Specifically, the bail-out engineered the direct acquisition

326. Reform Act, *supra* note 12.
327. *Id.*
328. Weismann, *supra* note 29, at 37.
329. Ben S. Bernanke, Chairman, Fed. Res. Bank, Remarks at the Council on Foreign Relations, "Financial Reform to Address Systemic Risk" (March 10, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.
330. STATE STREET CORP., VISION FOCUS: SYSTEMIC RISK: STRATEGIC CHALLENGES FOR POLICY MAKERS AND PRACTIONERS, (2011),

of impaired securities, the use of deficit spending to generate economic stimulus and the issuance of new liquidity through quantitative easing.[331] In short, the regulatory models designed to ensure that financial institutions would remain liquid and insulated from market failure in the event of crisis, were useless. The massive bank failures described above well illustrate this point. In fact, the bail-out strategy fueled by direct government intervention wholly circumvented the regulatory process and the consequences of natural market forces. The bail-out arguably incentivizes excessive risk taking where market participants escape failure and/or regulatory enforcement. The macroprudential approach, designed to embrace both the financial and securities markets, is an untested strategy designed to address these problems. Congress, now in lockstep with the regulators, has agreed in principle that some form of broader regulation is needed to close regulatory gaps and address other externalities that impact oversight in the market. However, the idea that broader regulation is necessary does not necessarily mean more rules. There will be some new rules to penetrate the dark markets – those heretofore unregulated products creating black box regulatory gaps in the marketplace. Yet, certain significant aspects of the regulatory infrastructure remain unchanged. This point is critical to understanding the question of ultimate success of macroprudential regulation under the new Reform Act.

Specifically, the model of market self-regulation, embedded in the Securities Act of 1933 and the Securities Exchange Act of 1934, will not change. The idea that natural market forces should control the operation of the markets and that regulation is an artificial constraint which results in market distortion is the governing philosophy of managerial capitalism. The regulators are expected to remain relatively detached from the day to day affairs of the marketplace, described by former SEC Chairman and U.S. Supreme Court Justice William Douglas as the "shot gun behind the door" approach: regulators should be ready to intervene when the private sector misbehaves.[332] This model is aptly characterized as reactive regulation to crisis.

Likewise, functional regulation will also remain in place. Regulators of each agency will continue to protect their own respective turfs and share very little of the actual regulatory redrafting, leaving out the FSOC

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http://www.statestreet.com/wps/wcm/connect/a862f6804a2d7e3697de9fed29523c35/11-0002-2684_VF_SystemicRisk.pdf?MOD=AJPERES&CONVERT_TO=url&CACHEID=a862f6804a2d7e3697de9fed29523c35.

331. *Id.* at 15.

332. *See* Douglas, *supra* note 139 at 82 (summarizing the addresses and statements of SEC Chairman Douglas).

altogether in the actual rule making process. The FSOC will remain a "looker" rather than a "doer." Functional regulation will continue the practice of overlapping agency authority based upon the particular financial activity as opposed to the industry being regulated.

What has changed is the recognition that the FSOC must exist to force the regulators to sit at the same table and share perceptions about market activity so that the possibility of an entire regulatory infrastructure being blindsided by the private sector is diminished. Thus, faith in the system of market self-regulation grounded on a functional regulatory infrastructure that is highly reactive to market events is a necessary condition precedent to concluding that the new system of macroprudential regulation can work.

The Hanson, Kashyap & Stein study raised the question of whether the existing weaknesses in the regulatory system itself can be addressed "sensibly."[333] That question cannot be answered simply given the complexity of the regulatory system upon which reform rests. While Nier recommends a new and sound taxonomy for the implementation of macroprudential policy,[334] the theory is somewhat disconnected from the actual regulatory infrastructure in place. Arguably, the current regulatory infrastructure does not mesh fully with the proposed taxonomy based on intentional legislative design and market realities. A reassessment of the role of regulatory agencies in the private sector may be required before any long-term strategic plan can be expected to meet reform expectations. In any case, in a world of private interests and Wall Street domination, it would be a long and bitter fight.

333. *S*ee Hanson et al., *supra*, note 22.
334. *S*ee Nier, *supra*, note 46.