# The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response

Lawrence A. Cunningham* and David Zaring**

## *Introduction*

First the financial markets collapsed, and second came massive government intervention designed to address the collapse. The third part of any financial crisis is reform. Judging by the exuberant production of scores of ambitious alternative visions for financial regulation reform, one might be forgiven for expecting unprecedented reform in the aftermath of the 2008 crisis.[1] In considering what reform should look like, we caution that the headlong rush to do something should not neglect the surprisingly good things about the old system or ignore the considerable reform that has already been achieved by the federal government's massive and unorthodox response to the recent financial crisis. Moreover, our note of caution may be practical, as well as good policy; we note that it is reflected by the Obama administration's first formal proposal for regulatory reform to Congress.[2]

Among the bewildering proliferation of alternatives, one, offered by Treasury Secretary Henry Paulson shortly after the failure of the

* Henry St. George Tucker III Research Professor of Law, The George Washington University Law School.

** Assistant Professor of Legal Studies, University of Pennsylvania, Wharton School of Business.

We thank participants in presentations at the following law schools: The George Washington University, University of Miami, and University of British Columbia. For specific comments, we thank Steve Charnovitz, Steve Davidoff, and Amanda Frost. For research assistance, we thank Nikki Cho and Hang Xu.

[1] Some say that if this crisis "fails to do the trick, then there is little hope Washington will ever summon the will to reorganize its creaking, disjointed system of financial regulation." Kevin Drawbaugh, *Now or Never for Financial Watchdogs Shake-Up*, REUTERS, Oct. 29, 2008, *available at* http://www.reuters.com/article/reutersEdge/idUSTRE49S6PD20081029. Others say "we don't have to start from scratch on regulatory reform of the financial-services industry: There's already a sensible blueprint for change." Editorial, *A Starting Point for Regulatory Reform*, MINN. STAR TRIB., Sept. 20, 2008, at 10OP.

[2] DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 1 (2009) [hereinafter A NEW FOUNDATION], *available at* http://online.wsj.com/public/resources/documents/finregfinal06172009.pdf.

first of many institutions in March 2008, boldly imagined a revolution in financial regulation, largely through a comprehensive reorganization of governing agencies.[3] After it, other recommendations poured in, each with their own revolutionary visions of financial regulation reform, including two by an organization of financial industry notables led by Paul Volcker, the Group of Thirty.[4] Other grand visions come from the Government Accountability Office ("GAO"),[5] the Consumer Federation of America,[6] the Congressional Oversight Panel created to oversee government interventions,[7] plus a flurry of reports by Washington think tanks, dis- or semi-interested observers, and blue ribbon panels.[8]

[3] DEP'T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter TREASURY BLUEPRINT], *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

[4] GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008) [hereinafter VOLCKER I], *available at* http://www.deloitte.com/dtt/cda/doc/content/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf; GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009) [hereinafter VOLCKER II], *available at* http://www.group30.org/pubs/pub_1460.htm.

[5] GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009) [hereinafter GAO FRAMEWORK], *available at* http://www.gao.gov/new.items/d09216.pdf.

[6] MARK COOPER & BARBARA ROPER, REFORM OF FINANCIAL MARKETS: THE COLLAPSE OF MARKET FUNDAMENTALISM AND THE FIRST STEPS TO REVITALIZE THE ECONOMY (2009), *available at* http://consumerfed.org/pdfs/FinancialMarketReformReport.pdf.

[7] CONG. OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM (2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

[8] BLANK ROME GOV'T RELATIONS LLC, NEW DEMOCRAT COALITION PRINCIPLES FOR FINANCIAL REGULATORY REFORM (2009), *available at* http://www.financialreformwatch.com/uploads/file/New%20Democrat%20Principles%20for%20Financial%20Regulatory%20Reform.pdf; CTR. FOR CAPITAL MKTS. COMPETITIVENESS, U.S. CHAMBER OF COMMERCE, U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS REGULATORY REFORM PRINCIPLES (2008), *available at* http://www.uschamber.com/assets/ccmc/081114ccmc_principles.pdf; INT'L SEC. EXCH., INTERNATIONAL SECURITIES EXCHANGE PROPOSAL FOR REGULATORY REFORM FOR THE U.S. FINANCIAL MARKETS (2009), *available at* http://www.ise.com/assets/files/about_ise/ISE_Proposal_for_US_Financial_Market_Regulatory_Reform.pdf; INV. CO. INST., FINANCIAL SERVICES REGULATORY REFORM: DISCUSSION AND RECOMMENDATIONS (2009), *available at* http://www.ici.org/pdf/ppr_09_reg_reform.pdf; Noel Sacasa, *Preventing Future Crises: Priorities for Regulatory Reform after the Meltdown*, FIN. & DEV., Dec. 2008, at 11; Luigi Zingales, *A New Regulatory Framework*, CITY J., Mar. 31, 2009, at 4, *available at* http://www.city-journal.org/2009/eon0331lz.html; Charles Calomiris, The Subprime Turmoil: What's Old, What's New, and What's Next (Oct. 2, 2008) (unpublished manuscript), *available at* http://www.williams.edu/Economics/seminars/Calomiris_10_02_08.pdf; Press Release, Comm. on Capital Mkts. Regulation, Committee on Capital Markets Regulation Releases Recommendations for Reorganizing the U.S. Financial Regulatory Structure (Jan. 14, 2009), *available at* http://www.capmktsreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Struc-

Not to be overlooked is the functional reform that the government's extensive intervention created on the fly: reform, in essence, by deal, rather than by report or legislation. There also continue to be good suggestions for reform of an incremental character, following the traditional U.S. approach to financial reform in response to crisis.[9]

These various visions of regulatory reform, including those that follow traditional approaches, cannot all be enacted, but they have contributed to an important debate, one that will last through the current round of regulatory reform and into the next rounds, impacting future efforts to change how finance is overseen. But even today, these visions of regulatory reform have been embraced, to varying degrees. The Treasury Secretary and Federal Reserve Chair have indicated their desire for legislation and outlined their own reform preferences, informed by the proliferation of reports.[10] Congress has debated proposals and is poised to enact reform, perhaps with a series of new laws. And President Obama has repeatedly called for a new approach to financial regulation, culminating in formal presentation of an outline for regulatory reform to Congress.[11]

Amid the hurly-burly, how shall rational choices among this avalanche of ideas be made? In this Article, we try to organize the choices for the perplexed. Although in details the reform proposals can vary enormously, at bottom, they reflect, we think, a few stark choices, which make for a notable difference between the large number of regulatory-reform proposals in circulation and the small number of functional regulatory-reform alternatives actually available. We think there are three or four feasible options for reforming finan-

ture.pdf; Stephany Griffith-Jones, Proposals for Regulatory Reform (July 29, 2009) (unpublished policy brief), *available at* http://www0.gsb.columbia.edu/ipd/pub/proposals_for_regulatory_principles.pdf. For an international perspective see Eric J. Pan, *Structural Reform of Financial Regulation: The Case of Canada*, 18 Transnat'l L. & Contemp. Probs. (forthcoming Fall 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1333385.

[9] *E.g.*, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safe*, 157 U. Pa. L. Rev. 1, 98 (2008) (proposing a federal Financial Product Safety Commission as a consolidated federal regulator akin to the Consumer Products Safety Commission); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 Va. L. Rev. 707 (2009) (concentrating on the Securities and Exchange Commission).

[10] *See, e.g.*, Press Release, Dep't of the Treasury, Treasury Outlines Framework for Regulatory Reform: Provides New Rules of the Road, Focuses First on Containing Systemic Risk (Mar. 26, 2009) [hereinafter Treasury Outlines Framework], *available at* http://www.financialstability.gov/latest/tg72.html.

[11] Damian Paletta, *U.S. to Toughen Finance Rules*, Wall St. J., Mar. 16, 2009, at A1; President Barack Obama, Remarks by the President After Regulatory Reform Meeting (Feb. 25, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-after-Regulatory-Reform-Meeting/.

cial regulation. These options may be broken down into Democratic, Republican, old, and new—or, at least, events-driven—alternatives, and each of these proposals has an exemplar.

We accordingly generate a picture of what financial regulation is or should be using a comparative analysis of the old, pre-crisis regulatory system, often termed "creaky" or fragmented; the new reformed system that government intervention created, a kind of de facto quasi-centralization; and the proposals for planned reforms, especially Treasury's blueprint, authored during a Republican administration, and its Democratic alternative, contained in the Group of Thirty reports. Both of these latter planned (and grand) visions prescribe formal centralization of financial regulation, although, as we shall contend, for different reasons and with varying implications. Of course, these solutions to our problems with financial oversight are more than just alternatives. Each offers a vision of not just what can go wrong in our financial markets, but what is valuable about them, along with a theory of regulation that either embraces or suspects disinterested regulatory expertise and politically responsive governance.

First, for example, the pre-existing system, although often castigated, has its merits and has long had its defenders. It is a highly fragmented set of regulators, distributing authority between federal and state governments and across various agencies within both levels. The system was disorganized but battle-tested and built out of repeated reforms, in a patchwork effort not to repeat the mistakes of the last business cycle. It brought, at its best, creative, competitive, and disaggregated oversight to the financial system. The advantages of such a system have been praised by scholars for decades, including Ralph Winter, Roberta Romano, Frank Easterbrook, and others.[12]

It is not, however, the system we currently have. A second approach to financial regulation and reform is the developed-on-the-fly approach adopted by Secretary Paulson and Federal Reserve Chair

[12] *E.g.*, Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 13–14 (1991); Roberta Romano, The Genius of American Corporate Law 148 (1993); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251, 289–92 (1977); *see also* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1, 69–71 (1990) (arguing federal regulation of corporate law impedes evolution of "efficient state laws and optimal governance contracts"); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 Va. L. Rev. 961, 965 (2001) (asserting federal regulation leads to pro-management, non-optimal corporate regimes and is too slow to adapt to changes); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225 (1985) (arguing decentralized system promotes efficiency while centralized system would have trouble duplicating features promoting efficiency).

Ben Bernanke during the crisis of 2008. This system developed from the old, disaggregated approach, yet looks like its own model of a reformed, and centralized, financial regulatory system. It puts the Federal Reserve ("Fed"), with its matchless ability to intervene in the economy, at the fore of a financial regulatory system without many of the checks and balances that administrative law usually provides.

The new crisis-driven approach amended the old system, not just in making the central bank particularly central, but in changing the organization of financial institutions, shutting down investment banks, and federalizing and nationalizing other firms. It shunted the Securities and Exchange Commission ("SEC") to the side, and created a de facto hierarchy of banking regulators (the Office of Thrift Supervision is at the bottom of that hierarchy, we expect). The form of financial regulation that resulted is best described as ad hoc. Still, the processes it has haphazardly put in place have adopted a centralized, unreviewable, emergency-based approach that has added to the regulatory arsenal market intervention, nationalization, and, above all, deals. It is not only a model for financial regulatory reform; it is the model we currently have.

A third approach appears in several widely circulating reports addressing financial regulation reform, including Secretary Paulson's blueprint released in March 2008. These reports offer variations on a broad theme contemplating considerable consolidation of regulatory oversight in the U.S. federal government. The Treasury blueprint champions a version of the "two-peaked" model, centralizing in the federal government two broad categories of overseers,[13] one focused on systemic stability and one on consumer and investor protection; in practice, Treasury has pursued this centralization to some degree during the financial crisis.[14] These proposals rationalize and centralize authority to regulate markets—but then adopt a model of delegation to self-regulation within the industry. Because the Paulson blueprint was the first, most prominent, and most detailed variant of these approaches, we highlight it to analyze this approach to financial regulation.

Surprisingly close variations on the consolidation theme appear in reports offered by others, including two by the Group of Thirty, headed by Paul Volcker, Chair of the Obama Administration's Eco-

[13] *See* Treasury Blueprint, *supra* note 3, at 137–82.

[14] Notably, much of what is articulated in architectural detail in the blueprint, and especially the centralization, was enacted on the fly by Secretary Paulson and the Federal Reserve Chairman during the 2008 crisis.

nomic Recovery Advisory Board. If Paulson's blueprint represents the view of the Republican financial establishment, the Volcker reports would seem to give the view of its Democratic counterpart—Treasury Secretary Timothy Geithner, appointed by President Obama to succeed Paulson, is a member of Volcker's group. These visions are not entirely different, and in practice, both Republicans and Democrats have embraced the rationalized centralization proposed by Paulson and Volcker (they also seemed to embrace the on-the-fly model of centralizing financial regulation in the Treasury and the Fed during the crisis).[15] We analyze them both in detail as exemplars of what thought leaders of the establishment think is wrong with current system, and how it should be changed.

Moreover, the areas of agreement among these thought leaders do not preclude some differences. The Volcker group has urged not only consolidation but also prescribed more stringent, substantive reform of financial regulation, establishing size limitations on financial institutions and other controls, such as limitations on proprietary securities trading by commercial banking institutions.[16] This sort of federalization follows a line of scholarship reaching from William Cary to Lucian Bebchuk.[17]

Although the Paulson blueprint and Volcker reports both endorse consolidation of financial regulation in the federal government, ending the traditional American fragmentary system, they appear to do so for different reasons and with different visions for the consequences. The blueprint promotes consolidation to enable U.S. capital markets and financial firms to compete globally with regulatory systems of other nations in what is ultimately an international market for law. In contrast, the Volcker proposals seek consolidation to stabilize and control American markets and firms, and concurrently to join other national regulators in similar regulatory control to maintain an

[15] *See, e.g.*, Fact Sheet, Dep't of the Treasury, Financial Stability Plan 4–6 (Feb. 10, 2009), *available at* http://www.financialstability.gov/docs/fact-sheet.pdf (announcing continuation of government investment in financial institutions' preferred stock but boasting of new transparency of approach and stating firm limits on any investee's right to declare cash dividends on common stock, to use cash for acquisitions, or to pay annual cash compensation to executive officers in excess of $500,000).

[16] Steve Vogel, *Report Faults Financial Oversight*, WASH. POST, Jan. 23, 2009, at A13. The GAO likewise encourages greater consolidation of regulatory authority in particular branches of the federal government and opines on characteristics that any refashioned U.S. financial regulatory system should have. *See* GAO FRAMEWORK, *supra* note 5, at 48–62.

[17] *E.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1499–502 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 700–02 (1974).

ordered global financial system. The Volcker approach is internationally *collaborative*, while Paulson's is internationally *competitive*. Even so, the consolidated approach endorsed by both Paulson and Volcker has gained traction. An emerging consensus among observers would extend regulation to new parts of the financial-services industry, including hedge funds, possibly private equity, and over-the-counter derivatives.[18] Enthusiasm endured despite how the political appetite for such consolidation abated.

As we have suggested, we think that within these various approaches to financial regulation, three or four models can be discerned. There is the decentralized old approach, the on-the-fly reforms in 2008 that have transformed it—not trivially—and the more considered centralized alternatives exemplified by Paulson's Treasury Department and Volcker's Group of Thirty. The considered suggestions, as we have indicated, may stand in for other proposals that, we think, look like a reimagining of the architecture of financial regulation from institutionally similar, but distinctively Democratic and Republican, viewpoints. More than two and less than five, these alternative visions of financial regulation are the approaches from which we will select our future system of finance.[19]

Which of these regulatory alternatives, then, should be preferred? As scrutiny of the system of financial regulation reaches a new apogee, should we embrace the greener grass of organized reform, or stick with one of the (arguably) two systems we currently have? If opting for planned centralization, is Paulson's or Volcker's grand vision to be preferred?

This Article delineates these alternative approaches to financial regulation and provides a framework to assess them. Some issues turn on questions well beyond law, including economic theory, political science, and international relations. Moreover, the alternatives confront a vast swath of the U.S. regulatory bureaucracy, essentially all aspects of its financial markets and dozens of large regulatory organizations; the approaches have considerable effects on the real economy and present literally hundreds of discrete, and important, issues for decision. These complexities, and the prospect of both many proposals

[18] The Treasury Secretary has testified before Congress on the need for "[a] [s]ingle [i]ndependent [r]egulator with responsibility over [s]ystemically [i]mportant [f]irms and [c]ritical [p]ayment and [s]ettlement [s]ystems." Treasury Outlines Framework, *supra* note 10.

[19] *Cf.* JOHN KENNETH GALBRAITH, THE GREAT CRASH: 1929 (1954) (reflecting cautiously upon the several alternative approaches to financial regulation to diminish the frequency or magnitude of economic crises).

and potential revolutionary change, suggest the usefulness of having a framework for evaluation, which this Article provides.

Our most important normative conclusions are worth emphasizing at the outset. First, as we have suggested, the pre-2008 crisis fragmented approach is a model in its own right, with characteristic benefits, although undoubtedly accompanied by flaws. Although debate about regulatory reform may incline to elide these benefits, they have a considerable academic pedigree that must be appreciated.

Second, there has already been considerable financial regulation reform amid the government's responses to the 2008 crisis. It is not as obvious as many appear to believe that additional, and certainly not revolutionary, formal steps are appropriate. If anything, it might be helpful to ratify the useful reformations to the system worked by the on-the-fly regulatory response and eliminate or reverse less desirable ones.

Third, although the approaches exemplified by the Paulson and Volcker proposals both prescribe centralization to abandon fragmentation, they do so using different models, for different reasons, and with different objectives—both federalize and centralize, but then one delegates to industry self-regulation in the name of promoting U.S. global competitiveness whereas the other proposes to regulate, as apolitically as possible, and collaborate with international counterparts.

Fourth, we think the practicalities of international regulatory reform may require some caution there as well, although the international implications of this reform are not the focus of this Article. We nonetheless think it is prudent for the chief regulatory reforms to depend on a vision of globalization. We also believe an approach that embraces the fact that both finance and regulators can cross borders is more sustainable than one failing to embrace those realities. Grand visionaries of regulatory reform may not be thinking through the practicalities and, increasingly, the necessity of regulatory cooperation; that cooperation has worked in the past through ad hoc regulatory response, and we think that abandoning effective ad hoc networks could be perilous. This does not mean that current domestic reform efforts in the United States should determine exactly how, and how much, international financial regulation should be coordinated. Reasonable minds may differ on that issue—indeed, we may not agree on the right institutions for international cooperation.

Finally, we observe that our cautions appear to be reflected in one particular implementation of these visions. On June 17, 2009, the

Obama administration announced its vision for financial regulation reform.[20] Captured in a document entitled "A New Foundation: Rebuilding Financial Supervision and Regulation," the proposal gives the Fed and the executive branch of government more power over financial markets. But it does not centralize oversight in the way that either the Volcker or Paulson proposals suggest; instead, it appears to embrace some of values of the old, disaggregated regime. In the Obama proposal, the government adds to the Fed's systemic stability powers—giving it, for example, the power to oversee more non-banks, should they threaten stability, and all institutions holding bank charters, who would otherwise be overseen, on a consolidated basis by a new National Bank Supervisor office in the Treasury Department.[21] Regulatory coordination would not be done by a new agency, but by a new Financial Services Oversight Council, which would be created to replace the President's Working Group on Financial Markets ("PWG").[22] The proposal also includes a new consumer protection agency to oversee mortgages, credit cards, and other financial devices used by ordinary individuals.[23]

The rest of this Article proceeds as follows. Part I examines the prevailing models, introducing first the traditional fragmented regulatory structure and illustrating its relatively familiar method of responding to periodic crises on an ad hoc basis. It then studies federal actions amid the 2008 crisis, which amounted both to ad hoc crisis response in the American tradition, as well as its own model of regulatory reform. We also consider unusual aspects of the tools used in the 2008 crisis, highlighting its response-by-mega-deal, and exploring the oddity and utility of Treasury's pre-crisis blueprint.

Part II examines the Treasury's blueprint and the Volcker proposals and illustrates their shared penchant for centralization of financial regulation. Examination reveals the subtle but important differences in their motivations, the blueprint seeing globalization as a challenge to meet with regulatory competition and the Volcker proposals seeing globalization as a solution to regulatory limitations worldwide, manifested in the 2008 crisis. Paulson seeks centralization in order to promote U.S. capital-market competiveness, projecting the U.S. into a regulatory competition with other systems. Volcker seeks centraliza-

[20] A New Foundation, *supra* note 2.

[21] *See id.* at 12, 32.

[22] *See id.* at 3–5, 10, 20–21.

[23] *See id.* at 4, 7, 14–15, 55–70.

tion within the U.S., and coordination among other nations, to promote order in global financial markets.

Part III considers these three or four approaches to financial regulation, and relates them to the literature on administrative law and regulatory theory. It discerns procedural and philosophical objectives of the Paulson and Volcker visions, the former vesting newly consolidated federal power in the executive for deregulatory and competitive ends, the latter in independent administrative agencies for re-regulatory and control-oriented ends.

Ultimately, neither grand vision may be sustainable. We may yet be left with remnants of the traditional U.S. fragmented system, as concentrated by the on-the-fly reforms made during the 2008 crisis, with perhaps new regulations addressing certain financial instruments and institutions previously outside federal regulatory purview. We evaluate the merits of this incremental approach as well, leading to our conclusion that incremental regulatory adjustments rather than sweeping regulatory revolution are both superior and more practicable. Indeed, in our view, the proposals that the Obama Administration first presented to Congress reflect an understanding of these values, and we have found their incrementalism to be appropriate and broadly consistent with the analysis of options presented here.

## *I. Prevailing Approaches: Dynamic Evolution*

This Part examines the prevailing model of financial regulation through one or two variants: the pre-2008 crisis model and the quasi-concentrated alternative that replaced it amid federal government interventions in response to the crisis. In doing so, it offers something of a history of financial regulation both before and during the crisis. Section A reviews U.S. financial regulation's traditional fragmentary character and its redeployment to respond to past crises. Section B discusses the 2008 crisis and the response to it, showing both a kinship to previous ad hoc responses in genus, but not in species, and an unprecedented exercise of federal, mostly executive branch, power. These are two related approaches to financial regulation.

Section C continues the historical inquiry by connecting the traditional fragmentation and crisis response to the unusual nature of Treasury Secretary Paulson's blueprint for regulatory reform which, given its timing and scope, may be seen as both anticipatory and preemptive. It exemplifies a species of financial regulation that rationalizes in an effort to ensure domestic political control and international market competitiveness. It was issued ahead of the crisis both to outline strategic and tactical responses to the crisis and to lead and influence national reform discussions that its authors may have anticipated as they foresaw the coming crisis.[24]

## *A. Traditional Fragmented Model and Ad Hoc Crisis Response*

Traditional financial regulation in the U.S. is best characterized as fragmented, and a fragmented approach is one model of financial regulation—indeed, it was the prevailing model until 2008. Because the model has received a great deal of criticism, it is worth emphasizing its values, chiefly innovation and regulatory discipline that provide a range of alternatives. The model featured a multiplicity of regulators, some of whom competed against one another, creating a market for law, and a crisis-driven evolutionary process.

In the old model, for example, insurance law was primarily state law; banking law was a combination of state and federal law, depending on whether a bank is chartered by a state or at the federal level; securities regulation was primarily, but not exclusively, federal; and futures regulation is entirely federal. Various other intermediaries, including government-sponsored mortgage-finance entities like Freddie

[24] Our thumbnail sketch of the 2008 crisis would begin with the increased personal savings rate in Asian countries in the late 1990s, following stringent economic controls to correct the bursting of speculative asset bubbles there. Resulting cash found its way into the U.S. mortgage-finance system, which was already expanding. Expansion arose in part from low interest rates the Fed maintained to combat a recession threatened by the collapse of the U.S. technology bubble in 2000 and terrorist attacks of late 2001. Existing mortgage-finance institutions, including Fannie Mae and Freddie Mac, supported expansion by continuing to buy or guarantee mortgage loans. Expansion was propelled by growing use of highly rated mortgage-backed securities, pools of mortgages that pay interest and principal to investors, sold through investment banks.

These forces led lenders to offer attractive deals to large numbers of borrowers lacking traditional indicia of creditworthiness. Trillions of dollars of loans were made on easy terms, including loans not requiring a down payment and low or no interest payments for initial periods, subject to reset at higher rates later. Reinforcing expansion of easy credit were novel financial-insurance products, called credit default swaps. These promised investors in mortgage-backed securities, and other debt, repayment by an insurer if their own debtor defaulted.

The result was rising home prices that became a speculative bubble. The bubble began to deflate in 2004. Interest rates rose, sales slowed, lenders tightened standards, and rating agencies identified greater risk in financial instruments supporting the expansion. Large numbers of people defaulted on mortgage loans when their outstanding balances exceeded a home's market value. Cascade effects ensued: prices fell, mortgage defaults rose, mortgage-backed securities were impaired, capital contracted, and the effects rippled through all financial markets, eventually infecting the real economy, triggering a steep recession. All these effects pulsed through the global financial system, sparing no national economy. Of course, many articles will be written on the causes of the crisis, by lawyers, economists, and other academics, and our thumbnail sketch is not meant to preempt that work. For a useful popular economic account, see David Leonhardt, *Can't Grasp Credit Crisis? Join the Club*, N.Y. TIMES, Mar. 19, 2008, at A1, *available at* http://www.nytimes.com/2008/03/19/business/19leonhardt.html?pagewanted=1&_r=1.

Mac and Fannie Mae, fit awkwardly into the picture and were subject to special federal regulatory oversight, while mortgage origination itself was left to state oversight. The same was true of credit unions. And of course, some of this breakdown of authority has survived the crisis, and the reform on the fly.

This fragmented system entailed roles for numerous actors, including state and federal lawmakers, regulators, supervisors, and administrators. In some fields, especially futures and to a lesser extent securities, important regulatory determinations were delegated to self-regulatory organizations, essentially industry groups charged with self-regulation. It was difficult for any single authority to command knowledge of the entire financial system. But if regulators found it difficult to evaluate systemic risk, the system, at least, knew what the regulators were up to. Most regulatory production and supervision was conducted in accordance with open government principles and procedures mandated by the Administrative Procedure Act (or state equivalents). It also featured judicial review of legislative, executive, and administrative action.[25]

The traditional system, conceived as a model of financial regulation, looked almost irrational, but offered its share of advantages, such as a close fit between regulatory expertise and targeted industries, a degree of devolution that enables exercise of state authority, and experimentation rather than monopolistic regulatory consolidation in Washington, and some competition among regulators themselves.[26] Overall, the system's characteristic open government promoted valued notions of democratic accountability and legitimacy. Moreover, the various overlaps meant that regulators competed against one another for business. To be sure, such a fragmented system resulted, at times, in both redundant and incomplete regulation. Under it, some institutions were subject to more than one layer of regulation while some transactions and institutions evaded regulation or oversight altogether.[27]

Moreover, the structure posed challenges when addressing periodic financial crises. Financial regulators certainly perform vital quotidian tasks, such as ensuring the safety and soundness of financial institutions, in addition to promoting fair treatment of customers and

[25] *See* 5 U.S.C. §§ 551–559, 701–706 (2006).

[26] Indeed, some observers have characterized the system as a law market. *See* Larry Ribstein & Erin O'Hara, The Law Market (2008).

[27] We provide more elaborate assessment, and implications of, this system's regulation *infra* Part III.

investors. But they also must deal with occasional financial shocks. A fragmented structure may enable authorities to respond to discrete institutional failures using tailored tools, but it may also blind senior regulators to important systemic risks that lead to widespread crisis. The question becomes the net value of disaggregation, an industry-by-industry focus, and redundancy with gaps, or whether consolidation is likely to result in better regulatory performance in crises, as by reducing their magnitude or duration.

Other scholars, along with many white papers and books, have described precisely how this chaotic system works, and repeating their organizational charts and diagrams here would be unproductive.[28] Instead, it is useful to offer four examples of how this structure has been used to respond to, and at the same time how the structure has been changed by, past crises.[29]

Although the exact response differed in each case, a familiar American crisis-response model of federal intervention appeared in each, along with the arguable failure of the system to evaluate systemic risk. At the same time, each crisis resulted from financial innovations that were not—to be sure—unambiguously useful, but that illustrate the remarkable number of market innovations over which the prior regime presided. In addition, the examples show small-scale versions of the kinds of crisis-response tools that the Fed and Treasury deployed during the crisis of 2008.

Consider first the widespread failure of savings-and-loan ("S&L") institutions during the 1980s.[30] In brief, these institutions heavily financed the purchase of individual properties, including many farms, at relatively high prices using relatively low interest rates.[31] After a real estate boom turned to bust, and property values fell while interest rates rose, borrowers defaulted in droves.[32] A downward spi-

[28] Readers seeking a description may consult GAO FRAMEWORK, *supra* note 5, at 5–47, or TREASURY BLUEPRINT, *supra* note 3, at 31–74; readers seeking charts and diagrams may consult GAO FRAMEWORK, *supra* note 5, at 6–7, 17.

[29] For a partial list of crisis responses, see Nelson D. Schwartz, *A History of Public Aid During Crises*, N.Y. TIMES, Sept. 6, 2008, at A27, *available at* http://www.nytimes.com/2008/09/07/business/07bailout.html?scp=1&sq=%22A+History+of+Public+Aid+during+Crises%22&st=nyt.

[30] For a more general overview of the S&L crisis, see Edward L. Rubin, *Communing with Disaster: What We Can Learn from the Jusen and the Savings and Loan Crises*, 29 LAW & POL'Y INT'L BUS. 79, 79–83 (1997).

[31] *Id.* at 80–82.

[32] *Id.* at 82–83.

ral ensued. All S&L's were affected and several thousand became insolvent.[33]

The government responded with a serial federal takeover of all those institutions, at a cost of more than $100 billion, under the supervision of the Treasury in a congressionally created special-purpose authority called the Resolution Trust Corporation.[34] It administered those institutions by selling off their assets over a period of years.[35] The response suggests a standard outline of using federal apparatus to resolve national problems that plagued thousands of state-based or regional institutions that were largely not subject to federal oversight.

Similarly, the crisis led to reorganization of the S&L industry as well as abolishment of existing regulatory bodies and replacement with new ones.[36] The government's reform could be characterized as an industry reorganization: it turned thrifts into something that looked more like banks and gave a parallel makeover to the thrift regulator, which was renamed the Office of Thrift Supervision and placed within Treasury (it was formerly called the Federal Home Loan Bank Board).[37]

Consider second the stock market break of October 1987, when the Dow Jones Industrial Average dropped 22.6% on a single day and nearly 35% in the course of a month.[38] Capital markets shut down. Panic was prevalent as the volume of corporate transactions, ranging from financings to mergers, fell. Financial innovations, such as computer-triggered block sales of stock, and associated absence of regulation, were again part of the story of that crisis.[39] President Reagan formed a working group to assess and advise on these matters.[40] Here government's reform was more measured and technical; it took reflec-

[33] *Id.* at 83.

[34] The Resolution Trust Corporation was established by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), § 501(b), Pub. L. No. 101-73, 103 Stat. 183, 369–76 (1989) (codified as amended at 12 U.S.C. § 1441a(b) (2006)). For an account of the Resolution Trust Corporation process, see Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. Banking Inst. 221, 247–48 (2000).

[35] *See* Markham, *supra* note 34, at 247.

[36] FIRREA abolished the Federal Savings and Loan Insurance Corporation and Bank Board and replaced them with the Resolution Trust Corporation and Office of Thrift Supervision. FIRREA §§ 401, 501, 103 Stat. at 354, 364–94.

[37] *See id.* § 301, 103 Stat. at 278.

[38] *See By the Numbers: Black October Market Crashes*, Newsweek, Nov. 15, 2008, http://www.newsweek.com/id/169279; *see also* Lawrence J. De Maria, *Stocks Plunge 508 Points, a Drop of 22.6%; 604 Million Volume Nearly Doubles Record*, N.Y. Times, Oct. 20, 1987, at A1.

[39] Anise C. Wallace, *Program Trading Gets More Brutal*, N.Y. Times, May 1, 1988, at 3:1.

[40] For further discussion of the PWG, see *infra* text accompanying notes 167–74.

tive, post-crisis advice, and then adopted a number of "small ball" reform proposals.

President Reagan's task force diagnosed causes, which it said were the proliferation of new financial instruments, such as financial derivative contracts, program trading, and portfolio insurance.[41] Adopted reforms were pegged to specific stock market operations, like establishing circuit breakers to halt market trading if stated declines occurred.[42] Suggested reforms that were not adopted include some appearing in 2008's Treasury blueprint and the 2009 Volcker report, such as reposing greater supervisory power over financial firms within the Fed and combining aspects of securities and futures regulation.[43]

Third, consider the collapse of the large hedge fund, Long Term Capital Management ("LTCM"), in 1997. Again financial innovation played a role in causing the crisis, although this one featured the growth of an alternative asset class, rather than a liberalization of lending practices or new computerized trading techniques. Hedge funds were just beginning to reach the massive size they achieved by 2008.[44] And regulatory gaps appeared: neither the SEC nor the Commodity Futures Trading Commission ("CFTC") oversaw the trades made by these funds.[45]

LTCM essentially placed side bets on the direction of various financial benchmarks, such as currency exchanges and interest rates. The firm used fairly sophisticated risk-management tools and appears to have invested heavily in careful scrutiny of its positions.[46] But due

[41] PRESIDENTIAL TASK FORCE ON MKT. MECHANISMS, REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 29–42 (1988) [hereinafter BRADY REPORT]. Critics extensively challenged these diagnoses, noting the international nature of the crash. *See, e.g.*, David D. Haddock, *An Economic Analysis of the Brady Report: Public Interest, Special Interest, or Rent Extraction?*, 74 CORNELL L. REV. 841 (1989).

[42] *See* BRADY REPORT, *supra* note 41, at 66.

[43] *See id.* at 59 (Chapter Seven on Regulatory Implications: "One Market Mandates One Agency for Inter-market Issues"); *id.* at 61 (recommending possible merger of SEC and CFTC to promote joint responsibility); *see also* Mike Guttentag, *Regulatory Rule #2: Insurance Products Need to be Regulated*, CONGLOMERATE, Oct. 17, 2008, http://www.theconglomerate.org/2008/10/regulatory-ru-1.html (describing the role of portfolio insurance in the 1987 stock market crash).

[44] *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED 23–39 (2002).

[45] *See* PRESIDENT'S WORKING GROUP, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 3 (1999) [hereinafter HEDGE FUNDS], *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf. For an account of the various proposals to regulate hedge funds by a current SEC commissioner, see Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1025–34 (2006).

[46] *See* LOWENSTEIN, *supra* note 44, at 3–122 (outlining the rise of LTCM).

to a financial crisis that swept across Asia, both currency rates and interest rates moved sharply in directions LTCM had deemed highly improbable.[47] As a result, the firm was exposed to losses on hundreds of billions of dollars of trades.[48]

Counterparties grew hesitant to deal with the firm, and the result was a rapid descent into dire financial straits.[49] But LTCM had obligations to many other participants in the markets, and those participants had relied on those obligations.[50] Seen to represent a pivotal component of the financial system, the Fed, led by its New York office, orchestrated a takeover of LTCM by a consortium of financial institutions, including Goldman Sachs.[51]

No systemic regulatory innovations were taken in the failure's wake, despite increasing spread of financial derivatives and calls by some for enhanced oversight and regulation of them.[52] However, the PWG, a descendant of President Reagan's post-1987 market crash task force, studied the crisis and resolved to strengthen cooperation among regulators in the future.[53]

Although not a financial crisis, as such, the corporate accounting scandals of the early 2000s and regulatory responses contribute perspective on the traditional fragmented system and pattern of crisis-response reform. Four large enterprises, mostly in the technology sector, although one in the energy sector, used fiendish accounting shenanigans to create the illusion of billions of dollars of value.[54] These and dozens of other corporations were discovered as all but (and in some cases total) frauds amid the collapse of the technology sector.[55]

Here too, financial innovations became increasingly popular. Off-balance sheet, special-purpose investment vehicles and various

[47] *See id.* at 117.

[48] *See id.*

[49] *See id.* at 152–57.

[50] *See id.* at 188.

[51] *See id.* at 183–218.

[52] *E.g.*, Thomas A. Russo, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431, 1497 (1991). Noted investor Warren Buffett famously quipped that derivatives had become "financial weapons of mass destruction." *See* WARREN E. BUFFETT, THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA 145 (Lawrence A. Cunningham ed., 2d ed. 2008).

[53] *See* HEDGE FUNDS, *supra* note 45; *see also supra* notes 40–43 and accompanying text (noting birth of Reagan's task force).

[54] *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 928–36 (2003).

[55] *See id.*

forms of aggressive accounting for financial instruments appeared.[56] Gaps in the division between state and federal oversight, and relatively laissez-faire federal accounting oversight, were exploited.[57]

The swift federal response was the Sarbanes-Oxley Act of 2002, reform targeted mostly at diagnosed causes of the frauds, plus a dozen remotely related provisions favored by various political interests.[58] The controversial legislation provoked criticism as an overreaction to the perceived crisis of investor confidence.[59] Although most of its provisions remain in effect, some implementing policies, especially concerning mandatory audits of corporate internal controls, were scaled back.[60] Many observers cite Sarbanes-Oxley as illustrating the kind of dangerous overreaction that crisis-driven legislative and regulatory reform can pose.[61]

These selected examples show some familiar traditional patterns of financial crisis and response in the fragmented model. The crisis can bubble up in a particular sector—real estate bank lending in the S&L crisis, equity market pricing in 1987's stock market break, derivative financial products in LTCM's 1997 failure, and technology in the early 2000s accounting scandals.[62] They also show a substantially co-

[56] *See id.*

[57] *See id.* at 928–41.

[58] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2006)).

[59] *E.g.*, Roberta Romano, *Sarbanes-Oxley and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528–29 (2005).

[60] *See, e.g.*, Stephen Labaton, *S.E.C. to Ease Auditing Standards for Small Publicly-Held Companies*, N.Y. TIMES, Dec. 11, 2006, at C1. For example, the original auditing standard governing internal control over financial reporting pursuant to Section 404 of Sarbanes-Oxley, Auditing Standard No. 2, adopted in 2004, was replaced in 2007 with Auditing Standard No. 5. Order Approving Proposed Auditing Standard No. 5, Exchange Act Release No. 56,152, 91 SEC Docket 522 (July 27, 2007); *see also* Pub. Co. Accounting Oversight Bd., Auditing Standard No. 5: An Audit of Internal Control over Financial Reporting that Is Integrated with an Audit of Financial Statements (2007), *available at* http://www.pcaob.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf. In addition, the SEC repeatedly adopted exemptions making Sarbanes-Oxley's auditor-attestation provisions inapplicable to smaller public companies. *See* Press Release, Sec. & Exch. Comm'n, SEC Approves One-Year Extension for Small Businesses from Auditor Attestation Requirement in Sarbanes-Oxley (June 20, 2008), *available at* http://www.sec.gov/news/press/2008/2008-116.htm; *see also* Feng Gao et al., *Unintended Consequences of Granting Small Companies Exemptions from Securities Regulation: Evidence from the Sarbanes-Oxley Act*, 47 J. ACCT. RES. 459 (2009) *available at* http://www3.interscience.wiley.com/cgi-bin/fulltext/122196986/PDFSTART.

[61] *See* Romano, *supra* note 59.

[62] Federal intervention to address problems of one or a few firms that could pose systemic ripple effects recurs. Famous examples include addressing Penn Square Bank, which threatened to topple Continental Illinois Bank, then 7th largest in the U.S.*, see* Phillip L. Zweig, *Learning Old Lessons from a New Scandal*, N.Y. TIMES, Feb. 2, 2002, at A19 (reviewing case in light of

ordinated national response, led at the federal level, usually based on ex post diagnostics of causes. Finally, they show that regulatory responses are often tailored to the particulars of the problem, although many unadopted proposals with greater systemic scope are often made. In short, comprehensive reform of financial regulation has usually required a crisis to develop, but a crisis does not always lead to comprehensive regulatory reform.

### *B. On-the-Fly Reform Model in 2008 Crisis: Ad Hoc Centralization*

The 2008 crisis bears kinship to predecessors in several ways, but its scale and scope were unprecedented. One of us has elsewhere provided a detailed account of how the government responded to the crisis;[63] here we consider its response as a *model of regulatory reform*.

We posit the response as a reform model cautiously. Nobody said they were reforming the financial system when they bailed out all those institutions, and it is easy to succumb to recency bias when evaluating the momentousness of legal developments. Moreover, there are some ways that the crisis evolved according to the usual playbook. But the response also centralized financial regulation, even if *sub silentio*, and so turned away from the old approach to financial regulation.

The response also dispensed with the usual trappings of administrative law in making what turned out to be the government's signature policy initiative during 2008 into something done without notice, comment, judicial review, or, for much of its duration, authorizing legislation. As we explain in what follows, the response changed the regulation of investment and commercial banking, mortgage finance, and even insurance regulation, and it coordinated that change globally. Yet, despite all of this action, it still left essentially unregulated the financial derivative instruments that some observers place at the root of the crisis.

Is the regulatory response to the 2008 crisis its own model of financial regulation? We are agnostic, and invite this Article's readers to decide. The following analysis should facilitate evaluation.

As with past crises, the 2008 crisis spread quickly. The S&L crisis and the 1987 stock market collapse exemplified the speed with which

pending crisis at Enron Corporation), and Bank of Credit and Commerce International, an illicit international web of financial operations whose collapse threatened the financial system's stability, *see* United States v. BCCI Holdings, 69 F. Supp. 2d 36, 38 n.3 (D.D.C. 1999).

[63] *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009).

financial markets can turn from relatively safe to extraordinarily risky. The 2008 crisis accelerated rapidly, especially in the final quarter of that year, when, instead of imperiling a few firms, credit markets froze, and many banks teetered toward insolvency.[64] As former Treasury Secretary Paulson wondered of the serial collapse of financial institutions during that period: "[w]ho are these guys that just keep coming?"[65]

The 2008 crisis also followed the financial crisis rulebook in response, at least in the beginning. The response began with firm-by-firm intervention in the spring, summer, and early fall of 2008,[66] but ensuing efforts broadened to prevent asset prices from plunging.[67] As with the S&L and LTCM crises, federal authorities used deals (mergers and acquisitions ("M&A") and corporate finance) to respond.[68] But, again given the scale, ultimate responses reached unprecedented levels, amounting to regulatory intervention involving what is best described as "regulation by deal."[69]

On balance, the government did something new in responding to the 2008 crisis, to the point of altering regulation of financial markets more generally. It provided financial guarantees, bought preferred stock and warrants in private companies, extended commercial loans to others, acted as broker of numerous mergers and takeovers of yet others, took over some companies, in whole or in part, and made what amounted to business decisions to participate in some corporate finance and M&A activity with certain companies while allowing others simply to fail.[70] The response paradigm was accordingly not unknown

[64] *See, e.g.*, Andrew R. Sorkin, *Lehman Files for Bankruptcy; Merrill is Sold*, N.Y. Times, Sept. 14, 2008, at A1; Louis Uchitelle, *Pain Spreads as Credit Vise Grows Tighter*, N.Y. Times, Sept. 18, 2008, at A1.

[65] *See* Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. Times, Oct. 23, 2008, at A1.

[66] As discussed below, the response dealt with Bear Stearns in investment banking; IndyMac, Washington Mutual, and Wachovia in commercial banking; AIG in insurance; and Fannie Mae and Freddie Mac in mortgage finance. *See infra* Part I.B.1–4.

[67] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 2, 122 Stat. 3765, 3766. This Act envisioned Treasury buying up to $750 billion in troubled assets using techniques such as reverse auctions to generate prices otherwise unformed amid distressed market conditions. It was subsequently used as the basis for Treasury's investment of $250 billion in preferred stock and warrants of banks. *See* Steve Lohr, *Bold Action With Basis in History*, N.Y. Times, Oct. 14, 2008, at A1.

[68] *See* Davidoff & Zaring, *supra* note 63, at 508–12.

[69] *See, e.g.*, *id.* at 67; *see also* Tyler Cowen, *Bailout of Long-Term Capital: A Bad Precedent?*, N.Y. Times, Dec. 26, 2008, at BU5 (adopting the "regulation by deal" terminology).

[70] *See* Charles Duhigg et al., *As Crisis Grew, A Few Options Shrank to One*, N.Y. Times, Sept. 8, 2008, at A1.

to the financial system, but is distinguished by ad hoc dealmaking out of the crisis, rather than post hoc reform to calm troubled waters, as in previous crises.

The Fed and Treasury's dealmaking and injection of liquidity into capital markets forced both to resort to the novel use of legal authority to justify their actions. And, given the scale of responses, it was never clear that either had that authority.[71] They did seek and obtain legislation authorizing using up to $750 billion in Treasury funds to buy distressed assets or make investments in banks on behalf of the U.S. government.[72] But they also relied extensively on flexible Depression-era statutes to get involved in sectors of the economy in which they previously never had purchase, dramatized by how the Fed bought an insurer—American International Group ("AIG")—and Treasury *became* an insurer of money market funds.[73]

As with other financial crises, this one and the response to it prompted proposals for large-scale, planned reform, including contributions made by groups and commentators ranging from the Group of Thirty to the GAO.[74] Ironically, however, in this case, some of the reforms achieved by the Fed and Treasury were contemplated before the scale of crisis became clear, in March 2008's Treasury blueprint. For example, as we will detail, the blueprint counseled the centralized model which the Fed adopted, with assistance from Treasury, during 2008. It advised consolidating safety and soundness supervision in a single entity, and during the crisis, the Fed took over supervision of investment banks from the SEC. The blueprint urged a federalization of insurance, and the government responded with a takeover of AIG.

This seems like a new order. In our view, in the 2008 crisis, real, even lasting reforms to the financial system were actually generated on the fly, *as* the government responded, rather than *after* the response. True, the various strands of the crisis led to different responses by different regulators. But by the end of 2008, the federal government's extensive financial commitment into nearly every financial-services industry had substantially consolidated the various forms of financial regulation. It centralized regulatory authority in the Fed

[71] *See* Davidoff & Zaring, *supra* note 63, at 467–68.

[72] Emergency Economic Stabilization Act of 2008 § 101, 122 Stat. at 3767.

[73] *See infra* text accompanying notes 110–16. On money market funds amid the crisis, see Mercer E. Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1351987; on AIG, see William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. (forthcoming 2009).

[74] *See supra* text accompanying notes 3–6 (citing sources).

and Treasury, significantly reducing the regulatory authority of other federal agencies and state regulators.

Below we explore how the prevailing system of financial regulation shifted radically during the 2008 crisis and the responses to it. As we have said, the practice of investment banking was essentially terminated, moving remaining investment banks from supervision by the SEC to supervision by the Fed. The regulation of commercial banking was extensively consolidated within the federal government, especially within the Fed and Treasury. Federal supervision of mortgage finance shifted from independent federal agencies to within the Fed and, especially, Treasury. Even some aspects of insurance regulation shifted at least slightly from state to federal authorities. It is all new, and it has transformed our formerly decentralized and fragmentary system into something quite different and novel.

### *1. Investment Banking*

The 2008 crisis changed the face of investment banking completely and arguably ended it as a separate sort of finance, in what amounts to de facto financial regulation reform. The industry was led by five large firms: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. Each of these firms during 2008 essentially failed as stand-alone institutions, with the result that all five ceased to be subject to the jurisdiction of the SEC and instead became subject to Fed oversight.

Bear tripped first, in March 2008, after counterparties refused to offer the short-term credit it needed to run its business.[75] In moves reminiscent of those applied to address the LTCM crisis in 1997, the Fed and Treasury orchestrated a merger of Bear with JP Morgan Chase, a commercial bank, at an initial price per share of about $2—a price that holders promptly protested, getting it raised within two weeks to $10 per share.[76]

In September 2008, an even worse fate befell Lehman Brothers, an investment bank, like Bear Stearns, heavily exposed to the subprime mortgage market.[77] The Fed and Treasury elected not to sus-

[75] *See* Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bearn Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 716 (2009).

[76] *See id.* at 719.

[77] *See, e.g.*, Devin Leonard, *How Lehman Brothers Got Its Real Estate Fix*, N.Y. TIMES, May 2, 2009, at BU1. Evidence of its dire straits appeared in how Lehman was the only major defendant that refused to settle lawsuits challenging the suitability of auction-rate securities for individuals. These were portrayed as liquid cash equivalents but their liquidity depended on investment banks' willingness to trade them, willingness that terminated amid the crisis and left

tain Lehman, though they helped to arrange for other financial institutions, like Barclays, a British commercial bank, to assume many of its operations.[78]

During the same September week that the Fed and Treasury signaled unwillingness to support Lehman, they sent the same signal to Merrill Lynch.[79] As a result, Merrill quickly merged with Bank of America on the weekend that Lehman Brothers fell, in a deal likewise supported by the Fed and Treasury.[80] Within that week, moreover, also with the blessing of the Fed and Treasury, Goldman and Morgan Stanley opted to turn themselves into bank holding companies under Fed supervision and with expanded access to its liquidity facilities.[81]

These changes were momentous, not only because they were achieved as a result of government decisions to provide or withhold support or to encourage or discourage particular transactions. In many ways, it was these events, rather than the 1999 repeal of the Glass-Steagall Act, that marked the real end of 75 years of separation of investment banking from commercial banking in the United States. The enactment of the Glass-Steagall Act, a Great Depression statute, had established the legal wall that separated commercial from investment banking.[82]

Under the Glass-Steagall Act—itself an ad hoc response to that period's financial crisis—commercial banks would take deposits and make loans; investment banks would buy and sell securities and engage in other transactional corporate finance.[83] Enterprises engaged

individuals holding securities they could not sell. *Cf.* Gretchen Morgenson, *As Good as Cash, Until It's Not*, N.Y. Times, Mar. 9, 2008, at BU1 (discussing auction rate notes in general).

[78] The effort to enlist Barclays was important to protect investors under securities laws designed to secure customer funds held in brokerage accounts. *See* Press Release, Sec. & Exch. Comm'n, Statement on Proposed Lehman Brothers, Inc. Acquisition by Barclays (Sept. 17, 2008), *available at* http://www.sec.gov/news/press/2008/2008-206.htm.

[79] *See* Merrill Lynch & Co., Definitive Proxy Statement (Form 14A), at 49–52 (Oct. 31, 2008), *available at* http://www.sec.gov/Archives/edgar/data/65100/000095012308014246/g15211mldefm14a.htm; *see also* Jonathan Keehner & Bradley Keoun, *Bank of America Said to Reach $44 Billion Deal to Buy Merrill*, Bloomberg, Sept. 14, 2008, http://www.bloomberg.com/apps/news?pid=20601110&sid=alGoI3fTq1Us (quoting an analyst stating that "If Lehman fails, the next bank to be attacked would be Merrill. They are attempting to forestall that attack by linking with Bank of America.").

[80] *See* Louise Story & Jo Becker, *Bank Chief Tells of U.S. Pressure to Buy Merrill Lynch*, N.Y. Times, June 11, 2009, at B1.

[81] *See* Press Release, Fed. Reserve Bd. (Sept. 21, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm.

[82] The Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162.

[83] *Id.*

in commercial banking could not engage in investment banking.[84] Most of that act was repealed by the Gramm-Leach-Bliley Act of 1999,[85] having gradually been chipped away by various means including exemptions for commercial banks to underwrite securities and investment banks to own commercial bank subsidiaries.[86] The partial repeal ended the legal limitations on combining these activities within one firm.

Despite that repeal, Bear, Goldman, Lehman, Merrill, and Morgan Stanley continued to epitomize traditional investment banking. After repeal, and until the cataclysmic events of 2008, the SEC had jurisdiction over the safety and soundness of these firms, though its role in determining their fate would ultimately be minimal. Indeed, the SEC exercised its oversight through a voluntary program.[87] The SEC Chairman who created and oversaw that program admitted in September 2008 that it was a total failure.[88] With Lehman bankrupt, Bear and Merrill subsumed by commercial banking institutions, and Goldman and Morgan Stanley officially commercial bank holding companies, the regulatory landscape was radically, although haphazardly, reformed, on the fly, by the Fed and Treasury.

### 2. *Commercial Banking*

Fed and Treasury activities during the 2008 crisis concerning commercial banking followed a more traditional model, although also on an unprecedented scale, and with the functional reform of concentrating regulatory authority in the Fed and Treasury. U.S. commercial banking was traditionally a dual system, created at state and federal levels, although both were subject to federal oversight. Three institu-

[84] *Id.*

[85] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[86] *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 319–20; *Regulatory Reform in Transition: The Dismantling of the Glass-Steagall Act*, 47 ADMIN. L. REV. 545 (1995); *see also* Christian A. Johnson, *Holding Credit Hostage for Underwriting Ransom: Rethinking Bank Anti-Tying Rules*, 64 U. PITT. L. REV. 157, 166–67 (2002) (recounting judiciary's involvement in the erosion of Glass-Steagall); George J. Papaioannou & Adrian Gauci, *Deregulation and Competition in Underwriting: Review of the Evidence and New Findings*, 5 J. INT'L BUS. & L. 47, 48–49 (2006) (tracing the history of the erosion of Glass-Steagall).

[87] The SEC's inspector general analyzed the program amid the crisis. OFFICE OF INSPECTOR GEN., SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM, at v (2008), *available at* http://www.sec.gov/about/oig/audit/2008/446-a.pdf.

[88] *See* Press Release, Sec. & Exch. Comm'n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), *available at* http://www.sec.gov/news/press/2008/2008-230.htm.

tional categories prevailed: national banks within the Federal Reserve system; national banks under supervision of the Comptroller of Currency within Treasury; and state-chartered banks, either within the Federal Reserve system or under the jurisdiction of the Federal Deposit Insurance Corporation ("FDIC").[89]

During the 2008 crisis, numerous commercial banks from within all three institutional categories faced extraordinary liquidity challenges. Some became insolvent, failed, and were taken over by federal authorities or sold to larger banks in deals orchestrated by federal authorities, especially the Fed and Treasury. Principal examples are IndyMac (put under FDIC supervision in July 2008),[90] Washington Mutual (arranged sale to JP Morgan Chase in September 2008),[91] and Wachovia (arranged sale to Wells Fargo in October 2008).[92] The Fed and Treasury enlisted larger banks, including Bank of America, Barclays, Citicorp, JP Morgan Chase, and Wells Fargo, to provide safer homes for these and other failing institutions.

The Fed and Treasury also directly invested federal government funds in smaller and larger banks alike, not only relying upon traditional lending, but buying equity positions, and not only extending credit to commercial banks within their traditional purview, but to banks and non-banks outside their traditional jurisdiction.[93] All of this was done quickly, on an emergency basis, and without the usual notice and comment that accompanies government rulemaking. Indeed, during Secretary Paulson's tenure, this was often done without any pre-action notice at all and, despite a commitment to greater

[89] For an overview of the various state and federal regulatory participants involved in banking supervision, see PATRICIA A. MCCOY, 1 BANKING LAW MANUAL § 3.02 (Matthew Bender, 2009). For concerns that the dual banking system is under attack, see Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004), *available at* http://ssrn.com/abstract=577863.

[90] *See* Fed. Deposit Ins. Corp., Failed Bank Information, http://www.fdic.gov/bank/individual/failed/IndyMac.html (last visited Aug. 31, 2009).

[91] *See* Christopher Palmeri, *JPMorgan Chase to Buy Washington Mutual*, BUSINESSWEEK.COM, Sept. 26, 2008, http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080925_760466.htm.

[92] *See* Andrew Frye & Alison Veshkin, *Wachovia Regulators Push Citicorp, Wells to Settle*, BLOOMBERG, Oct. 7, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aZ2gXzQV2ndI&refer=home (noting that Wachovia initially agreed to merge with Citicorp but terminated that agreement in favor of superior deal with Wells Fargo, with federal regulators intervening to encourage a tripartite settlement of resulting dispute).

[93] *See* Jon Hilsenrath & Prabha Natarajan, *Federal Reserve to Buy Commercial Paper*, DOW JONES NEWSWIRES, Oct. 7, 2008, *available at* http://www.smartmoney.com/breaking-news/smw/?story=20081007094827.

transparency, advance notice was not a feature of Secretary Geithner's program either.[94]

The Fed intervened in these events and transactions in two different ways: it provided financial support to some firms seeking liquidity, and it provided advice and support for others for whom mergers were deemed superior. Section 13 of the Federal Reserve Act creates the liquidity mechanism, called the discount window, which had been used in the past to support troubled financial institutions, although not to the extent that it was used in 2008 to backstop credit in commercial banking more generally.[95] The relevant part of Section 13 provides:

> In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank, . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when . . . indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, That before discounting . . . the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.[96]

The Fed interpreted that act to allow it to open its discount window not just to banks but to other institutions in emergencies.[97] These on-the-fly regulatory exertions did not overrule the system of dual banking in the United States, nor clearly reallocate authority within federal agencies, but they put the Fed in a far stronger regulatory position than it had been identified with historically.[98] As a rule of thumb in administrative law, if an agency has never done something in the past, it usually cannot do it, no matter how broad the grant of Depression-era authority.[99] But the dynamic paradigm of ad hoc centralization during 2008 allowed little time for quarrels over such legal niceties.

[94] *See supra* note 15.

[95] 12 U.S.C. § 343 (2006).

[96] *Id*; *see also* Davidoff & Zaring, *supra* note 63, at 465 (discussing the unprecedented nature of the Fed's legal interpretations); Edmund L. Andrews, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. Times, Mar. 17, 2008, at A1 (discussing the Fed's actions).

[97] The Fed also had invoked this authority when opening its discount window to investment-banking institutions early in the 2008 crisis. *See* Davidoff & Zaring, *supra* note 63, at 476–78.

[98] *See* Andrew Ross Sorkin, *A Bailout Above the Law*, N.Y. Times, Sept. 22, 2008, at C2.

[99] Or so Davidoff and Zaring argue. *See* Davidoff & Zaring, *supra* note 63, at 535–36.

### 3. *Mortgage Finance*

Treasury's secondary mortgage market forays also seemed to recalibrate the government approach to home ownership support through the process of a government takeover. By June 2008, it became clear that financial weakness plagued two of the most central participants in the U.S. mortgage-finance system, Freddie Mac and Fannie Mae.[100] These government-sponsored entities ("GSEs"), created by act of Congress but run as private firms, were widely but incorrectly perceived as enjoying government guarantees.[101]

The GSEs were subject to oversight by a separate federal governmental authority but enjoyed no such explicit government guarantees.[102] Their principal business was buying or guaranteeing home mortgages and repackaging them into securities to generate ongoing funding to support the U.S. housing market. These activities resulted in the GSEs owning or guaranteeing more than half the multi-trillion dollars of outstanding U.S. mortgage debt, including a large portion that would default or become delinquent in the 2008 crisis.[103]

The steadily worsening weaknesses at Freddie and Fannie, however, induced Treasury to intervene. It directed that they be put into a conservatorship.[104] The intervention "stemmed from a growing realization by Treasury and Fed officials that the two companies couldn't survive in their existing forms, and that any collapse would be devastating to the economy."[105] The intervention depended on hastily passed supervisory authority that the Treasury, and Fannie and Freddie's regulators, had promised Congress not to use.[106] The Congressional authority, given on July 30, 2008, provided that Fannie and

[100] *See* Duhigg et al.*, supra* note 70, at A1.

[101] The same was true for Ginnie Mae and the Federal Home Loan Banks; the same had been true for Sallie Mae until it transitioned fully into a private enterprise in the early 2000s. *See* PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, A REFERENCE GUIDE TO THE U.S. RESCUE EFFORTS 49 (2009) (Feb. 24 version) [hereinafter PAUL, WEISS]. For a prescient prescription that could have reduced the role that Fannie Mae and Freddie Mac played in the 2008 crisis, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543.

[102] *See generally* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019 (2008).

[103] *Id.*

[104] *See* Press Release, Fed. Hous. Fin. Agency, Fact Sheet: Questions and Answers on Conservatorship (Sept. 7, 2008)*, available at* http://www.ustreas.gov/press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf.

[105] *See* Deborah Solomon et al., *Mounting Woes Left Officials with Little Room to Maneuver*, WALL ST. J., Sept. 8, 2008, at A1.

[106] Treasury's promise not to use its sought authority to rescue the Frannies was based on an assumption that market knowledge of the existence of Treasury's power would increase market confidence in the viability of the two firms, thus obviating need to exercise the authority.

Freddie's regulator "may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of" either of the GSEs.[107]

Treasury used the ability to make these sorts of purchase and sales when it assumed control over Freddie Mac and Fannie Mae beginning in late summer 2008.[108] The conservator power was new, but bankruptcies, of course, happened under the old regime. What differed was the origin of the conservator—a government agency closely supervised by Treasury, and with a long-term, rather than short-term, view. The congressional delegation of authority to Treasury to decide whether to seize the firms exemplified the centralization in 2008.

Fannie and Freddie had their own regulators who had little to do with the final disposition of the institutions.[109] Treasury's intervention in mortgage finance thus represents another part of the considerable financial regulation reform that occurred during the crisis of 2008.

### 4. *Insurance*

The on-the-fly centralization of 2008 even reached insurance. The day after Lehman was allowed to fail, the Fed and Treasury intervened to buy or backstop the assets of American International Group, a large insurance company that they had never regulated in the past. AIG, subject to the jurisdiction of the New York State Insurance Department, ran sound insurance businesses through various divisions worldwide. It also operated one division that underwrote a large volume of credit default swaps, essentially insurance against borrower default on debt.[110]

Amid the 2008 crisis of borrower defaults that spread through the financial system, AIG's exposure on these reached staggering proportions that appeared to impair other parts of the company.[111] AIG's

This hypothesis proved incorrect. Notably, the same theory of market confidence appears in parts of the Treasury blueprint. *See infra* text accompanying notes 153–204.

[107] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1145, 122 Stat. 2654, 2734.

[108] Stephen Labaton & Edmund L. Andrews, *Mortgage Giants Taken Over by U.S.*, N.Y. Times, Sept. 8, 2008, at A1.

[109] The institutions also had plenty of skeptics, particularly of its forays into secondary mortgage finance, at the Fed (Alan Greenspan was particularly critical), in both parties, and at Treasury itself. Bethany McLean, *Fannie Mae's Last Stand,* Vanity Fair, Feb. 2009, *available at* http://www.vanityfair.com/politics/features/2009/02/fannie-and-freddie200902.

[110] Robert O'Harrow, Jr. & Brady Dennis, *Downgrades and Downfall*, Wash. Post, Dec. 31, 2008, at A1.

[111] In a scathing depiction of these operations, however, Delaware Vice Chancellor Leo Strine refused motions to dismiss certain AIG directors in a shareholder derivative action in part

New York State insurance overseer proved unable to come up with the financing to backstop the company's disastrous moves into credit default swaps and the mortgage market.[112] But, in the Fed's judgment, an AIG failure would threaten the financial system. As a result, the Fed opened its discount window for AIG, initially to lend it $85 billion, with Treasury subsequently investing additional amounts in exchange for preferred stock that represented a controlling interest in the company.[113]

The move was particularly notable because insurance law is primarily state law. It is, in fact, quintessentially state law (albeit controversially so), as it is strongly insulated from federal oversight and influence.[114] The 2008 crisis gave federal authorities reason and opportunity to revisit this arrangement. And, again, the imposition of the central bank into insurance supervision was not only novel, but such a trade of credit for equity was unprecedented in the Fed's use of Section 13 of the Federal Reserve Act.[115] Furthermore, numerous insurance companies sought to convert themselves into S&L associations precisely to become subject to the Fed's jurisdiction (in terms of both supervision and access to funds).[116]

Of course, this is not to say that such regulatory reform was comprehensive. States retain plenary authority over the creation and regulation of insurance companies in the United States.[117] Any efforts to alter this must await more planned and formal regulatory-reform ini-

on the grounds that the complaint's allegation supported characterizing AIG as a "criminal organization." *In re* Am. Int'l Group, Inc., 965 A.2d 763, 799 (Del. Ch. 2009).

[112] Serena Ng & Liam Pleven, *An AIG Unit's Quest to Juice Profit: Securities-Lending Business Made Risky Bets; They Backfired on the Insurer*, WALL ST. J., Feb. 5, 2009, at C1; *see* O'Harrow & Dennis, *supra* note 110, at A8.

[113] *See* Monica Langley et. al., *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J., Sept. 18, 2008, at A1, A7; Sjostrom, *supra* note 73, at 19–30; PAUL, WEISS, *supra* note 101, at 27–29.

[114] *See* McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011–1015 (2006); Barnett-Bank v. Nelson, 517 U.S. 25, 38–39 (1996); Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 14–15 (1993).

[115] *See* Press Release, Fed. Reserve Bd. of N.Y., Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008), *available at* http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html (noting use of section 13(3)); *see also* Greg Ip, *Central Bank Offers Loans To Brokers, Cuts Key Rate; Historic Steps*, WALL ST. J., Mar. 17, 2008, at A1 (noting novelty of securities dealers being able to borrow from Fed on similar terms as banks).

[116] *See* PAUL, WEISS, *supra* note 101, at 2, 12–13.

[117] *See* Dwight Cass, *Insurer Oversight Is Not Yet Broken*, N.Y. TIMES, Apr. 30, 2009, at B2 (arguing that state insurance regulation is not a bad thing); *cf.* Emeric Fisher, *Banking and Insurance: Should Ever the Twain Meet?*, 71 NEB. L. REV. 726, 726 (1992) (considering whether con-

tiatives. However, there is also no doubt that these measures represented at least some important substantive steps in a regulatory-reform road.

### 5. *Derivatives*

One important contributor to the 2008 crisis managed to evade the federal reform marked by the on-the-fly response to the crisis. The derivative business over which financial institutions made their most disastrous risk calculations were credit default swaps. AIG, for example, wrote a large book of business in the form of credit default swaps.[118] What doomed AIG were defaults and coverage on these, not its traditional insurance operations.[119] The credit default swaps it issued are like insurance contracts, which is presumably why AIG got into the business. But the swaps are not like homeowner protection or directors and officers coverage. For a fee, the insurer promises a lender to a third party that it would cover payments on the borrower's default. If larger than modeled defaults arise, as they did, this insurance program could wipe its underwriter out. This is exactly what happened to AIG.[120]

Credit default swaps, and many other modern financial products, evade tidy characterization within traditional classifications of financial devices. They could arguably be classified as insurance, securities, or futures and therefore subject to state, SEC, or CFTC regulation. In fact, however, many of these devices were simply put beyond regulatory reach in the Commodities Futures Modernization Act of 2000.[121] Whether due to this statutory exemption or general problems of classification and jurisdiction, it became clear that trillions of dollars in notional amount of these products had been created without the kind

sumers would be adequately protected if banks were allowed to underwrite and sell all types of insurance).

[118] *See* O'Harrow & Dennis, *supra* note 110, at A1; *supra* notes 111–13 and accompanying text.

[119] *See supra* notes 111–13 and accompanying text.

[120] Gretchen Morgenson, *A.I.G., Where Taxpayers' Dollars Go to Die*, N.Y. Times, Mar. 8, 2009, at BU1.

[121] Commodities Futures Modernization Act of 2000 ("CFMA"), Pub. L. 106-554, app. E, 114 Stat. 2763, 2763A-365 to -462 (codified in scattered sections of 7, 11, 12 & 15 U.S.C.) (enacted as part of Consolidated Appropriations Act, 2001, Pub. L. 106-554, 114 Stat. 2763 (2000)). CFMA largely put an array of financial derivative products outside the jurisdiction of either the SEC or CFTC. The blueprint provides a review of this legislation that seems generally favorable to it. *See* Treasury Blueprint, *supra* note 3, at 46–48.

of transparency, for markets or regulatory authorities, that usually accompany financial instrument creation, trading, and settlement.[122]

Many diagnoses of the 2008 crisis identified the regulatory gap that allowed credit default swaps to evade supervision under insurance, securities, and futures regulations as a culprit.[123] But authorities in those fields abjured oversight.[124] Little that the Fed or Treasury did addressed these issues either, although the Fed's intervention did guarantee a portion of AIG's debt, presumably providing the capacity for at least some supervision. In addition, by mid-February 2009, a bill was circulating in Congress to provide federal regulation of credit default swaps.[125] This is in keeping with more traditional crisis-response practice. Still, although complex derivatives appear to have been misvalued by financial institutions (to the peril of such institutions), none of the government regulators did anything about them in 2008.

### 6. *Corporate Governance*

All this on-the-fly dealmaking even reached into areas of corporate governance traditionally governed by state corporation law. For example, the AIG investments were accompanied by the AIG board's contractual commitment that it would "work in good faith" with the investors "to ensure corporate governance arrangements satisfactory to the Trustees."[126] More generally, an eruption of public interest in executive compensation arose, leading regulators and Congress to im-

[122] The difficulty of classifying credit default swaps continued amid the crisis, with New York State considering treating them as insurance, the SEC expressing concern that they were not covered by its regulations, and futures entrepreneurs floating proposals to develop organized futures trading markets for the instruments. *See* Serena Ng & Doug Cameron, *New York Fed Calls Meeting for CDS Market*, WALL ST. J., Oct. 9, 2008, at C7 (reporting discussions of participants seeking to create a new organized trading platform for credit default swaps).

[123] *See, e.g.*, Thomas Lee Hazen, *Filling the Regulatory Gap: It is Time to Regulate Over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123 (2008).

[124] *See, e.g.*, Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1046–51 (2007). Much has been made about the fact that AIG Financial Product's federal regulator oversaw thrifts, which usually make consumer and home loans.

[125] Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009) (sponsored by Representative Colin Peterson, Chair, House Committee on Agriculture). Other steps taken included efforts to establish an organized exchange market on which to trade credit default swaps. *See* PAUL, WEISS, *supra* note 101, at 4 (noting SEC approval of LCH.Clearnet Ltd. to operate temporarily as a central clearing agency for credit default swaps).

[126] This language appeared in an amendment to the credit agreement between AIG and the Federal Reserve Bank of New York, which AIG filed with the SEC. *See* Am. Int'l Group, Amendment No. 2 to Credit Agreement (Nov. 9, 2008), *available at* http://www.sec.gov/Archives/edgar/data/5272/000095012309004659/y75292exv10w1.htm.

pose limits on the compensation that investee companies were allowed to pay their senior executives.[127]

### 7. *Global Reach*

As we will see, globalization is an important component of the more organized models of financial regulatory reform that we consider in the next Part. It also played a part in the on-the-fly model. The foregoing discussion of problems and responses in the U.S. were replicated in dozens of other countries, including the United Kingdom, most European states, and many elsewhere around the world. By October 2008, Iceland even teetered on national bankruptcy as a result;[128] Denmark intervened by totally guaranteeing all inter-bank transactions for an initial two year period.[129] Global stock market indexes plunged, often in tandem with declines in the U.S. Dow, which also occurred during the 1987 stock market break.[130]

Justifications for U.S. intervention in many cases, especially as to Bear and AIG, included threats to the global financial system; such justifications also supported federal orchestration of the rescue of LTCM in 1997.[131] The ad hoc response to the crisis even had an official global component, as the principals from the G20 group of countries met to discuss the crisis in November, 2008.[132] They released a statement of relatively low specificity, but one that nonetheless underscored the global character of the crisis:

> We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject

[127] *See* Paul, Weiss, *supra* note 101, at 19–22.

[128] Eric Pfanner & Julia Werdigier, *Iceland, in a Precarious Position, Takes Drastic Steps to Right Itself*, N.Y. Times, Oct. 8, 2008, at B1.

[129] *See* Carter Dougherty, *Denmark Is Rethinking Its Spurning of the Euro*, N.Y. Times, Oct. 27, 2008, at B10.

[130] *See, e.g.*, Jeff Gerth, *A Push for International Market Rules*, N.Y. Times, Nov. 23, 1987, at D3; Mark Landler & Vikas Bajaj, *Some Currencies Plunge as Stocks Sink Worldwide*, N.Y. Times, Oct. 25, 2008, at A1.

[131] Wilmarth, *supra* note 86, at 370–71.

[132] Indeed, one way to think about international regulatory harmonization is as a three-stage process. First, domestic regulators agree to share information with their foreign counterparts. This does not harmonize regulation, but solves some globalization problems (at least from the regulator's perspective). Second, the mechanism used for international information exchanges becomes the forum to generate principles of regulation commanding assent. These tend to be gauzy, short, and vague, and it isn't clear that they amount to much. Third, some of these institutions actually develop their own set of hard rules, as the Basel Committee on Banking Supervision did with its capital-adequacy accord. *See* David Zaring, *Three Challenges For Regulatory Networks*, 43 Int'l Law. 211 (2009).

> to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.[133]

Given this statement's relatively vague quality, perhaps it is notable for the signal it sent about the global nature of the crisis, rather than for specific regulatory reforms agreed to at the international level.[134] Moreover, the ad hoc response to the 2008 crisis took on its most substantive global tint with various Fed efforts to coordinate monetary policy with its counterpart banks abroad.[135] And as future financial crisis will also draw on global trends, regulatory reform will likely be judged in part based on its global efficacy.[136]

* * *

Back on the domestic stage, in summary, the Fed and Treasury seized upon sweeping powers in response to the 2008 crisis. A couple of these were explicitly created by Congress during the crisis, including legislation authorizing the Troubled Asset Relief Program and granting Treasury authority to seize GSE assets. But, by and large, the agencies exercised authority in reliance on other, older statutes, in

[133] GROUP OF TWENTY, DECLARATION: SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY 3 (2008), *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf.

[134] To be fair, the action plan that follows the agreement on principles in some cases is more substantive; the International Monetary Fund gets a to-do list, and may serve as a preliminary agreement on credit default swap regulation:

> Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.

*Id.* app. at 3 (providing this, among several other steps, necessary to the G20's action plan from the Summit on Fiancial Markets and the World Economy).

[135] *See* Zaring, *supra* note 132, at 216 (discussing these meetings).

[136] Our evaluation in Part II and especially Part III includes considerable attention to globalization.

surprising novel ways, in exercises that amounted to the achievement of financial regulation reform.

Indeed, in addition to the powers referenced previously, the Fed and Treasury also extended their authority when expanding support into commercial paper markets, money markets, asset-backed securities markets, and even to bolster the financial stability of U.S. automobile manufacturers.[137] The Fed even let the financing arm of General Motors, GMAC, become a bank holding company, just as Goldman Sachs and Morgan Stanley had done, subject to Fed supervision and gaining access to the Fed's liquidity facilities.[138]

The extent of all of this transactional activity, ranging across the financial spectrum, was certainly novel and, as an administrative law matter, quite creative. There is some precedent, at least internationally, and to some degree in the LTCM case, for the Fed and Treasury's active engagement in coordinating transactions between failed and sustainable institutions.[139] The 2008 crisis, however—and the merger and investment scheme used to confront it—injected the Fed into industries it neither licensed nor in any other way regulated.

The 2008 crisis, in short, led to a "new model Fed," one turned into something of a financial roving commission in search of safety and soundness, no matter what the industry. It also placed the Treasury Department in an energetic and central role in crisis response. The result is regulatory reform producing a vastly more centralized financial regulatory system than the United States has had, despite no formal dismantling of the infrastructure of the traditional fragmented model.

### C. *Anticipatory Preemptive Reform*

We think that history helps to explain the old model and the way it has been changed, *sub silentio*, during the 2008 crisis. Accordingly, we conclude our overview of the recent history of our system of finan-

[137] *See* Paul, Weiss, *supra* note 101, at 33–37, 43–48, 50–51; Robert Schmidt & Scott Lanman, *Treasury, Fed Said to Unveil Plan to Bolster Consumer Financing*, Bloomberg, Nov. 25, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aIXCu2ptpeCQ. The FDIC also created a novel liquidity-guarantee program. *See* Paul, Weiss, *supra* note 101, at 38–42.

[138] Edmund L. Andrews & Bill Vlasic, *GMAC Receives $5 Billion in Government Aid*, N.Y. Times, Dec. 30, 2008, at B1.

[139] In other countries, cajoling one bank to buy another one would be clearly within the purview of a central bank. David Zaring, *How Does the Fed Have the Legal Authority to Bail Out Bear?*, Conglomerate, Mar. 25, 2008, http://www.theconglomerate.org/2008/03/how-does-the-fe.html.

cial regulation with a historical anomaly in the timing of one of the leading proposals for systemic reform. In past financial crises, the tendency was for regulatory and policy analysts to study events after the fact, diagnose them, and prescribe reform. The studies ranged in scope and formality, from detailed exhumations to rough guesses, depending on exigencies. But they were made in light of past events.

Unlike in prior crises, however, Treasury had produced its blueprint for reform in March 2008, before it became clear to the public that a crisis was at hand, and certainly before its severity was broadly understood. Indeed, much of the blueprint was prepared, including predecessor study papers,[140] amid comparatively calm market conditions, and released at the beginning of a crisis, rather than at the end of it. Certainly, numerous post-crisis diagnoses and proposals have been made,[141] in keeping with traditional U.S. responses to crises, yet the blueprint's early arrival remains a strikingly unusual feature of the 2008 crisis.

The blueprint preceded the 2008 crisis, is not exactly proportional or even always related to it, and is more organized than is typical of responsive regulatory reform. As we have noted, scholars have found a common pattern of financial crises followed by financial reform and that pattern partly generated the fragmented model that prevailed up until the crisis of 2008.[142] But with the blueprint, Secretary Paulson appeared to want to act ahead of the crisis, to prescribe radical change but relatively light regulation. To that extent, the blueprint can be seen as seeking to preempt what its authors anticipated, rightly, would be calls for heavier regulation.[143]

The blueprint is curious in another way. Past reforms tended, overall, to be roughly proportional to precipitating events. The stock market break of 1987 resulted in circuit breakers; the thrift crisis led to the creation of new agencies to replace failed ones; the LTCM rescue simply generated increased attention to financial derivative products; and even Sarbanes-Oxley, despite criticism for being

[140] *See, e.g.*, Comm. on Capital Mkts. Regulation, The Competitive Position of the U.S. Public Equity Market (2007), *available at* http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf; Comm. on Capital Mkts. Regulation, Interim Report of the Committee on Capital Markets Regulation (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[141] *See supra* notes 3–6.

[142] *See* Stuart Banner, Anglo-American Securities Regulation (1998); Larry Ribstein, *Bubble Laws*, 40 Hous. L. Rev. 77, 79–83 (2003).

[143] *See* Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. Times, Oct. 14, 2008, at A15.

overreaction, provided a number of specific reforms to address specific diagnosed weaknesses. The blueprint, in contrast, imagined wholesale renovation of regulatory structures along lines that, when written, would have seemed disproportionate to any manifest urgency.

True, on some subjects, the blueprint is consistent with the principle of proportionality. Indeed, in those instances there is an eerie sense that the blueprint anticipated substantially the kinds of powers that, amid the crisis, the Fed, Treasury, and Congress, in rapid fire, embraced. These included how the Fed substantially expanded its use of the discount window to provide liquidity and brought within its oversight major investment banks; other examples are how Treasury obtained congressional authorization for extraordinary funds to buy troubled assets, an authority it later interpreted to include buying equity stakes in financial institutions—a practice begun by Secretary Paulson in 2008 and continued by Secretary Geithner in 2009.[144]

Yet on other subjects, the blueprint may be less than proportional. For example, some obvious culprits in the 2008 crisis are not expressly addressed, including the proliferation of unregulated credit default swaps. Should they be regulated? Many called for it during the burgeoning crisis, and Congress proposed applicable legislation.[145] But the blueprint has nothing to say about it.[146] Other blueprint proposals address matters that had no diagnostic role in the crisis, such as merging the SEC and CFTC.[147]

Implicit in these observations about the blueprint's timing and content is a story about when regulatory reform is possible. As Professors Ribstein and Banner have separately shown, comprehensive reform is not something for prosperous financial times; it usually takes a crisis to generate the will for government innovation.[148] Crises contribute heavily to a felt need for reform, which often means that crises are opportunities to enact a mixture of reform proposals that had accumulated for years, resulting in a kitchen-sink model of reform (such as that appearing in parts of Sarbanes-Oxley).[149]

[144] Treasury Blueprint, *supra* note 3, at 137–82.

[145] *See supra* notes 123–25 and accompanying text.

[146] The blueprint does seem to endorse aspects of the Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, app. E, 114 Stat. 2763, 2763A-365 to -462 (codified in scattered sections of 7, 11, 12 & 15 U.S.C.), that limited federal regulation of certain financial derivative instruments. *See* Treasury Blueprint, *supra* note 3, at 46–48.

[147] Treasury Blueprint, *supra* note 3, at 16.

[148] Banner, *supra* note 142; Ribstein, *supra* note 142.

[149] *See* Cunningham, *supra* note 54 (reviewing potpourri provisions of this statute and noting how they were a collection of reforms in circulation for some time, and ranged from banning

Notably, the Paulson blueprint does not display this characteristic. Coherent and ordered, it is atypical for crisis-generated kitchen-sink style regulatory reform. Its archrival, contained in the Volcker reports, displays a mixture of the coherent vision with particular responses to the 2008 crisis. The next Part explores these competing visions for planned approaches to financial regulation.

## *II. Envisioned Approaches and Planned Structures*

The 2008 crisis certainly looks like a testimonial for the proposition that the fragmented, industry-by-industry, regulatory model is outdated and leaves regulatory gaps that must be closed. Moreover, the haphazard character and uncertain success of the on-the-fly response to that crisis makes its own case for more planned-out regulatory structures. The Treasury blueprint embraces a particular approach to unification. Unification the blueprint way means, ultimately, just a few senior regulators overseeing all financial markets and institutions—and those regulators would be politically accountable.[150] Similar calls for concentration appear in proposals made by the Group of Thirty, though the senior regulators would have a rather different relationship with the political branches in those cases.[151] The centralization prescribed by both has been echoed by a number of the testimonials of high-ranking political officials about regulatory reform, including the Treasury Secretary.[152] Because the blueprint and the Group of Thirty solutions represent the considered views of the Republican and Democratic establishments on financial regulation, the most important aspects of both warrant review, which this Part provides.

### *A. Paulson's Blueprint: Centralize, Delegate, and Compete*

The blueprint's motivations were not the 2008 crisis that widened after its release—the blueprint was released, basically, before every-

loans to corporate officials, blackout on corporate pension-fund trading rights, and requiring certain corporate-director attributes, to creating a new quasi-governmental agency to oversee the auditing profession); Romano, *supra* note 59 (criticizing Sarbanes-Oxley in part based upon how its mix of changes reflect the interests of various and diverse "policy entrepreneurs").

[150] Treasury Blueprint, *supra* note 3, at 13–14.

[151] Volcker II, *supra* note 4, at 29 ("In all countries, the activities of government-insured, deposit-taking institutions should be subject to prudential regulation and supervision by a single regulator (that is, consolidated supervision).").

[152] *See Addressing the Need for Comprehensive Regulatory Reform: Hearing Before the H. Ways and Means Comm.*, 111th Cong. 4–5 (2009) (statement of Treasury Secretary Timothy Geithner), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf; Treasury Outlines Framework, *supra* note 10.

thing that happened in the crisis except for the collapse of Bear Stearns. It is accordingly difficult to read the document as reflecting complete anticipation of those subsequent events. On the contrary, the blueprint says: "while functioning well, the U.S. regulatory system is not optimal for promoting a competitive financial-services sector leading the world and supporting continued economic innovation at home and abroad."[153]

The blueprint's stated justifications for its proposals are the increasingly global capital markets, financial innovations such as securitizations, and convergence among different kinds of financial institutions into large multi-line providers.[154] In the widening crisis that followed, all these forces had roles to play, as Part I explored, but not exactly the ones that the blueprint suggests. Globalization showed interlocking systemic dependencies, not threats to U.S. competitiveness; securitization emerged as at least a partial cause of the problems, not a positive development that regulation should accommodate; and convergence of financial institutions was hastened during government orchestrated bailouts and mergers, along with substantial regulatory concentration in the Fed and Treasury.[155]

On the other hand, the blueprint rightly noted that the existing environment prevented any single governmental authority from commanding all necessary information concerning systemic financial risk.[156] It attributed this limitation to regulatory fragmentation, separating functions according to industry (banking, insurance, securities, and futures).[157] It also presciently noted that market or regulatory failure in the financial sector could adversely affect the real economy.[158] As discussed below, the blueprint imagines a radical, formal overhaul of U.S. financial regulation. This overhaul consists of substantial federalization and unification, along with considerable delegation of regulatory authority to self-regulatory organizations in various

[153] Treasury Blueprint, *supra* note 3, at 1.

[154] *Id.* at 3–4.

[155] *See supra* Part I.

[156] Treasury Blueprint, *supra* note 3, at 27 ("[N]o single regulator has all of the information and authority necessary to monitor systemic risk.").

[157] Treasury Blueprint, *supra* note 3, at 31. For other evaluations of the blueprint, see Coffee & Sale, *supra* note 9; Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 Va. L. Rev. (forthcoming 2009) (arguing that the blueprint will not help the SEC become a more effective agency).

[158] Treasury Blueprint, *supra* note 3, at 4.

financial-services industries.[159] An important motivation is to promote U.S. capital-market competitiveness globally.

### *1. Federalization*

The blueprint's most significant suggestion for general regulatory authority over financial matters is formal expansion of Fed powers—pretty much those that the Fed exercised to address the 2008 crisis. While the Fed used an ad hoc approach during the crisis, the blueprint welcomes the centralization that the new model Fed represents. For example, during the crisis and for the first time since the Great Depression, in the interest of stabilizing markets, the Fed made loans to nondepository institutions through its discount window, the lending facility of last resort in the U.S.[160] Endorsing exactly these steps, the blueprint says this properly reflects the "fundamentally different nature of the [Fed's] market stability function in today's financial markets compared to those of the past."[161]

There is no doubt that this exercise of authority carried enormous systemic implications. The blueprint opines, however, that the kind of actions that the Fed would take during the crisis properly balanced promoting market stability with risks associated with extending federal support to investment banks (chiefly the risk that this will encourage imprudence, a risk called moral hazard).[162] It suggests formally authorizing the Fed to take these steps on a more regular basis, just as the Fed later did, although the blueprint emphasizes that doing so should be rare and subject to conditions,[163] which is not exactly how the new model Fed proceeded (as our discussion in Part I suggested).[164]

As noted, a presidential task force made similar recommendations in its report evaluating the stock market break of October

[159] The long-term regulatory structure recommended by the blueprint calls for three distinct regulators focusing exclusively on financial institutions: a market-stability regulator (the Fed), a prudential financial regulator, and a business-conduct regulator. *See id.* at 14.

[160] *See, e.g.*, Greg Ip, *Central Bank Offers Loans to Brokers, Cuts Key Rate*, WALL ST. J., Mar. 17, 2008, at A1 ("The Federal Reserve announced one of the broadest expansions of its lending authority since the 1930s in an effort to stem a credit crisis that is engulfing the financial system and threatening a deep recession.").

[161] TREASURY BLUEPRINT, *supra* note 3, at 7, 83.

[162] The blueprint opines that "explicit government guarantees often erode market discipline, creating the potential for moral hazard and a clear need for prudential regulation." *Id.* at 18.

[163] The blueprint recommends that the Fed's "lending to non-depository institutions should only occur in rare circumstances." *Id.* at 83–84.

[164] *See supra* Part I.B.

1987.[165] The blueprint's difference turns on the way this centralization is to be done. The blueprint specifies the availability of the discount window—the loanmaking power that the Fed relied upon to act in addressing failures at Bear Stearns and AIG—more clearly. The blueprint provides for broad powers to open the discount window to any who need it, but suggests that the power to lend ought to be used both judiciously, and more generally than it has been used in the most recent emergency. The idea is that a systemic regulator ought to act more systemically.[166]

The blueprint would also vest considerable new and expansive authority in the PWG, the group created after the 1987 market break discussed earlier.[167] The group is, if it works, an indirect form of centralization of financial regulation, and one without congressional approval or oversight. It brings the diverse federal regulatory agencies into a room heavily peopled with White House officials. We view the blueprint's intermediate recommendation of expanded PWG authority as an interim effort to begin its prescribed process of centralization in the executive in an administratively easy way.

The official PWG members are: (1) the Treasury Secretary (as Chair); (2) the Fed Chair; (3) the SEC Chair; (4) the CFTC Chair; and their respective staffs. The executive order creating the group directed it to analyze the "major issues raised" by the 1987 market break, to determine "the actions, including governmental actions under existing laws and regulations (such as policy coordination and contingency planning)," that could forestall future such crises, provided that the group would pursue "private sector solutions wherever possible."[168]

Since receiving that charge, the PWG grew in size and scope, although it has never coordinated financial regulation in the way the blueprint would have it. Its growth in size bespeaks both its importance as a matter of regulatory coordination and in setting financial

[165] *See* text accompanying notes 40–43.

[166] Early in the widening 2008 crisis, Secretary Paulson called for aid to industry sectors, rather than struggling individual institutions, and for clearer up-front rules on availability. *See* Greg Robb, *Brokerage Firm Failure Has to Be an Option*, MARKETWATCH, July 2, 2008, http://www.marketwatch.com/story/brokerage-firm-failure-has-to-be-an-option-paulson ("Treasury Secretary Henry Paulson will stress in a speech later Wednesday that federal regulators must craft a system to allow brokerage firms to fail without threatening the overall financial system."). Generally, the blueprint approaches bailouts with skepticism, but the skepticism is related to individual businesses. TREASURY BLUEPRINT, *supra* note 3, at 156.

[167] *See* text accompanying notes 40–43. President Reagan created the PWG in a 1988 Executive Order. Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

[168] Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

policy. Since the 1990s, in addition to the permanent members, who are conventionally thought to be the premier financial regulators, policymakers such as the head of the President's National Economic Council and the Chair of the President's Council of Economic Advisers began to attend the PWG's meetings.[169] Similarly, other banking regulators joined the Fed at those meetings: the Comptroller of the Currency and the President of the New York Federal Reserve Bank "frequently attend" PWG sessions.[170]

The group also evolved from undertaking ex post diagnoses of previous failures to a more proactive role in coordinating future regulation. The group has considered how financial regulators can together promote investor confidence, track credit-system issues (such as pursuing on-line clearing and same-day trade comparison for all equity and derivative products), develop effective market controls such as trading halts in emergencies, and how to deal with large and rapid unwinding of positions.[171]

The PWG has also considered how to more formally coordinate work—a chief goal tasked to the PWG under the blueprint. This is not clearly a question of presidential aggrandizement. Congress suggested in the early 1990s that the group could be used for "coordinating the activities of the agencies amidst increasingly integrated global financial markets."[172] The group has even been the source of some regulations.[173] During the 2008 crisis, according to Volcker's Group of Thirty Report, the PWG "provided the backdrop for U.S. financial supervisors to respond quickly and decisively" by fostering "ongoing and fluid communication among regulators."[174]

The blueprint proposes expanding the PWG's powers by turning it into the short-run locus of a consolidated financial regulatory approach through four steps: (1) broadening its focus "to include the entire financial sector, rather than solely financial markets"; (2) "promoting consumer and investor protection"; (3) expanding member-

[169] Brett D. Fromson, *Plunge Protection Team*, WASH. POST, Feb. 23, 1997, at H1, H8.

[170] *Id.*

[171] GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-46, FINANCIAL REGULATORY COORDINATION: THE ROLE AND FUNCTIONING OF THE PRESIDENT'S WORKING GROUP 18–19 (2000).

[172] *Id.* at 5.

[173] For example, in 1997, it suggested that the New York Stock Exchange change its circuit-breaker rules from a point decline in the Dow Jones Industrial Average to a percentage decline in that index. Those changes were made effective in 1998, when the group also proposed that Congress amend federal bankruptcy laws for financial institutions, and analyzed the LTCM hedge-fund debacle in a report that discussed ways to limit excessive leverage and cultivate better risk-management policies. *See* HEDGE FUNDS, *supra* note 45, at viii.

[174] VOLCKER I, *supra* note 4, at 49.

ship to formally include heads of the Office Comptroller of the Currency, FDIC, and Office of Thrift Supervision; and (4) authorizing the group to issue reports to the "President and others, as appropriate, through its role as the coordinator of financial regulatory policy."[175]

The point of this coordination is to put those with the disaggregated authority to shape and structure financial regulation in the same room. In some ways, this amounts to nothing less than the creation of a unified financial regulator by executive fiat, foregoing the need for often delayed and difficult to control congressional input. It is to implement the "blueprint-light", while the executive branch awaits Congress's promulgation of the formal coordination the actual blueprint promises.

Apart from this short-term expansion of Fed authority and PWG power, the blueprint introduces numerous new federal regulatory authorities. The following highlights several of the more consequential new authorities that the blueprint envisions creating. First, the blueprint proposes a Mortgage Origination Commission. This would have a President-appointed Director of a seven-person board composed of designated agency heads.[176] Federal legislation would create a uniform minimum licensing scheme for state mortgage market participants and the Mortgage Origination Commission would publish evaluative data on each state's system implementing that legislation. The blueprint says that this will create incentives among states to provide strong oversight and set floors for mortgage originators.[177]

Under the blueprint, insurance would no longer be exclusively a state matter but a federal matter because state regulation "makes the process of developing national products cumbersome and more costly, directly impacting the competitiveness of U.S. insurers."[178] Accordingly, the blueprint proposes to establish an optional federal charter for insurers within the existing insurance-regulation structure.[179]

In addition, the blueprint proposes an Office of National Insurance within Treasury to regulate insurers using the new, optional federal charter for insurance.[180] It is not obvious how congressional oversight would work for this arrangement, although the blueprint

[175] Treasury Blueprint, *supra* note 3, at 5–6.

[176] These are the Fed, Office Comptroller of the Currency, FDIC, Office of Thrift Supervision, Credit Union Administration, and Conference of State Bank Supervisors. *Id.* at 6.

[177] *Id.* at 7.

[178] *Id.* at 9.

[179] *See id.* at 10.

[180] *See id.*

notes that there was pending debate in Congress on the subject.[181] Still, it also recommends creating an Office of Insurance Oversight within the Treasury Department.[182] It would have authority to address international regulatory issues, including "authority to recognize international regulatory bodies for specific insurance purposes."[183] Similarly, the blueprint proposes a Federal Insurance Guarantee Fund.[184] This would be run, in turn, by a Federal Insurance Guarantee Corporation, which would be a reconstituted version of the FDIC, handling not only deposit insurance but also insuring insurance products.[185]

The blueprint also recommends that the "[t]he direct federal supervision of state-chartered banks . . . be rationalized," putting all such examination duties in the Fed or the FDIC.[186] The blueprint would abolish the existing separate thrift charter in favor of a single national bank charter.[187] This proposal would entail closing the Office of Thrift Supervision and transferring its power to the Office of the Comptroller of the Currency.[188] Finally, under the blueprint, payment and settlement systems that are systemically important would be federally chartered and subject to Fed oversight, with associated federal preemption.[189]

In some ways, this grab bag of proposals contains some of the most striking the federal government has ever made. These proposals are a particular rebuke to proponents of state regulation of business, and mark both a centralization of power and an expansion of federal regulation. States would lose a lot of their insurance regulatory authority. The state bank counterparts to federal banks would also be eliminated—although it is by no means clear that state banks played any precipitating roles in the 2008 crisis. And the mortgage and insurance regulatory powers that the federal government would take on are entirely new.

Nonetheless, this rationalization and centralization of regulatory authority would not happen without a role for states. The availability of state regulations and traditions are hard to break, as the way the blueprint's proposed mortgage origination commission would be set

[181] *See id.* at 11.

[182] *See id.*

[183] *Id.*

[184] *See id.* at 19.

[185] *See id.* at 19, 21.

[186] *Id.* at 8–9.

[187] *See id.* at 8.

[188] *See id.*

[189] *Id.* at 9.

up demonstrates. That commission, after all, would cajole states and permit state regulation over and above federal minimum standards.[190] It is a curious exception to the general federalization of power represented by the blueprint, but perhaps the oversight of home mortgages is something that regulators outside of Fannie and Freddie simply cannot bring themselves to get involved with.

Having proposed to expand executive branch power, and grow and consolidate federal power, the blueprint also proposes extensive delegation of much of this power to self-regulatory organizations (called SROs) in the various financial sectors being supervised.[191] It draws inspiration from extensive SRO use in futures regulation by the CFTC, urges expansion of SRO delegation by the SEC, and encourages other sectors either to create or expand such institutions too.[192] As one example, the blueprint proposes that Congress and the SEC converge broker-dealers with investment advisers to harmonize regulation of participants who are "offering similar services to retail investors."[193] It then proposes creating an SRO for investment advisers, pretty much along lines as presently exist for broker-dealers.[194]

### 2. *Unification*

Beyond the foregoing short or intermediate term proposals, the blueprint offers more sweeping views of the future in what it denominates as "the optimal . . . structure" of U.S. financial regulation."[195] Long-term, the blueprint proposes broadening the Fed's power (or power of something like it) even further, and creating two adjunct authorities, one to regulate financial aspects of institutions enjoying explicit government guarantees and one to regulate the business conduct of those and other financial institutions. In addition, the blueprint presents with limited elaboration a corporate finance regulator, which would resemble the current SEC (after merging with the CFTC, as the blueprint also recommends).

The blueprint sets three regulatory objectives and envisions three senior regulators to achieve them: overall market stability by the Fed;[196] financial supervision of firms with government guarantees by a

[190] *See id.* at 6–7, 80–83.

[191] *See id.* at 11–13.

[192] *See id.*

[193] *Id.* at 13.

[194] *Id*. at 13.

[195] *See id.* at 137.

[196] The blueprint envisions the Fed continuing as at present except with broader jurisdiction. The Fed would continue as the central bank, setting monetary policy and serving as lender

prudential financial regulator using prevailing regulatory philosophies;[197] and protective regulation for consumers of all financial firms by a new business conduct regulator.[198] These are supplemented by two junior federal agencies charged with (a) administering the system of explicit government guarantees and (b) supervising public securities markets, presumably including futures markets, to encompass corporate disclosure, governance, accounting, and auditing.[199]

The blueprint arrives at its proposed optimal structure by eliminating alternatives: (1) *institutionally-based functional regulation* pretty much describes the pre-crisis fragmentary system, the chief weakness of which is that no single regulator has all information or coordination power; (2) *pure functional regulation* is based on activities, the chief weakness of which is trouble delineating activities that

of last resort, among other traditional macroeconomic functions. Its supervision would extend to all financial institutions, not just depository institutions. This expansion is said to reflect changes in financial markets, in which nondepository institutions play at least as vital a role as depository institutions once did. In this vision, the blueprint emphasizes repeatedly that authority would be "broad, important, and difficult to undertake." *Id.* at 148, 152. The Fed's intervention powers would be "limited to instances threatening overall financial stability." *Id.* at 151. The blueprint envisions two aspects of the Fed's traditional function as lender of last resort. One would be regular discount-window operations, along traditional lines. *Id.* at 155. A new one would be called a "market stability discount window." *Id.* at 155–56. This would be available on more flexible terms, as to types of loans and borrowers. The idea is that the flexibility could be more effective to address short-term liquidity needs than the traditional discount window alone. *Id.*

[197] Prudential financial regulation refers to things like capital adequacy, activity limits, and related supervision. It is akin to regulation now applicable to depository institutions. *See id.* at 157. This regulation is necessary to address the moral hazard that arises from explicit government guarantees. *See id.* The blueprint imagines a new federal charter for all financial institutions enjoying explicit government guarantees. *See id.* Contending that the traditional U.S. model of federal-plus-state banking regulation and experimentation is no longer useful, it recommends a new federal charter for all depository institutions to replace the fragmentary chartering system. *See id.* at 160. It draws the same conclusion for insurers, suggesting all become federally chartered. *See id.* at 166. All related guarantees, including for insurers, would be administered by a reconstituted FDIC. The prudential financial regulator would oversee all such chartered firms. *See id.*

[198] The business-conduct regulator would have authority over all types of financial firms, not only those overseen by the prudential financial regulator, but also broker-dealers, hedge funds, private-equity funds, venture-capital funds, mutual funds, securities and futures firms, and others. *See id.* at 19. All would be subject to identical national standards overseen by this single agency. This regulator also would eventually oversee all financial markets, including securities and futures markets. Its primary function would address interactions between financial institutions and consumers and investors. *See id.* at 170. Regulatory focus would be on information, disclosures, and business-practice standards. Such focus would include prohibitions against unfairness, deception, and discrimination; it would also include regulation of financial capacity and expertise. *See id.* It would not include power to prohibit products, limit entry, control prices, or impose rigid licensing. *See id*.

[199] *Id.* at 137–38.

often overlap and assigning multiple regulators to individual firms; and (3) a *single consolidated regulator* for financial and consumer protection regulation, the chief drawback of which is it can limit synergies and reduce market innovation.[200] The blueprint's proposed optimal structure overcomes these weaknesses and its chief drawback, assuring communications between regulators, can be met, the theory goes.

The blueprint acknowledges that numerous issues are presented that it does not address, saying it only begins to identify main ones.[201] Despite this reticence, the blueprint is clear in offering a summary of guidelines that would govern regulation throughout these agencies. First, agencies would coordinate closely, perhaps with a coordinating body led by the Treasury Secretary.[202] Second, funding would be generated by fees imposed on regulated firms, not from general tax revenue.[203] Third, all regulation would be governed by stated general principles: "guidelines for regulatory process (e.g., public comment), analysis (e.g., cost-benefit analysis and alternative analysis), and review (e.g., monitoring compliance with the principles and reports to Congress)."[204]

### *B. Volcker's Group of Thirty: Centralize, Control, and Coordinate*

If the blueprint and its ilk encourage reorganization centered in Treasury, and then, at least in content, delegated to private industry, is there any other way to rationalize the financial system without privatizing it? We think that there may be a slightly different alternative available to policymakers, one developed by Democratic, rather than Republican, financial mandarins. We caution, however, that it is not too different.

The blueprint's optimal structure envisions three senior regulators of the financial system, although it is essentially a two-peaked model, in which the Fed and a prudential regulator probably rooted in Treasury are jointly responsible for systemic stability and a third senior agency is responsible for investor and consumer protection (this agency might also be situated within the Treasury Department).[205] The effort to remodel financial regulation into a "twin peaks" struc-

[200] *Id.* at 138–42.

[201] *See id.* at 146.

[202] *See id.*

[203] *See id.*

[204] *Id.*

[205] *Id.* ([The] "coordinating body could be headed by the Secretary of the Treasury, who would have the authority to settle disputes and ensure that appropriate amounts of coordination were taking place.").

ture has some currency among financial policy experts, and it is the remodeling achieved by Australia in the past decade and explored by numerous countries.[206] Variations on it abound, including an even more concentrated model that features essentially one regulatory authority, as the United Kingdom's Financial Services Authority.[207]

But the blueprint's vision is not the only way to rationalize the system. A similar sort of regulatory analysis might be called the Volcker approach. Paul Volcker, a former Fed chair and the inaugural Chair of the Economic Recovery Advisory Board in the Obama Administration, led a 2008 task force of public and private notables to opine on "The Structure of Financial Supervision."[208] Shortly thereafter, in early 2009, the group issued its more prescriptive report called "Financial Reform: A Framework for Financial Stability."[209]

Although not nearly as detailed as Paulson's blueprint, the Volcker reports state relatively clear principles and offer many specific proposals. The proposals show considerable affinity with the Treasury blueprint, along with some subtle yet important differences in philosophy, purpose, and implementation methods. It is a potential archrival to the Treasury blueprint for these reasons. Indeed, the Volcker vision might be thought of as the insider alternative to the Paulson (himself an insider) approach. The Volcker proposals also assume that status both because of Volcker's role in the Obama Administration and because the drafting committee included Secretary Geithner, also an insider, having worked closely with Secretary Paulson as the President of the New York Federal Reserve Bank during the 2008 crisis.[210]

It appears that in some ways insiders think alike, as both Volcker and Paulson in their reports express worry about globalization (albeit Volcker a bit more vigorously), exhibit an inclination to centralize and rationalize regulatory authority, and display a substantial amount of regard for central banks. This overlap between the Volcker and Paul-

[206] *See id.* at 3, 26, 176–78; *see also* Elizabeth Brown, *E Pluribus Unum, Out of Many One: Why the United States Needs a Single Financial Services Authority*, 14 U. MIAMI BUS. L. REV. 1, 94 (2005) (noting countries moving towards dual regulation).

[207] *See* TREASURY BLUEPRINT, *supra* note 3, at 3, 26, 108.

[208] VOLCKER I, *supra* note 4.

[209] VOLCKER II, *supra* note 4. Both reports were prepared under the auspices of the so-called "Group of Thirty," an exclusive group of former and current regulators, including Andrew Crockett, formerly of the Basel Committee, Jacob Frenkel, a former board member of AIG, and former Fed Board members Roger Ferguson and E. Gerald Corrigan. *See id.* at 10.

[210] David Cho & Neil Irwin, *A Crucible of Three*, WASH. POST, Sept. 19, 2008, at A01 (describing the close relationship between Paulson, Geithner, and Bernanke).

son approaches is either an indication of a reform consensus or a testament to the process by which Washington insiders quickly learn to see things in similar ways. As we will explain, however, despite some important points of consonance, including promoting centralization, the two differ in vital, though perhaps subtle, ways.

The 2008 Volcker report's chief insight is to present a four-box menu of approaches to financial supervision that closely resembles the similar formulation appearing in Treasury's blueprint. In the Volcker group's view, the approaches include: *institutional* (where banks are supervised by one regulator and broker-dealers by another), *functional* (where the regulator is determined by the type of business being transacted—meaning that a bank like Bank of America would be responsible to banking regulators and, regarding its newly acquired broker-dealer arm Merrill Lynch, to securities regulators), *consolidated* (where one regulator has responsibility over all financial institutions), and *twin-peaks* (where one regulator focuses on safety-and-soundness, and the other on conduct of business).[211] This menu is a descriptive, rather than prescriptive, accomplishment.

The 2008 Volcker report is like the Paulson blueprint in that it urges a rationalization of the U.S. regulatory system, which it characterizes as "somewhat dated and complex"[212] and the "exception" to the ordinary models for financial regulation prevalent elsewhere in the world.[213] It essentially embraces consolidation on either a single-peaked model or twin-peaked model, as both "more rationally reflect the changes that have taken place in the financial-services business over the past several years, and thus are widely viewed as more efficient and cost-effective by both regulators and regulated entities."[214]

The 2008 Volcker report all but fetishizes this sort of concentration, including coordination "with the central bank," securing the central bank's "involvement in crisis management."[215] It particularly urges coordination by regulators with their international counterparts over "systemically important global financial institutions."[216] It argues that financial reform in the United States is not impossible, observing that "a majority" of jurisdictions "are in the process of further restructuring or are actively debating the need for significant changes to

[211] VOLCKER I, *supra* note 4, at 13.

[212] *Id.* at 49.

[213] *Id.* at 14.

[214] *Id.* at 50.

[215] *Id.* at 51.

[216] *Id.*

modernize their systems" in the past 15 years.[217] The authors encourage the "trend toward the adoption of integrated regulators and towards regulation by objective."[218]

Volcker's second report, in early 2009, turns more prescriptive. It states four core recommendations, all of which are highly re-regulatory, in contrast to the much more de-regulatory framework that Treasury's blueprint envisions. These core points are to: (1) eliminate regulatory gaps; (2) tighten existing regulations; (3) strengthen existing governance; and (4) heighten market transparency.[219] Within these, Volcker's 2009 report continues to champion consolidation, using a one-peaked ("consolidated") or perhaps two-peaked model.[220] It urges all countries, including the United States, to use a single national authority for oversight of important banking institutions plus insurers, broker-dealers, money markets, private capital pools (including hedge funds and private equity firms), and government-sponsored entities (such as in mortgage finance).[221] It also prescribes imposing restrictions on proprietary trading by large banks and limits on deposit concentrations.[222]

As for institutions themselves, the theme of the Volcker reports is promoting an important public-sector role in safeguarding financial stability, given the "inherent volatility of free and open financial markets, and the danger that volatility may occasionally reach crisis proportions threatening economic stability."[223] Accordingly, the future of financial regulation, in Volcker's view, is in extending supervision over more of the financial system to governmental authorities.[224] The 2009 report accordingly recommends extending federal supervision over non-bank financial institutions like insurance companies and investment banks (to the extent any may exist).[225]

The federal agency to be created under the 2009 Volcker proposal would also oversee money market mutual funds, reasoning that there are "dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and li-

[217] *Id.* at 50.

[218] *Id.*

[219] *See* VOLCKER II, *supra* note 4, at 21.

[220] *See id.* at 28.

[221] *See id.* at 28–31.

[222] *See id.* at 28.

[223] *Id.* at 17.

[224] *See id.* at 28–31.

[225] *See id.* at 29.

quidity risk."[226] The Volcker report would extend financial supervision over hedge funds, albeit somewhat modestly. The report states that a "need for greater transparency supports the introduction of formal authority to register and track . . . funds, in terms of size, use of leverage, risk styles, and other important variables."[227] Certainly, this would require hedge funds to increase their disclosures about their positions to financial regulators.[228] Nonetheless, the report also recommends subjecting hedge funds to the possible discipline of formal regulatory authority to "reduce counterparty risk" (and so holds open the possibility of more elaborate command-and-control regulation).[229]

The only potentially deregulatory aspect of the Volcker proposals involves getting the government out of the secondary mortgage market.[230] Institutions like Fannie and Freddie, which are both "profit-seeking private companies and agents of government policy, ha[ve] been shown to be unworkable over time and particularly in the midst of crises."[231] Despite that slight ratcheting down of government's role in finance, enterprises engaged in mortgage lending activities would be subject to oversight of the new federal government regulatory apparatus.[232]

As for new financial products, the Volcker 2009 report concludes that it is "imperative that securitized and other structured product and derivative markets be held to regulatory, disclosure, and transparency standards at least comparable to those that have historically been applied to the public securities markets."[233] Concerning credit default swaps and other over-the-counter derivatives, the report urges the establishment of a "central counterparty clearing . . . arrangement for the credit derivatives market and coordinated efforts to greatly reduce the gross size of outstanding contracts through bilateral compression arrangements."[234] The goal is to reduce the size of these new markets, and to impose a "consistent regulatory framework on an international scale" over the novel financial products, in which "national regulators . . . share information and enter into appropriate cooperative ar-

[226] *Id.*

[227] *Id.* at 30.

[228] *See id.* at 30–31.

[229] *Id.*

[230] *See id.* at 31–32.

[231] *Id.* at 31.

[232] *Id.* ("Governmental entities providing support for the mortgage market by means of market purchases should have explicit statutory backing and financial support.").

[233] *Id.* at 49.

[234] *Id.* at 52–53.

rangements with authorities of other countries responsible for overseeing activities."[235]

As for the form of regulation, the Volcker report embraces an important role for the central bank in an extensively centralized regulatory edifice, which should "simplify and consolidate overly complex structures."[236] As for regulatory content, the report evinces a preference for principles over rules.[237]

Volcker's 2009 report also urges particular substantive changes, on subjects not only of concern to traditional central banks and banking supervisors. Certainly, the proposals call for enhancing capital requirements and ratios, and liquidity-risk requirements, and assuring that a mechanism to resolve failing institutions exists.[238] The report also says that credit-rating agencies should be compensated for risk analyses on a different payment model than they have used in the past.[239] They urge improving fair-value accounting and promoting the flexibility of accounting standards generally.[240] This includes a specific endorsement of mark-to-market accounting for "trading activities and most elements of market risk."[241] The Volcker 2009 report also ventures beyond any manifest elements of the 2008 crisis by recommending strengthening corporate board governance to improve risk management, executive-compensation oversight, and auditing functions.[242]

The Volcker reports emphasize need for regulatory authorities to be independent.[243] Although not specific, this may suggest that, within the United States, the Volcker reports imagine the newly-consolidated regulatory power to be reposed in one or two independent federal agencies. This implication thus differs sharply from the blueprint's prescription to put this power under the President's control along with considerable delegation of authority to self-regulatory organizations.

Above all, as with Volcker's 2008 report, its 2009 recommendations strongly emphasize the need for international approaches—and, in particular, international coordination. The Volcker reports em-

[235] *Id.* at 53.

[236] *Id.* at 35.

[237] *See id.*

[238] *See id.* at 59–68

[239] *See id.* at 51; Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. Rev. 1011 (2009).

[240] *See* Volcker II, *supra* note 4, at 46.

[241] *Id.* at 45.

[242] *Id.* at 18–19.

[243] *See id.* at 63–66.

brace international cooperation as a solution to prudent oversight amid increasingly global financial markets. For example, the reports suggest that "[p]rudential regulators in central banks should collaborate with international agencies in an effort to define leverage," and ultimately limit it.[244] It admits concerns about capital adequacy, naturally enough, given that the largest institutions during the crisis appeared to be—much to their surprise—substantially undercapitalized.

These views provide an interesting contrast between the Volcker report and Paulson's Treasury blueprint. While the Paulson blueprint pushed globalization as a reason for regulatory reform, the Volcker report characterizes it as part of the solution. Volcker's 2008 report pins high hopes on "colleges of supervisors"—that is, regulatory authorities from different jurisdictions who oversee the same multinational enterprise, and do so in a coordinated way.[245] Indeed, "international groupings [such as the informal networks represented by the Bas[el] Committee and International Organization of Securities Commissions] . . . need to be supplemented by colleges that facilitate communication between home and host supervisors in normal times so as to prepare the lines of communication for times of systemic crises."[246]

This focus on international coordination and control differs from the blueprint's engagement with globalization, which seems more intended to promote U.S. competiveness in global capital markets than a way to impose order on them. Indeed, although both the Paulson and Volcker visions imagine substantial federalization and consolidation of regulatory power over wide-ranging financial institutions, markets, and products, they appear to do so for different reasons. These differences, and further contrasts with how both differ from the preexisting structure and the developed-on-the-fly system forged by the 2008 crisis, entice the following framework for choosing among these three or four approaches to financial regulation.

## *III. Choosing Among Approaches*

Our three or four models of financial regulation take different views on centralized versus decentralized government, the place of the executive branch in administrative law, and even the place of states and self-regulators in financial law. In this Part, we evaluate the implications of each of these approaches on these areas. In the end, al-

[244] *Id.* at 38.

[245] Volcker I, *supra* note 4, at 48.

[246] *Id.*

though we understand the impetus for reform, we register a note of caution. Centralization and rationalization along the Paulson and Volcker models seems sensible, and certainly has been practiced, to some degree, in 2008 and 2009. But we think the unlovely older system had its advantages that should not be overlooked—redundancy has its uses, and so does regulatory competition.

As debate, Congress, and the executive branch turn away from the old way of doing things, we think that there is a serious risk that they may abandon some of the useful values of the old system. We also think that there is more to the usefulness of the old system than appears to meet the current eye. If there must be reform, we lean towards the values of expertise, global cooperation, and the like embodied by the Volcker approach, but we do not hew too closely to any of the centralization proposals—at least not if, ultimately, they put all the regulatory eggs in one putatively super-competent basket.

The Treasury blueprint offers, as we have explained, an approach to regulation that turns first on a centralization of power, and second on a delegation of that power to industry.[247] The centralization would manifest itself in two ways. First, power moves away from states to become increasingly concentrated within the federal government; second, within the federal government, power moves away from independent agencies like the SEC and to the Treasury Department, President, and, at least partly, even the Fed. Maximal delegation to self-regulatory organizations would follow. An important goal seems to be to promote U.S. international capital-market competitiveness.

The Volcker approach, although offering less detail or prescription, likewise envisions a planned, centralized, and substantially unified approach to regulatory reform and resulting regulatory structures. But both Volcker reports seem to vest resulting federal authority in independent agencies, not in the executive branch under the President's control, and are motivated more by a desire to establish international regulatory control over global capital markets rather than to encourage or promote competition across national markets.[248]

These paired proposals, then, would in very different ways radically alter the indisputably creaky current approach. The current system relies on an incongruous blend of state supervision in some cases, while in others it depends on federal supervision divided by specific industry, and sometimes by various issue areas within an industry—

[247] *See supra* Part II.A.

[248] *See supra* Part II.B.

say, local banks regulated by states, national banks regulated by the Fed and Treasury, and all federally insured banks, whether state or federally chartered, subject to the discipline imposed by the Federal Deposit Insurance Corporation.

The 2008 Volcker report found the old American approach to be so idiosyncratic as to mark the United States as the "exception" to the world's financial regulatory approaches.[249] As we explained in Part I, there is no question that the pre-crisis system evolved through path dependency and a reactive, crisis-driven, rather than systematic, approach to financial regulation. But that does not mean that it is without its attractions. The system kept regulators on their toes through regulatory competition, and yet permitted regulators to act substantively, through litigation, formal rules-laden regulation, and informal oversight using broad statements of principles. Small patchwork fixes to this system, such as assuring some regulatory authority over credit default swaps, may be both politically feasible and appropriately cautious.[250]

In any event, the blueprint and Volcker reports are unusual in other respects. The blueprint proposes the most radical reorganization of financial regulation since the Great Depression. The Volcker reports are likewise bold. How should we make sense of these? The blueprint's proposed reorganization is, we think, meant to pursue two broad themes, one procedural and one philosophical. Both bear specific, mostly unstated, substantive implications, some of which are clear and immediate while others are inchoate and potential. Contrasting implications flow from the Volcker proposals.

First, procedurally, the blueprint embodies a new vision of the bureaucracy as a creature to be tamed and supervised by the President—and no one else.[251] This means a consolidation of power in the federal government rather than states. It involves reposing that power in the executive branch rather than in Congress. The vision then concentrates that power in the office of the President and the cabinet secretaries removable by him or her at will, rather than distributing it through independent agencies like the SEC and the Fed. After this amassing of power, the executive would delegate it, to the extent feasible, to self-regulatory organizations in the various industries.

[249] Volcker I, *supra* note 4, at 32.

[250] As noted, House Committee on Agriculture Chairman Colin Peterson in February 2009 introduced legislation to require the CFTC to regulate credit default swaps and other derivative financial instruments. *Supra* note 125.

[251] *See supra* notes 160–94 and accompanying text.

The Volcker proposals, in contrast, while also contemplating a radical reorganization, seem to follow the more traditional approach of using independent federal agencies, which are in turn more responsive to Congress, rather than reposing extensive power in the President and the executive branch. The 2008 Volcker report calls for "[a] system in which those responsible for prudential regulation and supervision have a high degree of political and market independence," and emphasizes a "need to ensure the political and market independence of national regulatory authorities."[252] That would rule out giving plenary power to the President and his cabinet appointees, as the blueprint contemplates (and, indeed, as the on-the-fly approach to the crisis of 2008 reflected).

The reason for the different approaches seems to lie, in part, in competing understandings of political pressures that can be brought to bear against regulators during financial crises. While the Paulson blueprint centralizes the response to crises in politically accountable officials in the Treasury Department, the Volcker approach, consistent with a long line of scholarship suggesting that central banking is best done independently from the political process, prefers insulating decisionmakers as remotely as possible from such political accountability and pressure.[253] Furthermore, the Volcker reports evince no or little enthusiasm for expanded use of self-regulatory organizations so exuberantly championed in the blueprint.

Second, philosophically, the blueprint would make this presidentially controlled financial scheme into a deregulatory enterprise. Despite consolidation of regulatory power in the federal government, the vision is to delegate much of that authority in turn to self-regulatory organizations. This deregulatory impulse is also reflected in the blueprint's strategic timing, issued at the onset of crisis whose widening a year later produced calls for greater regulation, making for a dialogue that required engaging with the blueprint as a baseline alternative. The philosophy is manifested in a move from the relative clarity of administrative rules to a vaguer principles approach that is comparatively opaque and committed to discretion.

The blueprint's philosophy entails heavier focus on minimums of safety and soundness for financial institutions, than on traditional in-

[252] VOLCKER II, *supra* note 4, at 16, 35.

[253] The report explains: "when risks are materializing and extreme pressures mounting, it is even more challenging for supervisors not to overreact to the use of capital, reserve, and liquidity buffers that should have been built up for use in just such circumstances. All this further underscores the importance of these agencies having . . . independence." *Id.* at 42.

vestor or consumer protection for which U.S. financial regulators are best known. This reflects a particular view of the purposes of financial regulation, concentrating on systemic stability—and American competitiveness—rather than constituent protection, with minimal standards of prudential oversight and business conduct or corporate disclosure.

The Volcker proposals also evince a preference for principles to rules and offer at least some gestures of a deregulatory nature, such as withdrawing the federal government from the mortgage-finance business. But the Volcker proposals recommend a more substantive regulatory philosophy than the Treasury blueprint. They imagine specific substantive limits on institutional size and trading activities. They imagine specific regulation of financial products. They imagine specific ways to regulate rating-agency compensation and even weigh in on accounting debates and matters of corporate governance like board performance and executive compensation. The role of independence for domestic regulators and global coordination for the Volcker group are hard to overstate. Volcker emphasizes that markets have "become international in scope," but this is not a reason to compete; instead, "efforts to reopen them" are best approached "on a coordinated basis."[254]

Many implications follow from the striking similarities coupled with subtle differences between these two grand visions. Although it may be possible, and desirable, to conduct a specific proposal-by-proposal dissection and selection between them, we think these broad procedural and philosophical differences provide a more productive general way to think about the approaches, to assess their competing implications, and to compare these with those of the prevailing approaches, before and since the 2008 crisis.

Framed this way, two themes warrant the special attention supplied in the following framework and evaluation. The first theme, which Section A explores, concerns a longstanding debate among administrative lawyers about what to make of the independent agencies that the blueprint would eliminate, in favor of executive branch control, followed by delegation to industry groups. In this view, the independence of regulators is a problem that the financial crisis presents an opportunity to solve. The Volcker approach, on the other hand, appears more likely to welcome regulatory independence, and appears less sure about the value of delegation to private industry. The

[254] *Id.* at 49.

2009 Volcker report contends that "[t]he time has also come to move beyond moral suasion and enlightened market self interest" to create a comprehensive regulatory scheme.[255]

The second theme, which Section B explores, concerns a long-standing debate in regulatory theory about the relative merits of regulatory competition, which Paulson's blueprint and Volcker reports both could reduce, versus regulatory monopoly, which they could create or increase. The blueprint seems to embrace consolidation of U.S. regulatory authority in large part to project U.S. capital-market competiveness onto a global stage where other nations likewise compete. The Volcker reports suggest embracing such consolidation domestically with a further view to achieve similar consolidation at the global level. The fragmented pre-crisis model rested significantly upon notions of regulatory competition and the on-the-fly quasi-concentrated model that now exists is a non-trivial challenge to those notions.

Finally, Section C considers political realities confronting both these visions. To be sustainable, the Volcker vision requires the international community's will and capacity to collaborate as expected. Both visions depend on the assumption that domestic regulatory concentration is politically feasible and sustainable. Neither prospect seems highly likely. The upshot may be that the most probable, and possibly appealing, approach to financial regulation is remnants of the traditional fragmented model, as modified during 2008, plus incremental reforms taken from the otherwise grand visions laid out by Messrs. Paulson and Volcker.

### *A. Administrative Law*

As a matter of administrative law, Paulson's and Volcker's formal centralizing proposals for regulation roundly reject the old, disaggregated model; Paulson's blueprint may vindicate those theorists who support presidential control over decisionmaking; and both raise some questions about the future of preemption in this vigorous and federalized area. We consider the administrative law implications of the approaches to financial regulation by focusing on the blueprint. The blueprint's proposed reorganization both federalizing and centralizing financial regulation is unusual in the degree of power concentrated within the executive branch of the federal government, to the point where the structure of financial regulation would change. Before, that regulation has been conducted by agencies that have always existed

[255] *Id.* at 53.

outside the executive branch—the SEC, CFTC, and, to some degree, the Fed.[256] The President cannot fire the heads of these agencies absent cause (which in practice has meant that they are not fired at all), and the agencies are run by a balanced set of Republican and Democratic appointees.[257]

But under the blueprint, these agencies would be replaced by new regulators with less obvious independence.[258] In the interim, financial policy would be set by an interagency working group chaired by the Secretary of the Treasury, and not subject to many of the usual constraints on bureaucratic power, such as open government and even judicial review.[259] Ultimately, moreover, the powers of the Treasury Department would grow under the new regime, as the PWG would be folded into the new, Treasury-controlled regulators which would supersede the SEC and much of the Fed. The President's control over financial regulation would also grow. Treasury, of course, is in the heart of the executive branch, and led by secretaries who serve at the will of the president. These officials can be, and often are, fired by the President.[260]

The blueprint thus marks a move away from independence and towards executive branch control. Executive control over agency decisionmaking is something that administrative lawyers have been thinking carefully about since Elena Kagan made the case for such control after serving in the Clinton White House for seven years.[261] To Kagan, executive authority over administration in general is all for

[256] Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 Yale J. on Reg. 253, 257–58 (2007) (noting the independence of federal financial regulators); *cf.* John Schwartz, *Some Ask if Bailout Is Unconstitutional*, N.Y. Times, Jan. 15, 2009, at A8 (describing some potential separation of powers concerns related to the government's response to the financial crisis).

[257] For an interesting view of the potential for the president to be reconstituted as an independent agency, see Christopher R. Berry & Jacob E. Gersen, *The Unbundled Executive*, 75 U. Chi. L. Rev. 1385 (2008).

[258] Treasury Blueprint, *supra* note 3, at 146 (arguing that Treasury should be able to coordinate consolidated oversight).

[259] These sorts of interagency commissions are usually not subject to the Freedom of Information Act (FOIA), 5 U.S.C. § 552(b)(5) (2006) (exempting interagency letters and memoranda which would not be available by law to a party in litigation with the agency from FOIA), and the Administrative Procedure Act, which reviews final rules and adjudications of agencies, would not be applicable to the putatively coordinative work of the PWG. *See* 5 U.S.C. § 706 (2006) (setting forth the availability of judicial review).

[260] Recent examples include the case of President George W. Bush's Secretary of the Treasury, Paul O'Neill. David E. Sanger, *The Treasury Secretary: Departure from Cabinet and Niceties*, N.Y. Times, Dec. 10, 2002, at A30.

[261] Elena Kagan, *Presidential Administration*, 114 Harv. L. Rev. 2245 (2001).

the best. She approved, in a well-known article, of President Clinton's ability to "treat[ ] the sphere of regulation as his own."[262] This means that Clinton "convert[ed] administrative activity into an extension of his own policy and political agenda."[263] In Kagan's view, this can lead to "enhanced government" through "executive[ ] vigor."[264] She is not alone in this view. Steven Croley has concluded that the White House is, and should be, a principal source of bureaucratic initiative.[265] Other scholars believe that presidential power "inevitably expands," and that this is no bad thing.[266] Skeptics exist, of course. For example, Thomas Sargentich characterized the most awe-inspired and enthusiastic of the "presidentialists" as proponents of a "presidential mystique."[267]

[262] *See id.* at 2281–82.

[263] *Id.* at 2282; *cf.* David J. Barron & Elena Kagan, Chevron*'s Nondelegation Doctrine*, 2001 SUP. CT. REV. 201, 201–02 (arguing judges should defer to the agency decisions of high-level government officials, rather than those of low-level bureaucrats).

[264] Kagan, *supra* note 261, at 2342.

[265] Steven Croley, *White House Review of Agency Rulemaking: An Empirical Investigation*, 70 U. CHI. L. REV. 821, 883 (2003) ("[T]he White House clearly has used rulemaking review to put its own mark on particular agency rules increasingly often over the course of the past two decades, and at an accelerated pace during the Clinton administration."). As a descriptive matter, Presidents tend to locate the (to their minds) worthy enhancements of the President's role in the domestic administrative state in a series of executive orders. President Reagan's 1981 Executive Order on regulatory review, Exec. Order No. 12,291, 46 Fed. Reg. 13,193 (Feb. 17, 1981), which required agencies within the executive branch to run their draft regulations through the White House's Office of Management and the Budget ("OMB") before promulgating them, was a sea change that marked the beginning of ever greater amounts of presidential control over the federal bureaucracy. The Clinton Administration's cognate Executive Order, Exec. Order No. 12,866, 58 Fed. Reg. 51,735 (Oct. 4, 1993), underscored the need for OMB to review particularly significant regulatory action on a cost-benefit plan and adopted an annual regulatory planning process. George W. Bush issued a subsequent executive order that largely retained these elements of Presidential supervision and brought even more agencies into the planning process. *See* Exec. Order No. 13,422, 72 Fed. Reg. 2763 (Jan. 23, 2007).

[266] William P. Marshall, *Eleven Reasons Why Presidential Power Inevitably Expands and Why It Matters*, 88 B.U. L. REV. 505, 517 (2008) ("The President's power is also enhanced by the vast military and intelligence capabilities under his command. In his roles as Commander-in-Chief and head of the Executive Branch, the President directly controls the most powerful military in the world and directs clandestine agencies such as the Central Intelligence Agency and National Security Agency. That control provides the President with immensely effective, non-transparent capabilities to further his political agenda . . . ."). *But see* Lisa Schultz Bressman & Michael P. Vandenbergh, *Inside the Administrative State: A Critical Look at the Practice of Presidential Control*, 105 MICH. L. REV. 47, 70–76 (2006) (offering an empirical perspective qualifying and specifying the influence the White House has over EPA policymaking).

[267] Thomas O. Sargentich, *The Emphasis on the Presidency in U.S. Public Law: An Essay Critiquing Presidential Administration*, 59 ADMIN. L. REV. 1, 4–5 (2007); *see also* Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260, 1262–63 (2006) (arguing that presidential administration has led to an "unwarranted embrace of an unjustified antiregulatory mission"); Cynthia R. Farina, *The "Chief Executive" and*

The Bush administration did much to prove the descriptive part of Kagan's hypothesis accurate. It did so in the war on terror in particular, under which essentially every government agency, and many state and local ones too, were pressed into a quintessentially executive sort of service—and concomitantly within the ambit of executive supervision.[268] Eric Posner and Adrian Vermuele have concluded that the presidentialism of the war on terror has also characterized the prominence of the executive in responding to the financial crisis.[269]

But until Treasury's blueprint, no executive had proposed turning large, famous, and old independent agencies into executive branch subordinates before. Nor has the coordination of the actions of financial regulators proceeded along quite so novel administrative processes.[270] Moreover, the blueprint does more than just centralize power. It also would extend regulatory supervision over any remaining investment banks, and perhaps even hedge funds. It would move the federal government into the regulation of insurance carriers and extensively curtail enduring state roles in banking law.[271]

In this, the Volcker approach is quite duplicative, and the urge to rationalize and nationalize is strong in both the Democratic and Republican versions of financial reform. The difference in the centralization between the two approaches lies in the independence of the regulators to whom centralization would be entrusted; with Volcker, the independence of the regulator is particularly important, whereas with the Paulson blueprint, the idea is to consolidate regulatory power

*the Quiet Constitutional Revolution*, 49 Admin. L. Rev. 179, 179 (1997) (decrying the "cult of the Chief Executive"); Peter M. Shane, *Political Accountability in a System of Checks and Balances: The Case of Presidential Review of Rulemaking*, 48 Ark. L. Rev. 161, 200 (1995) ("If bureaucratic accountability to elected politicians is to be used as a structural mechanism aimed at achieving direct responsiveness to public opinion, it would probably make more sense to intensify the influence that Congress—especially the House—has over the agencies. Members of Congress are eligible for reelection indefinitely; a common observation of the House is that its members are in a constant election campaign.").

[268] *See* David Zaring & Elena Baylis, *Sending the Bureaucracy to War*, 92 Iowa L. Rev. 1359, 1361 (2007) ("Since September 11, the government has mobilized not just its national security apparatus, but almost all of the myriad units of the federal civil administrative state to battle against a small and elusive foe.").

[269] Eric A. Posner & Adrian Vermuele, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301164.

[270] Ironically, these far-reaching proposals were made through a process that is both administratively regular—the Department requested comment on its proposal the same day it issued the work—and seemingly legally modest, in that it was not accompanied by draft legislation or even an executive order.

[271] Treasury Blueprint, *supra* note 3, at 165–70.

in the executive branch under presidential control, which is pretty much where it resided after the on-the-fly responses to the crisis in both 2008 and 2009.

Finally, this federal centralization, especially in the blueprint but also in the Volcker proposals, raises federal preemption issues, because they represent the federalization of so much of our decentralized financial regulatory architecture. This is especially true of the blueprint because, by creating so many new federal institutions, it raises the prospect that those institutions would preempt state regulation of finance, including banking, insurance, futures, and securities, even if Congress does not provide for preemption in its reform bill. Similar consequences could follow from implementing changes that the Volcker proposals contemplate, and these could even easily reach into subjects such as corporate board performance and executive compensation that traditionally have been treated as part of state corporation law.

The idea that federal law might preempt state law is unsurprising to anyone with a passing familiarity with the Supremacy Clause of the Constitution.[272] But when, exactly, the federal government *has* preempted state law is lately an increasing preoccupation of the Supreme Court. Congress does not always explicitly express its desire to preempt all state law in a sphere of federal regulation with clarity. This reticence puts courts in the difficult position of deciding whether the legislature silently intended to displace state rules, usually by enabling a federal agency to regulate in the area.[273] Because the objectives of this sort of federal statutory scheme might be frustrated by enforcement of state law, a court may also find the state law preempted.[274]

Agency-driven preemption cases arise in a variety of contexts, but often arise when federal consumer protection or safety standards conflict with state tort law.[275] The Supreme Court has recently shown in-

[272] U.S. Const. art. VI, § 2.

[273] This is known as implied preemption, and Congress is sometimes unclear about how much state law is to be preempted intentionally, in the view of some scholars. *See, e.g.*, Roderick M. Hills, Jr., *Against Preemption: How Federalism Can Improve the National Legislative Process*, 82 N.Y.U. L. Rev. 1, 16 (2007); Caleb Nelson, *Preemption*, 86 Va. L. Rev. 225, 302 n.235 (2000) ("When members of Congress focus on a particular issue but fail to reach a collective decision about how to resolve it, they sometimes compromise by enacting intentionally ambiguous language that transfers the issue to the courts.").

[274] *See, e.g.*, Nash v. Fla. Indus. Comm'n, 389 U.S. 235, 238–40 (1967) (holding a state law which denied unemployment compensation to anyone who filed a complaint with the National Labor Relations Board to be preempted by the National Labor Relations Act, 29 U.S.C. §§ 151–169 (2006)).

[275] *See, e.g.*, Riegel v. Medtronic, Inc., 128 S. Ct. 999 (2008). These sorts of preemption

creasing willingness to conclude that federal law does preempt state tort law in these cases, particularly if a federal regulatory agency supports that stance.[276] There are, of course, exceptions, such as the recent decision in *Wyeth v. Levine,* where the Court decided against state tort law preemption.[277]

Still, as Catherine Sharkey has noted, the Supreme Court almost always sides with the federal agency when the preemption of state law by federal regulation comes before it.[278] Accordingly, there is a prospect that the new, central, and powerful institutions envisioned by the blueprint, and perhaps those required to implement the Volcker proposals, could see their ambit to require regulations that they would conclude should preempt state law—and that federal courts could agree with them.

### *B. Regulatory Theory*

Administrative law differences aside, it may be difficult to imagine consolidating into just a few federal agencies the traditional and varying functions performed by the Fed, other federal and state banking authorities, the various state insurance regulators, and the SEC and CFTC. Admittedly, federal government agencies are both created and terminated from time to time and no agency's permanent survival can be taken for granted.[279] Yet such large-scale reorganizations of numerous agencies simply have not happened in the administrative state, at least not since the Great Depression.[280]

cases have been going on for some time. *See also* Marin R. Scordaro, *Federal Preemption of State Tort Claims*, 35 U.C. Davis L. Rev. 1, 13 (2001) ("[I]n a 1913 Supreme Court case, a Wisconsin statute required that certain containers of syrup be labeled in such a way that the producer, in order to comply, would have to remove the product labels that were required by Congress under the Pure Food and Drug Act.").

[276] *See* Watters v. Wachovia Bank, 550 U.S. 1, 20–21 (2007) (finding state banking regulations preempted by Office of the Comptroller rules). *But see* Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2720–21 (2009) (finding state consumer protection rules not preempted by Office of the Comptroller rules).

[277] Wyeth v. Levine, 129 S. Ct. 1187 (2009).

[278] Cartherine Sharkey, *Products Liability Preemption: An Institutional Approach*, 76 Geo. Wash. L. Rev. 449, 471 (2008) ("[F]rom *Cipollone* in 1992 to *Riegel* in 2008, the Supreme Court's position in every products liability preemption case (save one—*Bates*) aligned with the relevant underlying federal agency's take on preemption.").

[279] *E.g.*, David E. Lewis, Presidents and the Politics of Agency Design: Political Insulation in the United States Government Bureaucracy, 1946–1997, at 154 (2003); David E. Lewis, *The Politics of Agency Termination: Confronting the Myth of Agency Immortality*, 64 J. Pol. 89, 92–93 (2002) (noting 62% of agencies created after 1946 were terminated by 1997).

[280] With the possible exception of the Department of Homeland Security after 9/11. On the larger issue, see Darrell Delamaide, *Washington Witch Hunt*, MarketWatch, Apr. 3, 2008,

But assuming for the moment that the political will exists, what are the implications of a reorganization of financial regulation that extensively consolidates power in Washington—in banking, insurance, futures, and securities certainly—and possibly, as some suggestions in the Volcker reports signal, for cognate fields as wide-ranging as corporation law? How would the implications of the blueprint and the Volcker proposals differ from each other? Finally, how would either compare to the traditional fragmented approach or the quasi-centralized approach as it exists after the Fed and Treasury's on-the-fly reforms amid the 2008 crisis?

As a matter of regulatory theory, proponents of the principles of experimentation and regulatory competition might not welcome the centralization of either the Paulson or Volcker proposals. True, the prevailing U.S. fragmentary system of financial regulation is, as we have explained, not a particularly coherent one. But it also offers recognizable virtues. Chief among these is the application of divided government to financial regulation.

Believers in a Madisonian vision of divided government may be inclined to keep the financial regulatory system in the form closely resembling the current one (whether or not treated as modified by the 2008 crisis-response centralization). Divided government slows down the ability of new visionaries (which may include Messrs. Paulson and Volcker) with a comprehensive approach to regulation to implement that vision. And there are those who believe that this would be no bad thing, such as, for example, those persuaded by the Burkean advantages of making change difficult.[281]

Proponents of decentralized experimentalism, such as Michael Dorf and Charles Sabel, might have additional reasons to prefer the relative disunity of the current system, or something that looks like it.[282] On this view, it is desirable that the CFTC and SEC oversee markets that do similar things, because it creates something of a market for law. Dispersion of regulatory authority creates incentives for competing authorities to engage in experimentation.

http://www.marketwatch.com/story/washington-witch-hunt-finding-the-subprime-culprits. Practical political problems also warrant skepticism about the likelihood of an SEC-CFTC merger. The two agencies are overseen by different committees in Congress, each with vested stakes in maintaining their respective oversight.

[281] For an overview of the distinctions between Madisonian and Burkean visions of governance (particularly constitutional governance), see Cass R. Sunstein, *Five Theses on Originalism*, 19 Harv. J.L. & Pub. Pol'y 311 (1996).

[282] *See, e.g.*, Michael Dorf & Charles Sabel, *A Constitution of Democratic Experimentalism*, 98 Colum. L. Rev. 267, 284 (1998).

Consolidation of regulatory authority would alter those incentives. It is not clear that experimentation could occur under a centralized financial regulator, even if that regulator delegated considerable standard-setting authority to private self-regulatory organizations, as visions like the blueprint contemplate, and certainly seems unlikely under the centralization that the Volcker reports contemplate.

The optimal balance between state and federal regulation, and corresponding fragmentation or consolidation, is an issue in substantially all fields of financial regulation implicated in the blueprint and Volcker reports. In banking, consider capital-adequacy regulations, a fundamental tool intended to promote the safety and soundness of banks. A global standard for this tool appears in the Basel II Capital Accord.[283] In the United States, different regulators embraced the global standard in various measures. The Fed, the FDIC, Treasury, and even the SEC each took tailored approaches to capital adequacy of the institutions they supervised. Some adopted the tool slowly or in tranches or even made adoption of it by certain institutions voluntary.[284]

A potentially appealing result of this fragmentation of authority is a palette of options for participants in financial markets. It also promotes a close fit between regulatory expertise and the targeted firms. Of course, there are also costs to this disharmony. For example, there is reason to believe that the SEC's adaptation of the Basel II Capital Accord from commercial banking to investment banking failed to appreciate the different capital structures and business operations of the two types of institutions. In addition, the many federal and state banking regulators have made bank operation an excessively paper-intensive task. They have complicated the banking sector's efforts to create common international supervisory standards.

These costs may increase amid globalization. Consider insurance. The fact that insurance supervision in the United States is managed by the fifty states has been one reason why efforts to harmonize insurance regulation internationally have gone much less far than parallel efforts to harmonize banking supervision standards and even securities regulation, especially in the area of accounting.[285] Although insur-

[283] For a review of the accord, see David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 Chi. J. Int'l L. 547, 575–77 (2005).

[284] *See id.*

[285] *See* Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. Rev. 1 (2008) (examining the expansion of international accounting standards); David Zaring, *International Law by Other Means: The Twilight Existence*

ance companies have not hesitated to expand operations widely and deeply around the globe, oversight of them has not followed. Even if the regulatory dis-census and gaps in insurance were deemed desirable, they result not from any conscious national decision but are haphazard consequences of the fragmented National Association of Insurance Commissioners' inability to coordinate internationally.[286]

Scholarly debate on federalism and regulatory theory has been particularly vibrant in the context of securities regulation and its cognate field of corporation law. Since the days of Ralph Winter, scholars have found some value in the fragmented approach to regulation, especially in corporation law.[287] To some, like Roberta Romano, fragmentation makes it possible for small, fee-dependent regulators to be responsive—indeed more responsive—to the interests of the regulated industry than would the federal government (this is seen as desirable).[288] To many, fragmentation can lead to a race to the regulatory top, where the best regulatory policies are forced to prove themselves in a 50-state market for law.

Opponents object that through regulatory rent-seeking[289] or managerial power, the result becomes a race to the bottom.[290] More agnostic are those scholars who doubt the efficacy of any such competition leading to any particular or predictable results.[291] Despite this longstanding debate over whether state competition in corporate law is a race to the top or to the bottom, that competition has abated considerably in recent years.[292] Delaware won, with some newfound competition for it from Washington replacing erstwhile

*of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281 (1998) (considering systematizing efforts regarding international-banking and securities-regulation standards).

[286] *See generally* Zaring, *supra* note 285.

[287] *E.g.*, Winter, *supra* note 12, at 254–62.

[288] *See* Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 752–57 (1987); *see generally* EASTERBROOK & FISCHEL, *supra* note 12.

[289] *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 469–73 (1987).

[290] *See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION 54–61 (1976); Cary, *supra* note 17, at 663–70; Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 966 (1990).

[291] *See, e.g.*, Robert B. Ahdieh, *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*, 77 GEO. WASH. L. REV. 255 (2009); Lucian Arye Bebchuk & Assaf Hamdani, Essay, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002); William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401 (1994).

[292] Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1777–80 (2002); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 681–87 (2002).

state competitors. This occurs primarily when Congress uses or threatens to use federal securities regulation to enact laws that intrude into subjects traditionally seen to be within state corporation law, as with Sarbanes-Oxley.[293]

Federal corporate regulation preempts state law, however, meaning the potential for federal monopoly which can result in inefficient laws. To address that concern, proponents of state competition in corporate law adapted its insights to the federal securities regulation context.[294] They propose devices to overcome that monopoly by creating avenues for regulatory competition among jurisdictions worldwide. Leading examples are to give securities issuers the choice of applicable laws;[295] give stock exchanges where issuers list that choice;[296] or offer "substituted compliance" (also called mutual recognition), which lets foreign entities regulated comparably at home access securities markets abroad without regulation there.[297] Although the desirability of such proposals can be questioned,[298] there is less doubt about their feasibility given global stock-market competition.[299]

In fact, when United States capital markets were among the only places to raise large amounts of capital, U.S. federal securities regulation may have been a functional monopoly. But of late, stock-exchange competition and accompanying regulatory oversight intensified amid globalization and technology changes.[300] There are now dozens of vibrant capital markets in the world, all vying with each other to attract capital. These markets and regulators compete with

[293] *See* Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. Corp. L. 625, 627–29 (2004); Mark J. Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588, 605 (2003). *But see* Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 Oxford Rev. Econ. Pol'y 212, 223–29 (2005).

[294] *See generally* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998) (arguing federal preemption of state law is not the proper way to reduce frivolous lawsuits).

[295] *See* Stephen J. Choi & Andrew T. Gozman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903, 907 (1998).

[296] *See* Romano, *supra* note 294, at 2399–401.

[297] *See* Howell E. Jackson, *A System of Selective Substituted Compliance*, 48 Harv. Int'l L.J. 105, 105–06 (2007).

[298] *See, e.g.*, James D. Cox, *Regulatory Duopoloy in U.S. Securities Markets*, 99 Colum. L. Rev. 1200 (1999).

[299] *See* John C. Coffee, Jr., *Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757, 1759–62 (2002); Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 Fordham L. Rev. 2541, 2541–44 (2006).

[300] Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. Chi. L. Rev. 1435, 1435–37 (2008).

one another, breaking the erstwhile U.S. federal monopoly.[301] Choice-of-law devices may not even be necessary to enable national markets and related regulatory oversight to compete on a global basis.[302]

The blueprint and Volcker reports respond to such global developments in different ways. True, both would take large strides towards ending the state role in financial regulation and substantially consolidate it in the federal government. The blueprint explicitly contemplates doing so for traditional state insurance and banking, and maintaining and unifying federal regulatory authority over securities and futures.[303] Although not explicit, the blueprint's logic even allows for consolidation of federal authority over state corporation law,[304] and the Volcker reports refer to the need to increase corporate board governance generally, and especially in the areas of executive compensation and financial reporting.[305] Both also raise the prospect of the preemption of state law in all these fields, something that federal regulators and courts, as we noted, have increasingly interpreted their statutory responsibilities to require.[306]

To that extent, the blueprint and Volcker proposals may seem to promote a federal regulatory monopoly that could result in inefficient laws. But the grand visions part ways in their respective responses to globalization and resulting global regulatory competition. The blueprint seeks to promote U.S. capital-market competitiveness, consolidating oversight in Washington but adopting a relatively loose supervisory approach with considerable delegation to industry self-regulators. This attempts to put U.S. financial firms, and the U.S. federal regulatory apparatus, in a favorable competitive position with other nations. In effect, the blueprint first concentrates U.S. financial regulation using a consolidated federal structure and then embraces global fragmentation among competing national structures participating in global competition.

These implications of the blueprint entail a reconception of federalized financial regulation that would essentially reverse contending stances in regulatory-theory debates. Proponents of federal financial regulation have urged it as an antidote to state law's perceived lax-

[301] *Id.* at 1437.

[302] *Id.* at 1480–91.

[303] *See* Treasury Blueprint, *supra* note 3, at 11, 20, 99–100, 106–25

[304] *See* Lawrence A. Cunningham, Response, *The New Federal Corporation Law?*, 77 Geo. Wash. L. Rev. 685, 700–07 (2009).

[305] *See supra* text accompanying notes 126–27; Volcker II, *supra* note 4, at 42.

[306] *See supra* text accompanying notes 189–94.

ity.[307] Opponents express concern about how the resulting regulatory monopoly may yield inefficient laws.[308] But if the U.S. federal regulatory monopoly in securities regulation is abating, and global regulatory competition intensifying, then risk of inefficient laws from U.S. regulatory monopoly declines. So the blueprint sides with those otherwise averse to federal regulatory monopoly by using it to embrace global regulatory competition and committing the United States to succeed in it.

In contrast, the Volcker reports implicitly side with those favoring federal regulatory monopoly precisely to provide mandatory controls in financial regulation. The Volcker vision is to make U.S. capital markets sound and its real economy stable. It consolidates oversight in Washington, using a substantive regulatory philosophy with limitations like caps on the size of financial institutions or businesses they can pursue. It responds to globalization not by embracing competition but by seeking collaboration. The quest for domestic concentration coupled with international collaboration addresses concern that, if the U.S. federal regulatory monopoly abates, free global competition may spell lax regulation. A global regulatory monopoly is sought.

### C. *Political Reality*

These normative distinctions between Paulson's blueprint and the Volcker reports raise additional matters that turn more political and practical. We are not sure that wholesale centralization is realistic, and so our assessments of the grand visions posit that they must contend with prospects for their sustainability. For the Volcker approach, this requires attention to whether the envisioned global coordination among nations is feasible. For both, it requires considering whether the envisioned domestic concentration is achievable and sustainable. Already, there is some support for turning any form of consolidated regulation into regulation by committee, where extant regulators coordinate approaches more carefully.[309] This "National Director of In-

[307] David Cho et al., *Long Fight Ahead for Treasury Blueprint: Consumer Groups, Agencies Criticize Regulatory Overhaul*, WASH. POST., Mar. 30, 2008, at A01. (describing the arguments of supporters, including Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee; Spencer Bachus (R-Ala.), member of Financial Services Committee; and former SEC Chairs Christopher Cox and Harvey L. Pitt).

[308] *See id.* (describing the arguments of opponents as well, including Sen. Christopher J. Dodd (D-Conn.), chairman of the Senate Banking Committee, and John M. Reich, former director of the Office of Thrift Supervision, who "discounted the importance of the blueprint").

[309] *See* A NEW FOUNDATION, *supra* note 2, at 10–18.

telligence" approach for financial markets appears to represent centralization more in name than in fact.

The Volcker vision sees extensive collaboration among national regulators in a large number of countries who will not only agree to share information but who will also coordinate on setting, maintaining, and enforcing agreed regulations of financial markets. Although there is some modest support for such a prospect in certain discrete contexts,[310] and some progress evident in the converging of international accounting standards,[311] it is not obvious that the requisite coordination for broad financial regulation will occur or be sustainable, though one of us believes that more financial coordination would be a good idea.[312]

In times of economic crisis, such as during 2008 and 2009, there may be greater willingness among nations to join together, even to sign cooperation agreements and join periodic communiqués, such as the G20 overture cited earlier.[313] Yet crisis also can induce national leaders to concentrate more intensively on domestic affairs and interests,[314] even among members of otherwise successful economic blocs, such as the European Union.[315] It is difficult to predict international propensity toward regulatory cooperation during periods of economic expansion, particularly considering how the globalization of finance and related competition is a relatively recent phenomenon.

Cold comfort appears in various initiatives to develop bilateral and multilateral platforms to coordinate undertakings among financial regulators from different countries.[316] A main example is the SEC's developing mutual recognition program.[317] Despite much fanfare, the SEC has formally entered into only one such agreement, with Austra-

[310] *See* Benedict Kingsbury et al., *The Emergence of Global Administrative Law*, 68 Law & Contemp. Probs., Summer/Autumn 2005, at 15, 31.

[311] *See* Cunningham, *supra* note 285.

[312] For an argument about the value of increased international financial coordination, see David Zaring, *Reforming International Financial Regulation*, The Hearing, http://voices.washingtonpost.com/hearing/2009/07/reforming_international_financ.html, (July 2, 2009, 12:30 EDT, blog hosted by *The Washington Post*).

[313] *See supra* text accompanying notes 132–34.

[314] *See* Roger Altman, *The Great Crash of 2008: A Geopolitical Setback for the West*, 88 Foreign Aff. 2, 9 (2009).

[315] *See* Editorial, *Protecting European Unity Against Crisis*, Fin. Times, Feb. 19, 2009, at 12.

[316] *See* Chris Brummer, *Post-American Securities Regulation*, 97 Cal. L. Rev. (forthcoming 2009).

[317] This enables foreign firms to operate in the U.S. without local registration or supervision, so long as they are overseen sufficiently by a regulator comparable to the SEC and with comparable regulations. *See* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. Int'l L.J. 31, 32 (2007).

lia, concerning only one such participant, brokers.[318] Furthermore, even the considerable SEC and international cooperation and convergence that has been achieved concerning international accounting standards is beset with holdouts and disagreement.[319] In part, this reflects extensive variation among nations in legal origins, and historical, political, sociological, and economic orientations towards capital markets, securities investment, corporate governance, and the roles of markets and the state in national affairs.[320]

The appetite for international coordination in financial-market and regulation matters is constrained by inherent national interests to promote capital markets and financial industries domestically.[321] There is ongoing and increasing regulatory competition among national securities regulators, operating in part and indirectly through their stock exchanges.[322] That competition is mediated, but only slightly, by efforts to harmonize regulation that the International Organization of Securities Commissions and entities like it have made.[323]

Despite occasional signs of mild collusion among national regulators, this may simply reveal that it is necessary to engage with one another, and this often means competing to attract capital to their home markets. These limitations may diminish prospects for the kind of regulatory collaborations that the Volcker plan would need and, without them, the Volcker vision's stringent regulatory impositions could put the United States at a competitive disadvantage internationally.[324] That remains true despite occasional expressions of interna-

[318] *See* Press Release, Sec. & Exch. Comm'n, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008), *available at* http://www.sec.gov/news/press/2008/2008-182.htm. For a discussion, see Eric J. Pan, *Single Stock Futures and Cross-Border Access for U.S. Investors*, 14 Stan. J.L. Bus. & Fin. 221, 223–24 (2008).

[319] *See* Cunningham, *supra* note 285, at 41–42; Zaring, *supra* note 285, at 281.

[320] *See, e.g.*, Cunningham, *supra* note 285, at 40–53 (documenting these variations in the context of assessing the prospects for sustained international commitment to uniform financial-accounting standards).

[321] *See* Otmar Issing & Jan Krahnen, *Why the Regulators Must Have a Global "Risk Map*,*"* Fin. Times, Feb. 19, 2009, at 11 (attributing lack of international coordination concerning systemic risk to "the competitive situation in international financial markets, with governments aiming at preserving the competitive advantages of national banking industries").

[322] *See* Brummer, *supra* note 316.

[323] *See* Zaring, *supra* note 283, at 601–02.

[324] True, more informal networks may enable substantial coordination of international financial regulation. *See* Zaring, *supra* note 285, at 283 ("[The International Organization of Securities Commissions] and [the International Association of Insurance Supervisors] have accordingly expanded during their short lifetimes to include representatives from a majority of the world's countries. The Bas[el] Committee has focused more narrowly on the expensive regulation of most of the world's largest international banks."). But the Volcker vision seems to

tional unity, amid the 2008 crisis, when certain countries long deemed to be out of step with international financial regulatory norms got into step.[325]

Unlike the Volcker vision, the Paulson vision essentially assumes that such international collaborations are unlikely to result in sustainable consensus. Even so, both plans must confront domestic political realities and practical limitations on their shared visions for concentration of regulatory authority within the United States. Here, there is reason to doubt whether a truly concentrated regulatory structure, such as a two-peaks model, is sustainable in the United States. The blueprint nearly acknowledges as much, despite proclaiming the need for a "modern" regulatory structure to reflect "convergence of the financial-services industry."[326] In the same discussion of such perceived convergence, it explicitly recognizes different enterprise business models and different government interaction with enterprises.

For example, the blueprint notes that "the requirements for financial capacity and managerial expertise should vary by type of financial product being sold."[327] It distinguishes consumer-retail transactions from business-wholesale transactions and distinguishes firms with government guarantees from those without them.[328] It recognizes differences between securities and futures firms, even though it recommends having them supervised by a single agency.[329] It distinguishes these firms from banks and insurers, which are also acknowledged to be different kinds of institutions. The customers of all these firms have different needs and related regulations probably should reflect them. That means inherent fragmentation. Nothing in the Volcker proposals counters these realities.

Furthermore, the vaunted two-peaks model endorsed by both visions may not have proven its mettle. These and other proponents invariably mention that numerous other nations have moved to the two-peaks model in the past decade.[330] Yet the 2008 crisis rocked the

recognize that much more than that would be required and, in our view, this does not seem highly probable.

[325] *E.g.*, Haig Simonian, *Haven to Relax Rules on Bank Secrecy*, FIN. TIMES, Mar. 13, 2009, http://www.ft.com/cms/s/0/1908ee26-0f71-11de-ba10-0000779fd2ac.html?nclick_check=1 (noting that Liechtenstein, under pressure from the Organization for Economic Cooperation and Development, agreed to conform its banking laws more closely to internationally ordained standards).

[326] TREASURY BLUEPRINT, *supra* note 3, at 137.

[327] *Id.* at 170.

[328] *Id.* at 137.

[329] *Id.* at 106–26.

[330] *See* Brown, *supra* note 206, at 94.

financial markets and many specific financial institutions in those countries at least as severely as in the United States. This certainly gives reason to wonder whether any regulatory authority, no matter how centralized, ever could be in a position to become aware of excessively concentrated systemic risk. It does not mean there is not value to the structure or the quest, but experience does not demonstrate superiority of the two-peaks model compared to alternatives, including the battle-tested traditional fragmented U.S. approach.

Accordingly, it is not clear the blueprint's ordered coherence or the Volcker reports' coherent ambitions will help their kind of centralization to triumph over contenders, including remnants of the traditional fragmented system as changed by the new-model Fed's on-the-fly responses to the 2008 crisis. The on-the-fly approach appeared to reinvigorate the PWG; it is possible that political realities of transforming multiple regulators into a putative single regulator would stop at the regulation-by-committee form that the PWG resembles.[331] Although the resulting quasi-concentration's sustainability cannot be assured, its accomplishment attests to at least some staying power. In any event, the de facto reform remains less sweeping than that imagined under either the Paulson or Volcker visions.

We believe that a superior resolution will be achieved by recognizing that many reforms in both the blueprint and Volcker proposals can proceed piecemeal. Within the grand visions that each elaborate appear a grab bag of discrete proposals that can be selectively adopted following the traditional crisis-response approach to U.S. financial regulation. For example, Congress could accept the blueprint's recommendation for a federal Mortgage Origination Commission and enact an optional federal insurance charter;[332] following Volcker's prescriptions, it could pass legislation to regulate credit default swaps and, by legislation or direction to the SEC, increase regulatory supervision of rating agencies.[333]

We believe reforms such as these offer a more sensible and pragmatic response to the events we have catalogued. After all, what are the prospects for adoption of either of these grand visions or any of the discrete reforms that each contains? Although we disclaim political-scientific expertise, the content of reform post-crisis depends on a number of factors that turn a bit more on political economy than on law. For example, although it raises the possibility of capture, recog-

[331] *See supra* notes 167–73 and accompanying text.

[332] *See* Treasury Blueprint, *supra* note 3, at 6–7, 78–80.

[333] *See* Volcker II, *supra* note 4, at 52, 66–67.

nized in public choice theory, industry support does help to overcome the status quo bias of both regulators and the legislature.[334]

We have seen some evidence of this, including a number of tacit bows to the coming regulatory expansion, ranging from apparent acquiescence of hedge funds to some degree of oversight, to the willingness of senior bank officials to accept bailout largesse—even at the cost of their own executive compensation.[335] One reason for crisis-generated reform may be consistent with another strand of public choice theory: it takes events of widespread consequence to motivate poorly engaged and disaggregated majorities to re-examine institutionalized regulatory schemes, which between crises are likely to be responsive to more easily organized minorities.[336]

Amid the 2008 crisis, political sensibilities undoubtedly galvanized and possibly shifted. The blueprint's deregulatory posture, along with delegation, was offered essentially pre-crisis, when appetites had been building for several years, after Sarbanes-Oxley, for just such a deregulatory commitment. Its origins are in a series of reports lamenting a decline in U.S. capital-market competeveness.[337] It is a call to reform that, in that pre-crisis period, may have enjoyed considerable political traction, certainly among market devotees and perhaps commanding appeal across wide parts of the center of the political spectrum.

While market purists may yet prefer a blueprint type of approach that embraces global regulatory competition, more vocal advocates of regulation's virtues, and a wide swath across the political center, may be prepared to embrace the more controlled regulatory vision set out in the Volcker reports. Even so, when a triggering event inspires reform and even generates requisite political will to make change, the event and the reform are not always closely connected to each other,

[334] *See* SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC Interest 17–25 (1981) (providing an overview of public choice theory).

[335] Mark Mooney & Matt Jaffe, *New TARP Rules: Curb Executive Pay, Bonuses, Parachutes*, ABCNEWS.COM, Feb. 4, 2009, http://abcnews.go.com/Politics/Business/story?id=6801950&page=1 (describing the executive pay limitations); Tomoeh Murakami Tse, *For Hedge Funds, Biggest Fear is More Regulation*, WASH. POST, June 25, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/06/24/AR2009062403450.html (noting that 37% of hedge fund managers favored more regulation).

[336] *See, e.g*, Ribstein, *supra* note 142, at 78–83; *see generally* BANNER, *supra* note 142 (outlining early history of securities regulation and the influence of public opinion thereon).

[337] *See* MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP, at i (2007), *available at* http://home.nyc.gov/html/om/pdf/ny_report_final.pdf. The Committee on Capital Markets Regulation issued similar reports, available at http://www.capmktsreg.org.

as Part I illustrated. These political and practical realities may point toward following America's more traditional response to crisis of targeted incremental reform rather than pursuing the more sweeping visions offered by Paulson's blueprint or the Volcker reports. Our suggestion has been, we think, reflected by the Obama Administration's initial proposal for financial reform, which more modestly recommended giving more powers to the Fed and endorsed a strengthened committee-coordination system that would leave in place most of the existing regulators, who compete, do not always get along, and yet have presided over a great deal of financial prosperity and strength.[338]

Still, those alternatives do appear to constitute the range of realistic possibilities and principal approaches ahead. We believe, as we have said, that incremental rather than revolutionary reform is the more prudent and pragmatic approach.

## *Conclusion*

Proposed reforms in light of the 2008 crisis are certainly sweeping. The Paulson blueprint calls for the alteration or disbandment of federal governmental agencies that have been around for a century, and the Volcker plan echoes those calls. The Fed was created in 1913 and the SEC in 1933.[339] The Federal government got involved with futures regulation with the 1922 Grain Futures Act,[340] and established thrift oversight in the 1932 Federal Home Loan Bank Act.[341] The McCarran-Ferguson Act, which formally delegated authority to establish insurance laws to states, dates to 1945.[342] Reform under either grand vision would mean that these agencies and statutes be replaced, in whole or in part, with a new set of laws and financial regulators that would have very different responsibilities. Under both Paulson's and Volcker's proposals, broad supervisory responsibilities would be consolidated in one or two senior federal regulators. The response to the financial crisis, in many ways, began a consolidation process that the considered proposals would finish. But, as we have said, and as both

[338] *See* A NEW FOUNDATION, *supra* note 2.

[339] Although the CFTC was not organized until 1975, the federal government has asserted regulatory authority over futures trading since at least the 1920s. *See* Future Trading Act, ch. 86, 42 Stat. 187 (1921), *invalidated by* Hill v. Wallace, 259 U.S. 44, 69–70 (1922).

[340] Grain Futures Act, ch. 369, 42 Stat. 998 (1922); *see also* Bd. of Trade of Chi. v. Olsen, 262 U.S. 1 (1923) (upholding Grain Futures Act).

[341] Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932).

[342] *See* McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011–1015 (2006).

the current Congress and the current administration have suggested, there are attractions to disaggregated domestic regulation.

To some, of course, financial reform, like much of corporate regulation, is not so important, and grand visions like these may be mere visions that financial players simply contract around or game.[343] When the Paulson blueprint was first mooted, moreover, some observers thought that its recommendations did not amount to much. Economist Paul Krugman, a member of the Volcker report team, sniffed "[t]o hide their lack of any actual ideas about what to do, managers sometimes make a big show of rearranging the boxes and lines that say who reports to whom."[344] *The Wall Street Journal's* editorial board quipped that "[n]o bureaucratic deck chair goes unmoved" under the plan, and otherwise exhibited little interest in its substance.[345]

This sort of early dismissal, and the regulatory-triviality argument more generally, is curious in light of what has happened since Treasury first mooted widespread reform. Since then, the United States federal government devoted some $750 billion to bailing out the financial system, which collapsed in a way that rendered investment banking as we knew it extinct, drastically altered the structure of commercial banking and mortgage finance, and caused severe hardship in the real economy.

Despite early dismissal, since its release, visions of reform have garnered considerable, and, as the crisis widened, escalated, attention. Paulson's blueprint has influenced the Obama administration.[346] The Volcker group's reports, commanding equal interest, address some of the same territory directly. One of Volcker's reports describes the blueprint as "far-reaching," and says that the "fact that Treasury has put these proposals on the public agenda, together with the seriousness of current conditions, suggests that there will be an active debate" on approaches to financial regulation.[347]

The increasing focus on bold reform to concentrate regulatory authority should be taken seriously but cautiously. After all, our evaluation suggests some enduring merits of the traditional U.S. fragmented approach and the accomplishment of extensive reforms to it

[343] *E.g.*, Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990).

[344] Paul Krugman, *The Dilbert Strategy*, N.Y. TIMES, Mar. 31, 2008, at A21.

[345] *Reform a la Glasgow*, WALL ST. J., Apr. 1, 2008, at A16.

[346] Michael Corkery, *Obama's Regulatory Overhaul vs. the Paulson Blueprint*, DEAL J., http://blogs.wsj.com/deals/2009/06/17/obamas-regulatory-overhaul-vs-the-paulson-blueprint/ (June 17, 2009, 10:15 EDT, blog hosted by *The Wall Street Journal*).

[347] VOLCKER I, *supra* note 4, at 224.

that significantly concentrated the structure of U.S. financial regulation. Additional concentration may not be necessary and may in any event prove unsustainable. A grab bag of reform ideas appears in the otherwise grand visions for planned centralized reforms. Adopting some of those would follow an American tradition of crisis response, using its traditional fragmented system. In any event, one of these three or four approaches to financial regulation seems destined to become the approach we take into the next crisis—and perhaps to pull us out of the current one.