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## Dodd-Frank: Toward First Principles?

Reza Dibadj\*

### INTRODUCTION

When confronting a major crisis, tinkering at the margins of policy will likely do precious little either to ameliorate the system or avert the next catastrophe. Rather, lawmakers need to return to first principles by examining the underlying causes of the crisis and stemming them. Participating in a symposium over two years ago, well before the advent of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”),<sup>1</sup> I argued that to mitigate, or perhaps even avoid, future disasters, policymakers should focus on remedying four pernicious facilitators to scandal: (1) the dissemination of information that is false or misleading; (2) the ability to abuse regulatory gaps; (3) the willingness to exploit credulous consumers; and (4) the use of corporate size to privatize profits and socialize losses.<sup>2</sup> This Article, written a few months after the passage of Dodd-Frank, builds on this prior work to assess whether the statute effectively addresses these four root causes of our financial meltdown.

Mapping the statute against these four facilitators, I argue that while a positive step forward in some respects, Dodd-Frank exhibits more of an intricate reaction to our last financial crisis than a concise attempt to address fundamental flaws in how Wall Street is regulated. To some degree, this might be unsurprising, given that regulators were reacting *ex post* to a crisis rather than averting it *ex ante*.<sup>3</sup> Yet Dodd-Frank makes surprisingly few important decisions. Fascinatingly, along each of these four

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\* Professor of Law, University of San Francisco. I thank the editors of the *Chapman Law Review* for giving me the opportunity to present the ideas contained in this Article at the Journal’s Symposium, “From Wall Street to Main Street: The Future of Financial Regulation,” in Orange, California, on January 28, 2011.

<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank].

<sup>2</sup> See Reza Dibadj, *Four Key Elements for Successful Financial Regulatory Reform*, 6 HASTINGS BUS. L.J. 377, 377 (2010).

<sup>3</sup> Cf. John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* 2 (The Ctr. for Law and Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 380, 2010), available at <http://ssrn.com/abstract=1675015> [hereinafter Coffee, *Bail-Ins*] (“Just as generals fight the next war in the terms of the mistakes made in the last war, so do financial regulators focus (possibly obsessively) on the immediate causes of the last financial contagion in planning for the future.”).

dimensions, the Act almost exclusively defers to agency rulemaking or the creation of a new organization. Of perhaps even greater concern is the statute's postponement of essential reforms to further study.<sup>4</sup> Dodd-Frank's ornate 848 pages are a far cry from Glass-Steagall's 34 pages;<sup>5</sup> ironically, the extra bulk diminishes rather than enhances the law's effectiveness.

This Article is structured into two principal sections. In Part I, I outline each facilitator and examine what a first principles-based response might encompass; then, I analyze what Dodd-Frank did. Each time, I find that while Dodd-Frank might contain some positive provisions, it ultimately fails to address the root causes of financial crisis. To the extent there is a mismatch between first principles and the legislation, Part II asks why sophisticated lawmakers would choose largely to defer these issues rather than confront them more simply and directly. While there are benefits to statutory vagueness and delegation to agencies and courts, the main factor underlying voluminous legislation that ironically postpones the major questions lies in the political economy of twenty-first century Congressional action and the jostling among interest groups. This Article concludes by suggesting that a path forward may lie in structural reforms pertaining to the legislative process.

## I. FOUR FACILITATORS

As I have argued in detail elsewhere, four phenomena have facilitated our current crisis: (1) the dissemination of information that is false or misleading; (2) the ability to abuse regulatory gaps; (3) the willingness to exploit credulous consumers; and (4) the use of corporate size to privatize profits and socialize losses.<sup>6</sup> Below, I argue that Dodd-Frank does not adequately address any of these facilitators.

### A. Dissemination of False or Misleading Information

The first facilitator to crisis has been the dissemination of false or misleading information. A very simple, though too often glossed-over, principle animating financial regulation is that markets must process information into prices for securities and

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<sup>4</sup> See Edward J. Kane, *Missing Elements in US Financial Reform: A Kübler-Ross Interpretation of the Inadequacy of the Dodd-Frank Act 27* (Aug. 24, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1654051> ("In the end, many controversial issues were designated as subjects for further study.")

<sup>5</sup> See *Banking (Glass-Steagall) Act of 1933*, Pub. L. No. 73-66, 48 Stat. 162 (1933).

<sup>6</sup> See Dibadj, *supra* note 2, at 377.

assets. Inaccurate information leads the system to break down.<sup>7</sup> Two principal causes of inaccurate information have been the delegation of credit-rating functions to conflicted private actors unaccountable to the public, and a sharp curtailment of the ability to bring private antifraud lawsuits.

Our current credit rating model, central to the economic collapse,<sup>8</sup> suffers from two central infirmities. First, given that issuers themselves pay for the securities to be rated, there is an inherent conflict of interest at the heart of the business model; after all, “banks and other issuers have paid rating agencies to appraise securities—a bit like a restaurant paying a critic to review its food, and only if the verdict is highly favorable.”<sup>9</sup> Second, “the credit rating system is one of capitalism’s strangest hybrids: profit-making companies that perform what is essentially a regulatory role.”<sup>10</sup> In parallel, antifraud mechanisms have been watered down over the past several years as both federal statutes and federal common law have made it increasingly difficult to bring private securities antifraud lawsuits against disclosures that either finesse or obfuscate the truth. While even a cursory glance at securities filings indicates that there is ample disclosure, such disclosures can be useless, perhaps even harmful, unless there is some mechanism to ensure their truthfulness.<sup>11</sup>

Beginning in the mid-1990s, a triad of securities reform statutes began making it increasingly difficult to bring private

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<sup>7</sup> *Id.* In the parlance of computer programmers, “garbage in, garbage out.” *Id.* at 379.

<sup>8</sup> See, e.g., William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WIS. L. REV. 1155, 1185 (“If there is widespread consensus on the profound failure of any single component of the U.S. financial system during the recent crisis, surely it is with these ratings agencies that continued to assign their highest ratings to securitized bundles of ultimately worthless subprime mortgages.”).

<sup>9</sup> David Segal, *Debt-Rating Agencies Avoid Broad Overhaul After Crisis*, N.Y. TIMES, Dec. 8, 2009, at A1. See also Andrea J. Boyack, *Lessons in Price Stability from the U.S. Real Estate Market Collapse*, 2010 MICH. ST. L. REV. (forthcoming 2011) (manuscript at 27), available at <http://ssrn.com/abstract=1665124> (“Today, the issuer of securities pays credit rating agencies to rate its product. But this structure is fraught with conflict of interest and resulted in systematic over-rating of securities.”); Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008 at MM36 (noting that in structured finance deals, “the banks pay only if Moody’s delivers the desired rating . . . . If Moody’s and a client bank don’t see eye to eye, the bank can either tweak the numbers or try its luck with a competitor like S.&P., a process known as ‘ratings shopping.’”).

<sup>10</sup> Segal, *supra* note 9, at A22. See also Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 3–4 (2002) (“Rating agencies, however, are private companies. They are not substantively regulated by the United States or any other major financial-center-nation.”).

<sup>11</sup> As Adam Pritchard has observed, “Congress and the SEC focus almost exclusively on disclosure because it reinforces the myths of investor autonomy and sovereignty, a very lucrative myth as far as the financial services sector is concerned.” A.C. Pritchard, *The SEC at 70: Time For Retirement?*, 80 NOTRE DAME L. REV. 1073, 1097–98 (2005).

antifraud claims. First, in 1995 the Private Securities Reform Litigation Act (PSLRA) introduced, “*inter alia*, heightened pleading requirements for class actions alleging fraud in the sale of national securities.”<sup>12</sup> One year later, in 1996, Congress passed the National Securities Market Improvements Acts (NSMIA) whose “primary purpose . . . was to preempt state ‘Blue Sky’ laws which required issuers to register many securities with state authorities prior to marketing in the state.”<sup>13</sup> Third, the Securities Litigation Uniform Standards Act (SLUSA) in 1998 made “federal court the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law.”<sup>14</sup> In sum, through heightened pleading standards and the preemption of more generous state securities laws, Congress has made it increasingly difficult for private plaintiffs to bring securities actions.

Federal common law has evolved into a more defendant-friendly posture as well. Beginning with two landmark cases in 1975—*Blue Chip Stamps v. Manor Drug*<sup>15</sup> and *Cort v. Ash*<sup>16</sup>—the United States Supreme Court has essentially cabined the federal common law of securities fraud.<sup>17</sup> Over the past five years, and in rapid succession, the Court has placed restrictions on plaintiffs along two principal dimensions. Decisions such as *Dura*,<sup>18</sup> *Tellabs*,<sup>19</sup> and *Stoneridge*<sup>20</sup> move in the direction of imposing heightened pleading requirements on plaintiffs.<sup>21</sup> Moreover, opinions such as *Merrill, Lynch*,<sup>22</sup> and *Credit Suisse*<sup>23</sup> have

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<sup>12</sup> *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001). See generally A.C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U. L.Q. 435, 481–83 (2000).

<sup>13</sup> *Lander*, 251 F.3d 101, at 108. The securities exempted, called “covered securities,” are those nationally listed on the New York or American Stock Exchanges, or on NASDAQ. See 15 U.S.C. § 77r(b). Note, however, that the “NSMIA expressly preserved state authority to bring enforcement actions with respect to securities transactions.” Stefania A. Di Trolio, *Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 WM. MITCHELL L. REV. 1279, 1295 (2004).

<sup>14</sup> *Lander*, 251 F.3d at 108.

<sup>15</sup> 421 U.S. 723 (1975).

<sup>16</sup> 422 U.S. 66 (1975).

<sup>17</sup> See Reza Dibadj, *An Uneasy Case for White-Collar “Martyrs,”* 44 U.S.F. L. REV. 505, 522 (2010).

<sup>18</sup> *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).

<sup>19</sup> *Tellabs, Inc. v. Makor Issues and Rights*, 551 U.S. 308 (2007).

<sup>20</sup> *Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

<sup>21</sup> See generally Todd R. David, Jessica P. Corley & Ambreen A. Delawalla, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-On-The-Market—Available Defenses to Claims under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53 (2010).

<sup>22</sup> *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006).

<sup>23</sup> *Credit Suisse Sec. (USA) LLC v. Billing*, 551 U.S. 264 (2007).

effectively given broad preemptive effect to the federal securities regime, to the detriment of state securities and antitrust law, respectively.<sup>24</sup>

A first principles-based approach would reform credit rating agencies and place greater emphasis on policing fraud. First, government could provide public ratings or require investors, rather than issuers, to pay for ratings.<sup>25</sup> At the very least, “upward adjustments and deviations from the CRA’s [credit rating agency’s] normal valuation model should be the regulatory focus.”<sup>26</sup> Second, policymakers would need to reinvigorate private antifraud suits as a deterrent to the dissemination of misleading information—perhaps it is no coincidence that scandals have mushroomed in the post-1995 legal regime. Private enforcement might also be expanded beyond securities to financial regulation generally through mechanisms such as *qui tam* suits.<sup>27</sup>

Sadly, Dodd-Frank achieves precious little on either front. To be sure, it increases internal controls, and provides for greater procedural transparency of credit rating agencies<sup>28</sup>—in a manner reminiscent of Sarbanes-Oxley.<sup>29</sup> It also creates a new SEC “Office of Credit Ratings”<sup>30</sup> while also confirming that there is a private right of action against rating agencies.<sup>31</sup> All this may be fine as far as it goes,<sup>32</sup> but the legislation does not alter the

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<sup>24</sup> See generally Melanie P. Goolsby, Note, *Merrill Lynch v. Dabit: The Case of the Scorned Broker and the Death of the State Securities Fraud Class Action Suit*, 67 LA. L. REV. 227 (2006); Stacey S. Chubbuck, Note, *Securities Law and Antitrust Law: Two Legal Titans Clash Before the United States Supreme Court in Credit Suisse Securities v. Billing*, 62 OKLA. L. REV. 145 (2009).

<sup>25</sup> See, e.g., John C. Coffee Jr., *Ratings Reform: The Good, the Bad, and the Ugly 5* (Eur. Corporate Governance Inst., Working Paper No. 162, 2010), available at <http://ssrn.com/abstract=1650802> [hereinafter Coffee, *Ratings*] (“Possible such responses include: (1) authorizing an independent body to select the rating agency; (2) mandating (and thereby effectively subsidizing) a ‘subscriber pays’ model for ratings; and (3) creating a governmental rating agency to issue ratings . . . .”); Schwarcz, *supra* note 10, at 16 (“In theory, a regulation could require investors to pay this fee, or could require an issuer to pay the fee irrespective of the rating ultimately assigned.”); Michael Lewis & David Einhorn, *How to Repair a Broken Financial World*, N.Y. TIMES, Jan. 4, 2009, at WK10 (“There should be a rule against issuers paying for ratings. Either investors should pay for them privately or, if public ratings are deemed essential, they should be publicly provided.”).

<sup>26</sup> Coffee, *Ratings*, *supra* note 25, at 56.

<sup>27</sup> See, e.g., Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 1012 (2010) (“This Article suggests that reforms should include a private enforcement mechanism that directly addresses systemic risk.”).

<sup>28</sup> See Dodd-Frank § 932.

<sup>29</sup> See Stanley Keller, *Corporate Governance, Disclosure & Capital Raising Provisions of the Dodd Frank Act*, 14 WALL STREET LAWYER 1, 9 (2010).

<sup>30</sup> See Dodd-Frank § 932(a) (modifying § 15E(p) of the Securities and Exchange Act of 1934).

<sup>31</sup> See Dodd-Frank § 933.

<sup>32</sup> Cf. Coffee, *Ratings*, *supra* note 25, at 50–51 (“An obvious (and politically

“issuer pays” business model of rating agencies.<sup>33</sup> Nor does it contemplate making credit ratings a public good. Instead, there will be studies on credit rating agency independence,<sup>34</sup> alternative credit agency business models,<sup>35</sup> the creation of an independent professional rating analyst organization,<sup>36</sup> and assigned credit ratings.<sup>37</sup> Similarly, though the statute clarifies that “recklessness” is sufficient mens rea for SEC “aiding and abetting” actions<sup>38</sup> and expands the SEC’s extraterritorial jurisdiction,<sup>39</sup> it does not reinvigorate private antifraud suits. All it does is commission studies on whether private rights of action should be extended extraterritorially<sup>40</sup> or to secondary liability<sup>41</sup>—hardly a bold legislative move.

### B. Abuse of Regulatory Gaps

A second facilitator that needs to be thwarted is the abuse of regulatory gaps. There are regrettably too many examples of actors and products that have “fallen through the cracks” of regulatory oversight.<sup>42</sup> Opportunists exploited the fact that banking, securities, commodities, and even insurance are each overseen by a different complex of regulators<sup>43</sup>—agencies that may not even share the same regulatory vision.<sup>44</sup> Significantly

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irresistible) approach toward reform of the credit rating agencies is to regulate their internal corporate governance . . . . From a policy perspective, it is difficult to place great hope on these reforms, but they are low cost reforms that may sometimes provide valuable information to experienced regulators.”)

<sup>33</sup> See, e.g., DAVID A. SKEEL, JR., *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 7 (2011) (“[T]he legislation did not eliminate the ‘issuer pays’ feature of credit ratings . . . .”).

<sup>34</sup> See Dodd-Frank § 939C.

<sup>35</sup> See Dodd-Frank § 939D.

<sup>36</sup> See Dodd-Frank § 939E.

<sup>37</sup> See Dodd-Frank § 939F.

<sup>38</sup> See Dodd-Frank §§ 929M(b), 929O.

<sup>39</sup> See Dodd-Frank § 929P(b).

<sup>40</sup> See Dodd-Frank § 929Y.

<sup>41</sup> See Dodd-Frank § 929Z.

<sup>42</sup> See, e.g., GILLIAN TETT, *FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE* 62 (2009).

<sup>43</sup> See, e.g., Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks that are Too-Big-to-Fail?* 27 n.100 (Brooklyn Law Sch. Legal Studies Research Paper Series, Research Paper No. 202, 2010), available at <http://ssrn.com/abstract=16809887> (“Commercial banking activities are regulated by the bank regulators, securities activities are regulated by the SEC and state securities commissions. Commodity futures and options activities are regulated by the CFTC, and insurance activities would be regulated by multiple state insurance regulators.”).

<sup>44</sup> See, e.g., Kara Scannell, *Exchanges Offer Varying Views as Regulators Discuss Turf*, WALL ST. J., Sept. 3, 2009, at A21 (“The two agencies [SEC and CFTC] have different philosophies in regulating markets.”); Stephen Labaton & Edmund L. Andrews, *As U.S. Overhauls Banking System, Two Top Regulators Feud*, N.Y. TIMES, Jun. 14, 2009, at A1 (“Two of the nation’s most powerful bank regulators [Comptroller of the Currency and Federal Deposit Insurance Corporation] were once again at each other’s throats.”).

and in an era of financial conglomerates, “no agency had regulatory oversight and control of subsidiaries of holding companies that sheltered off-balance sheet liabilities and threatened the viability of its parent and regulated entities.”<sup>45</sup> Of particular salience in this regard is the so-called “shadow banking” system: as the Chairman of the FDIC observes, “[t]he principal enablers of our current difficulties were institutions that took on enormous risk by exploiting regulatory gaps between banks and the nonbank shadow financial system, and by using unregulated over-the-counter derivative contracts to develop volatile and potentially dangerous products.”<sup>46</sup>

Given these fundamental problems, a first principles-based approach would strive for two basic goals: (1) simplifying and consolidating administrative agencies to resolve jurisdictional boundaries,<sup>47</sup> and (2) regulating the “shadow” financial system.<sup>48</sup>

Dodd-Frank actually achieves precious little toward achieving these goals. To improve coordination, it creates the multi-agency Financial Stability Oversight Council (FSOC)<sup>49</sup> as well as the Office of Financial Research (OFR).<sup>50</sup> While perhaps impressive at first glance, these actions are problematic. Not only have multi-agency oversight bodies been difficult to implement,<sup>51</sup> but the FSOC will be led by Treasury. Similarly, the OFR will be housed within Treasury with no mandate to

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<sup>45</sup> Karmel, *supra* note 43, at 47.

<sup>46</sup> Sheila C. Bair, *The Case Against a Super-Regulator*, N.Y. TIMES, Sept. 1, 2009, at A29. Sadly enough, “shadow” banking also contributed to prior scandals, notably Enron and Refco. *See, e.g.*, Diana B. Henriques, *Commodities: Latest Boom, Plentiful Risk*, N.Y. TIMES, Mar. 20, 2008, at A23; Deborah Solomon & Michael Schroeder, *How Refco Fell Through Regulatory Cracks; Scandal Highlights a System that Didn't Require Much Oversight of the Firm's Units*, WALL ST. J., Oct. 18, 2005, at A4.

<sup>47</sup> *See, e.g.*, Gary DeWaal, *America Must Create a Single Financial Regulator*, FIN. TIMES, May 19, 2005, at 13 (“[o]nly by amending its [financial] regulatory system and adopting unitary regulation of financial services can the US ensure it will maintain its supremacy as the home of global financial services participants.”).

<sup>48</sup> *See, e.g.*, Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. TIMES, Oct. 14, 2008, at A15 (“Companies and instruments that currently are not regulated could be brought under the government's thumb; unregulated derivatives, hedge funds, mortgage brokers and credit-rating agencies all have been implicated in the current crisis.”).

<sup>49</sup> *See* Dodd-Frank § 111. Duties of the FSOC include to “identify gaps in regulation that could pose risks to the financial stability of the United States.” Dodd-Frank § 112(a)(2)(G).

<sup>50</sup> *See* Dodd-Frank § 152(a).

<sup>51</sup> *See* Arthur E. Wilmarth, *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. (forthcoming 2011) (manuscript at 101), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1719126](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719126) (“Moreover, the future effectiveness of the FSOC is open to serious question in light of the agency turf battles and other bureaucratic failings that have plagued similar multi-agency oversight bodies in other fields of regulation . . .”). As just one example, consider that the FSOC's recommendations when resolving disputes among agencies “shall not be binding on the Federal agencies that are parties to the dispute.” Dodd-Frank § 119(d).



report its findings to the public.<sup>52</sup> The FSOC and OFR are thus likely to enhance Treasury's power.<sup>53</sup> While this may not be inherently bad, it does raise several questions: Treasury is neither an independent agency,<sup>54</sup> nor does it face the legislative and judicial scrutiny that most other administrative agencies do.<sup>55</sup> As such, delegation of power to Treasury raises serious issues in administrative law that Dodd-Frank elides.<sup>56</sup>

In terms of agency consolidation, the legislation eliminates the Office of Thrift Supervision (OTS).<sup>57</sup> But jurisdictional ambiguities—between the CFTC and the SEC and the FDIC and OCC, as just two examples—linger. This is not even to mention the irony of Dodd-Frank creating more organizations in an environment where there are already too many regulatory gaps—OFR, Federal Insurance Office (FIO),<sup>58</sup> and Bureau of Consumer Financial Protection (BCFP),<sup>59</sup> to name a few.<sup>60</sup>

Dodd-Frank's most significant attempt to close regulatory gaps is the requirement that some over-the-counter (OTC) derivative swaps<sup>61</sup> be cleared and exchange traded.<sup>62</sup> The

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<sup>52</sup> See, e.g., Kane, *supra* note 4, at 15 (“The OFR is authorized only to communicate its findings to FSOC and its member agencies and also to ‘support’ and ‘assist’ agencies in improving data collection. But it is not specifically authorized or required also to report its findings or concerns to the public.”).

<sup>53</sup> As David Skeel notes: “Yet the Treasury secretary is given leadership responsibility on the new Financial Stability Oversight Council and in other areas. Dodd-Frank also locates an enormous new research facility—the Office of Financial Research—in the Treasury Department. Control over knowledge is power, of course, which suggests that the ostensibly neutral research facility could become yet another channel of Treasury influence.” SKEEL, *supra* note 33, at 12; but see Priya Nandita Pooran, *Legislative Advances in Financial Stability in the US—the Wall Street Reform and Consumer Protection Act 2010*, 83 AMICUS CURIAE 21, 24 (Autumn 2010) (noting “greater concentration of supervisory control in the Federal Reserve”).

<sup>54</sup> See, e.g., SKEEL, *supra* note 33, at 12 (“Because the Treasury secretary is directly responsible to the President, he is the least independent, and the most political, of the financial regulators.”).

<sup>55</sup> See David Zaring, *Administration by Treasury*, 95 MINN. L. REV. 187, 190 (2010) (“Treasury has created for itself an ambit of discretion beyond the reach of the judiciary, and only somewhat within the bounds of congressional oversight. The financial crisis illustrated just how independent Treasury has become.”).

<sup>56</sup> This is perhaps unsurprising given that the initial blueprint for Dodd-Frank emerged from Treasury. See generally U.S. Dep't of Treasury, *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (2009), available at [http://www.treasury.gov/initiatives/wsr/Documents/FinalReport\\_web.pdf](http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf). See also SKEEL, *supra* note 33, at 3 (“The Dodd-Frank Act got its start in March 2009, when the Department of the Treasury released a framework it called ‘Rules for the Regulatory Road’ shortly before a major meeting of the G-20 nations.”).

<sup>57</sup> See Dodd-Frank § 313.

<sup>58</sup> See Dodd-Frank § 502(a).

<sup>59</sup> For a discussion of the BCFP see *infra* notes 113–122 and accompanying text.

<sup>60</sup> Consider, for instance, the ambiguities in regulatory authority between the newly-created BCFP and the Federal Trade Commission. See Dodd-Frank § 1031.

<sup>61</sup> Derivative swaps “trade financial outcomes such as those of changing currency rates or of long-term for short-term interest rates. Some derivatives are effectively

animating principle, of course, is that greater transparency will minimize risk.<sup>63</sup> Even here, though, there are several concerns. First, close reading of the statutory language likely suggests that only standardized swaps will need to be cleared; customized ones would not and would only be subject to capital and margin requirements.<sup>64</sup> As such, one can imagine the temptation to make contracts appear customized.<sup>65</sup> Similarly, trades by non-financial entities that are using swaps to “hedge or mitigate commercial risk” are excluded from the rule provided the CFTC is notified of how the counterparty intends to meet its financial obligations.<sup>66</sup> For its part, the clearinghouse idea itself might be fraught with peril, as Mark Roe summarizes:

Deep weaknesses afflict the clearinghouse, making it unwise to rely on it primarily, as Dodd-Frank has. First, it’s unclear whether the exchange would itself be properly incentivized to handle counterparty risk, particularly if the major derivatives dealers themselves control the clearinghouse.

Second, many types of derivatives just cannot be handled by a clearinghouse, because there’s no market price against which the

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guarantees of financial performance of a third party. One party . . . promises to pay a risk-avoiding party if a third party defaults on its financial obligations.” Mark J. Roe, *The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 546–47 (2011).

<sup>62</sup> See Dodd-Frank § 763. See also Michael Greenberger, *Is Our Economy Safe? A Proposal for Assessing the Success of Swaps Regulation under the Dodd-Frank Act* 3 (Univ. of Md. Sch. of Law, Research Paper No. 2010-50, 2010), available at <http://ssrn.com/abstract=1689174> (“The Dodd-Frank Act transforms the regulation of OTC derivatives by requiring that swaps be subject to clearing and exchange trading as well as capital and margin requirements.”).

<sup>63</sup> See SKEEL, *supra* note 33, at 5 (“Clearing reduces the risk to each of the parties directly, while exchange trading reduces risk to them and to the financial system indirectly by making the derivatives market more transparent.”).

<sup>64</sup> See Willa E. Gibson, *Clearing and Trade Execution Requirements for OTC Derivatives Swaps Under the Frank-Dodd Wall Street Reform and Consumer Protection Act* 8 (Univ. of Akron Sch. Of Law, Research Paper No. 10-12, 2010), available at <http://ssrn.com/abstract=1710822> (“[T]he Dodd-Frank Wall Street Reform Act creates a bifurcated regulatory system that effectively subjects counterparties with standardized contracts for which a liquid market exists to clearing requirements, while subjecting counterparties that trade customized OTC derivatives swap contracts to certain capital and margin requirements and reporting requirements.”). This conclusion likely emerges from a detailed reading of provisions such as section 723 (adding § 2(h)(4)(B) to the Commodity Exchange Act) which discusses swaps that “no derivative clearing organization has listed” and section 731 (adding § 4s(e)(2) to the Commodity Exchange Act) which imposes capital and margin requirements “on all swaps that are not cleared by a registered derivatives clearing organization.” Dodd-Frank §§ 723, 731.

<sup>65</sup> See Gibson, *supra* note 64, at 9 (“[W]ill the bifurcated regulatory system for OTC derivatives swap contracts incentivize market participants to customize their contracts to avoid the clearing requirements to which standardized trades are subject and to avoid the added transparency of exchange trading to which most cleared trades will be subject?”).

<sup>66</sup> See Dodd-Frank § 723 (amending section 2(h)(7)(A) of the Commodity Exchange Act). See also Greenberger, *supra* note 62, at 5 (“[R]egulators should carefully consider how they define hedging for commercial risk.”).

clearinghouse employees can mark the cleared but open transaction. Worse, one major class of derivatives—credit default swaps—face ‘jump-to-default’ risk. They look fine until the underlying security has a credit event and a huge payment is due. Collateralizing these on an exchange or clearinghouse has proven to be difficult thus far and no easy solution is available.<sup>67</sup>

Third, and insidiously, a “clearinghouse ups the ante on ‘too-big-to-fail,’ *because the clearinghouse will itself be too big to fail.*”<sup>68</sup>

In addition, ambiguities in regulatory jurisdiction regrettably still remain,<sup>69</sup> and there is nothing in the statute that requires disclosure of conflicts of interest when trading debt and its derivatives.<sup>70</sup> An approach that is impressive at first glance thus largely dissolves upon closer inspection.

One point that cannot be overemphasized is that the “shadow banking” system remains essentially unregulated. As Gary Gorton & Andrew Metrick point out, “[t]hree important gaps are in money-market mutual funds (MMMFs), securitization, and repurchase transactions (repo).”<sup>71</sup> Securitization converts debt obligations such as mortgages into pools and allows them to be moved off-balance sheet, away from regulatory and investor scrutiny.<sup>72</sup> Dodd-Frank tries to address this issue by asking a group of regulators to issue regulations on risk retention<sup>73</sup> and disclosure.<sup>74</sup> As expected, there are a variety of exemptions to the risk retention requirements, notably for

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<sup>67</sup> Roe, *supra* note 61, at 586–87.

<sup>68</sup> *Id.* at 587. Cf. Coffee, *Bail-Ins*, *supra* note 3, at 52 (noting how major stock and derivatives exchanges and the new clearinghouses “concentrate risk and so need to devise ways to avoid default.”).

<sup>69</sup> See Dodd-Frank § 712 (asking the SEC and CFTC to “consult and coordinate to the extent possible”). See also Gibson, *supra* note 64, at 11 (“[T]he Act allocates the jurisdiction of OTC derivatives swaps between the Securities Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) . . . with the exception of identified banking products, which are within the regulatory jurisdiction of prudential banking regulators.”).

<sup>70</sup> See, e.g., Jonathan C. Lipson, *Controlling Creditor Opportunism* 2–3, (Univ. of Wis. Law Sch., Legal Studies Research Paper Series Paper No. 1129, 2010), available at <http://ssrn.com/abstract=1662127> (“The secondary debt market is essentially an unregulated securities market, which Dodd-Frank does not change. Although Dodd-Frank may put some derivatives on exchanges, nothing will force a distress investor to disclose to a troubled borrower—or its other stakeholders—that it simultaneously holds debt and a short, a combination that creates obviously perverse incentives.”).

<sup>71</sup> Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System* 1 (Oct. 18, 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1676947>.

<sup>72</sup> See Linda M. Beale, *In the Wake of Financial Crisis*, CURRENT DEV. MONETARY FIN. L. (forthcoming 2011) (manuscript at 3), available at <http://ssrn.com/abstract=1681577> (“[T]he off-balance sheet treatment of securitization vehicles was a genuine factor in the crisis, and should appropriately be addressed.”).

<sup>73</sup> See Dodd-Frank § 941.

<sup>74</sup> See Dodd-Frank § 942.

“qualified residential mortgages.”<sup>75</sup> As such, the regulations are unlikely to reform the securitization market. True to form, the statute commissions a study on the “macroeconomic effects of risk retention requirements.”<sup>76</sup>

For their part, MMMFs appear similar to bank accounts, except for the inconvenient fact that after years of effective lobbying by the mutual fund industry, while MMMFs are allowed to maintain fixed net asset values (NAVs), they do not have to pay depositor insurance.<sup>77</sup> The idea, of course, would be that in exchange for this additional risk, they offer higher returns to investors. Yet, “[w]hen these funds needed insurance during the 2008 debacle, the federal government provided it free of charge, thus rewarding the fund sponsors’ apathy.”<sup>78</sup> Reform would be rather straightforward:

[w]ere these [money market mutual] funds required to use the same pricing system [floating net asset values (NAVs)] as every other mutual fund or to contribute the same deposit insurance premia as bank accounts, they would either look a great deal less like those bank accounts or generate materially lower but more risk-appropriate yields.<sup>79</sup>

Dodd-Frank, however, does not adopt either of these approaches.

Finally, there are repurchase agreements, known as “repo” in the jargon.<sup>80</sup> The repo problem is similar to that of MMMFs in

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<sup>75</sup> See Dodd-Frank § 941 (adding section 15G(e)(4)(B) to the Securities Exchange Act of 1934).

<sup>76</sup> Dodd-Frank § 946.

<sup>77</sup> The history of how this came to be is not altogether inspiring:

[T]hroughout the 1970s, sponsors of mutual funds petitioned the SEC for, and received, exemptions to use an alternative to the mark-to-market accounting technique. By using a method known as amortized-cost accounting, money market funds could maintain a stable NAV [net asset value] that looks much more like the valuation of a bank deposit, thus dramatically closing the gap in appearances between the two instruments.

Birdthistle, *supra* note 8, at 1174. See also *id.* at 1170 (“And thus with a switch from floating to fixed pricing was laid the foundation of the massive run on money market funds that occurred during the 2008 financial crisis.”).

<sup>78</sup> *Id.* at 1162–63.

<sup>79</sup> *Id.* at 1161.

<sup>80</sup> A repurchase agreement,

is a sale of a financial instrument, such as a treasury bill, with the seller promising to buy that asset back, often the next day. The agreed repurchase price is a little higher than the sale price, with the difference being the *de facto* interest. The instrument sold is usually called the collateral, as the transaction is functionally a loan. Repos are typically used to finance a firm, often a financial firm.

Roe, *supra* note 61, at 546. See also Beale, *supra* note 72, (manuscript at 4) (“For example, banks (and other firms) conducted ‘repo’ deals—purported sales transactions with repurchase arrangements that in reality functioned as financings—to make their balance sheets appear less leveraged.”).

that both “were initially perceived as safe and ‘money-like’, but later found to be imperfectly collateralized.”<sup>81</sup> The mechanism behind overuse of repo, however, is different: “For large depositors, repo can act as a substitute for insured demand deposits because repo agreements are explicitly excluded under Chapter 11: that is they are not subject to the automatic stay [which protects debtors from creditor actions].”<sup>82</sup> As such, “the bankruptcy ‘safe harbor’ for repo has been a crucial feature in the growth of shadow banking . . . .”<sup>83</sup> This subsidy—garnered in part through effective lobbying,<sup>84</sup> much like MMMFs’ fixed NAVs<sup>85</sup>—“encourages risky, knife’s-edge financing, which, when pursued in financially central firms, transfers risks to the United States as the ultimate guarantor of the key firms’ solvency. We get more derivatives and repo activity than we would otherwise. Financial resiliency is drained; market discipline, weakened.”<sup>86</sup> A straightforward and effective approach would have been for Dodd-Frank to modify the priorities in bankruptcy.<sup>87</sup>

In sum, Dodd-Frank’s willingness to close regulatory gaps appears limited: it “conspicuously avoids . . . regulatory consolidation among the nation’s illogical morass of financial regulators”<sup>88</sup> while doing precious little to regulate the “shadow banking” system.

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<sup>81</sup> Gorton & Metrick, *supra* note 71, at 16.

<sup>82</sup> *Id.* at 12. As Mark Roe elaborates:

Chapter 11 typically bars creditors from collecting on their loans from the bankrupt debtor, requires that creditors who preferentially seize security or get themselves repaid on the eve of bankruptcy return the assets seized or the repayment made, requires that fraudulent conveyances be recaptured by the debtor, and allows the debtor, but not the creditor, to affirm or reject outstanding contracts.

None of these rules apply to a bankrupt’s derivatives and repo counterparties. Instead, derivatives and repo players can seize collateral, more widely net out gains and losses on open contracts, terminate contracts, and keep eve-of-bankruptcy preference payments from the debtor that favor them over other creditors. Their privileged capacity to jump the queue can induce a run on the failing financial institution, and such a run may have hit AIG, Bear Stearns, and Lehman, deepening and extending the recent financial crisis.

Roe, *supra* note 61, at 588.

<sup>83</sup> Gorton & Metrick, *supra* note 71, at 3.

<sup>84</sup> See Roe, *supra* note 61, at 548 (“Regulators and lobbyists sought the exceptions when the derivatives market was young, partly to clarify some treatment issues, partly due to effective lobbying of the derivatives players, and partly due to a regulatory belief that such financial markets were sufficiently beneficial to warrant special treatment.”).

<sup>85</sup> See *supra* note 77 and accompanying text.

<sup>86</sup> Roe, *supra* note 61, at 546.

<sup>87</sup> See, e.g., *id.* at 549 (claiming it would have been better to have modified the derivatives and repo priorities in the Dodd-Frank financial package).

<sup>88</sup> Lawrence G. Baxter, *Did We Tame the Beast: Views on the US Financial Reform Bill*, 2 J. REGULATION & RISK 209, 210 (2010).

### C. Exploitation of Credulous Consumers

A third facilitator has been the exploitation of credulous consumers and investors, upon whom an ever-increasing array of financial products and decisions has been foisted. Regrettably, too many consumers are making risky life-changing decisions without having sufficient knowledge of financial basics such as the time value of money or the implications of credit.<sup>89</sup> A first principles-based approach would pay particular attention to the regulation of advisers and funds who too often have not placed their clients' interests ahead of their own, as well as to the self-regulatory organizations (SROs)<sup>90</sup> who, while imposing a significant compliance cost in regulating financial advisers and markets, have remained curiously ineffectual in recognizing and remedying major scandals and crises.<sup>91</sup> It would also seek to improve the financial literacy of the population. Unfortunately, though, while Dodd-Frank does introduce a few arguably positive developments, its provisions are unlikely to do much to stem this facilitator.

When it comes to regulating advisers, the statute does create a category of private advisers who must register with the SEC.<sup>92</sup> Yet one should question the impact such registration will have. After all, registered broker-dealers and investment advisers have been involved in shocking fraud: recall, as just one particularly troubling example, that Bernard Madoff's operations were registered as both a broker-dealer and as an investment adviser.<sup>93</sup> To the extent one argues that such registration is even useful, the statute contains a significant loophole for so-called "foreign private advisers"—defined based on the number of U.S.

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<sup>89</sup> See, e.g., Thomas F. Cooley, *America's Financial Illiteracy*, FORBES.COM (Jan. 1, 2010, 12:01 AM EST), <http://www.forbes.com/2010/01/12/cfpa-financial-illiteracy-credit-cards-opinions-columnists-thomas-f-cooley.html>.

<sup>90</sup> Perhaps the most prominent contemporary SRO is the Financial Industry Regulatory Authority (FINRA). FINRA was "[c]reated in July 2007 through the consolidation of NASD [National Association of Securities Dealers] and the member regulation, enforcement and arbitration functions of the New York Stock Exchange." *Securities Regulation Resource Guide*, CLEVELAND-MARSHALL COLLEGE OF LAW, <http://devel-drupal.law.csuohio.edu/lawlibrary/resources/lawpubs/SecuritiesRegulationResourceGuide.html>.

<sup>91</sup> As one article in the business press points out, "Wall Street's self-regulators have missed virtually all of the major securities scandals of the past two decades—from troubles that brought down Kidder Peabody, to analysts' conflicts, to favoritism in awarding initial-public-offering shares, to trading abuses at the Nasdaq Stock Market." Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, at A1.

<sup>92</sup> See Dodd-Frank §§ 402-403.

<sup>93</sup> See, e.g., Liz Moyer, *How Regulators Missed Madoff*, FORBES.COM (Jan. 27, 2009, 3:20 PM EST), [http://www.forbes.com/2009/01/27/bernard-madoff-sec-business-wall-street\\_0127\\_regulators.html](http://www.forbes.com/2009/01/27/bernard-madoff-sec-business-wall-street_0127_regulators.html).

investors and amounts of capital managed on behalf of U.S. investors,<sup>94</sup> but not on U.S. securities holdings.<sup>95</sup> Perhaps unsurprisingly, major issues such as the obligations of broker-dealers,<sup>96</sup> the examination of investment advisers,<sup>97</sup> and investor access to information on investment advisers and broker-dealers<sup>98</sup> are deferred to further study. Similarly the regulation of SROs is essentially limited to giving the SEC authority to restrict pre-dispute arbitration,<sup>99</sup> while calling for more study of whether it would be worthwhile to have SROs for investment advisers<sup>100</sup> or private funds.<sup>101</sup>

Even more troubling is the lack of attention to consumer education. To be sure, the statute does make it more difficult to qualify as an “accredited investor” who has access to unregistered securities products,<sup>102</sup> but to the extent income or net worth is even a proxy for financial sophistication, one could be forgiven for wondering whether tweaking the definition will make any difference. As one might expect, we are treated to a cornucopia of future studies: issues as significant as financial literacy among investors,<sup>103</sup> mutual fund advertising,<sup>104</sup> financial planners and financial designations,<sup>105</sup> the thresholds for accredited investors,<sup>106</sup> credit scores,<sup>107</sup> and person to person lending,<sup>108</sup> are left for another day. In the same vein, one might wonder what impact the new mortgage lending standards outlined in the

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<sup>94</sup> See Dodd-Frank § 402(a). See also Michael I. Overmyer, Note, *The “Foreign Private Adviser” Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110 COLUM. L. REV. 2185, 2186–87 (2010) (“The WSRCPA [Dodd-Frank] excludes from its registration requirement foreign hedge fund managers whose funds do not meet certain thresholds regarding numbers of U.S. investors or amounts of capital managed on behalf of U.S. investors.”).

<sup>95</sup> As one observer summarizes it, “[m]anagers of hedge funds based in another country and that lack significant participation from American investors, but which nonetheless could contribute to systemic risk in the U.S. economy, do not need to register.” *Id.* at 2213. The suggestion would be that “U.S. law should require managers of foreign hedge funds with a sufficiently large presence in U.S. markets to register with the SEC.” *Id.* at 2219.

<sup>96</sup> See Dodd-Frank § 913. See also Reza Dibadj, *Brokers, Fiduciaries and a Beginning*, 30 REV. OF BANKING AND FIN. L. 205 (2011) (discussing the possibility of fiduciary duties for brokers).

<sup>97</sup> See Dodd-Frank § 914.

<sup>98</sup> See Dodd-Frank § 919B.

<sup>99</sup> See Dodd-Frank § 921.

<sup>100</sup> See Dodd-Frank § 914(a)(2)(B).

<sup>101</sup> See Dodd-Frank § 416.

<sup>102</sup> The new standard excludes an investor’s primary residence in calculating the one million dollar net worth threshold. See Dodd-Frank § 413(a).

<sup>103</sup> See Dodd-Frank § 917.

<sup>104</sup> See Dodd-Frank § 918.

<sup>105</sup> See Dodd-Frank § 919C.

<sup>106</sup> See Dodd-Frank § 415.

<sup>107</sup> See Dodd-Frank § 1078(a).

<sup>108</sup> See Dodd-Frank § 989F(a)(1).

statute<sup>109</sup> will have and simply note that important topics—reverse mortgages,<sup>110</sup> appraisal methods,<sup>111</sup> mortgage foreclosure rescue scams and loan modification fraud<sup>112</sup>—are once again simply remitted to future study.

Finally, arguably the best hope the statute provides in protecting consumers is the creation of the Bureau of Consumer Financial Protection (BCFP)<sup>113</sup> “for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”<sup>114</sup> Though it is too early to assess the BCFP’s performance, a careful reading of the statute raises some concerns. For example, the BCFP will operate under the auspices of the Federal Reserve System (Federal Reserve),<sup>115</sup> an entity whose primary focus is not consumer protection; its decisions can be set aside by the FSOC,<sup>116</sup> and it is not authorized to impose a usury limit.<sup>117</sup> Furthermore, no private right of action is created to supplement the BCFP’s enforcement.<sup>118</sup> Of perhaps greatest concern is that the statutory authority given to the BCFP to address “unfair” practices is actually not one predicated on consumer protection, but mandates a cost-benefit analysis focused on overall economic efficiency.<sup>119</sup> While there might be some hope in the additional “abusive” standard Dodd-Frank articulates,<sup>120</sup> one could be

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<sup>109</sup> See Dodd-Frank § 1411.

<sup>110</sup> See Dodd-Frank § 1076.

<sup>111</sup> See Dodd-Frank § 1476(a)(1)(A).

<sup>112</sup> See Dodd-Frank § 1492.

<sup>113</sup> See Dodd-Frank § 1011.

<sup>114</sup> Dodd-Frank § 1021(a). See also SKEEL, *supra* note 33 at 14 (noting that the BCFP was created “to serve as a consumer watchdog with respect to credit card and mortgage practices”).

<sup>115</sup> See Dodd-Frank § 1011(a).

<sup>116</sup> See Dodd-Frank § 1023.

<sup>117</sup> See Dodd-Frank § 1027(o).

<sup>118</sup> See, e.g., Carey Alexander, *Abusive: Dodd-Frank Section 1031 and the Continuing Struggle to Protect Consumers* 17–18 (St. John’s Univ. Legal Studies Research Paper Series, Paper No. 10-193 2011), available at <http://ssrn.com/abstract=1719600> (“The CFPB [Consumer Financial Protection Bureau], by contrast, does not need to set the bar for abusive conduct nearly as high as the FDCPA [Fair Debt Collection Practice Act] because Dodd-Frank does not authorize a private right of action.”).

<sup>119</sup> See Dodd-Frank § 1031(c)(1).

<sup>120</sup> Section 1031(d) states that an “act or practice” cannot be deemed “abusive” unless it:

- (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- (2) takes unreasonable advantage of—
  - (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or



forgiven for lamenting that “Congress has, for the first time in recent memory, subordinated the goal of fairness in consumer credit transactions to a new goal of economic efficiency.”<sup>121</sup> To the extent the BCFP flexes its muscles, one can only imagine the spate of lawsuits alleging it exceeded its statutory authority. In sum, “the future landscape for the field of consumer financial protection is filled with uncertainty.”<sup>122</sup>

#### D. Use of Corporate Size to Privatize Profits and Socialize Losses

In addition to the dissemination of misleading information, abuse of regulatory gaps, and exploitation of credulous consumers, there is one additional crucial facilitator: the ability to use corporate size to privatize profits and socialize costs. With the creation of corporate behemoths via mergers and acquisitions, industries such as financial services have become increasingly concentrated and oligopolistic.<sup>123</sup>

Large companies become so large and complex that they emerge as “too-big-to-fail” (TBTF)—a clever posture that internalizes profits when things go well and externalizes costs when they do not. It is perhaps easy to forget that the financial actors at the center of the financial meltdown were chasing higher profits by extending subprime loans and trading esoteric financial products. All this may be fine as far as it goes, of course, provided that these same actors suffer the financial repercussions of their risky behavior if things go wrong. Instead, these apparently sophisticated actors turned to the federal

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(C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

Dodd-Frank § 1031(d). *See also* Alexander, *supra* note 118, at 20 (“Congress’s enactment of a flexible definition of abusive, coupled with Congress’s clear dissatisfaction with the Fed’s narrow interpretation of its powers to reach abusive practices suggests that the CFPB should adopt a broad, expansive interpretation of its powers to address abusive practices.”); Vincent di Lorenzo, *The Federal Financial Consumer Protection Agency: A New Era of Protection or More of the Same?* 89–90 (St. John’s Univ. Legal Studies Research Paper Series No. 10-0182, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1674016](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1674016) (explaining that if the “abusive” standard were in practice from 2002–2008 it “would have allowed the Bureau to prohibit or regulate many loan products and practices”); Boyack, *supra* note 9, at 60 (“The addition of the word ‘abusive’ in the Dodd-Frank Act, however, suggests an expanded definition of liability.”).

<sup>121</sup> Di Lorenzo, *supra* note 120, at 84. *See also id.* (“Two consequences surface from the embrace by Congress of a net societal benefits standard for future regulatory intervention: (a) the adverse legislative signal created by Congress, and (b) the possibility of a less responsive Consumer Protection Bureau.”).

<sup>122</sup> *Id.* at 85.

<sup>123</sup> *See, e.g.,* Reza Dibadj, *Deregulation: A Tragedy in Three Acts*, WASH. POST, Sept. 13, 2003, at A21.

government for a bailout under the theory that they are simply TBTF.<sup>124</sup>

The culminating affront here, of course, is that it is the individual—the ordinary taxpayer who has already suffered mightily as shareholder and consumer—who is asked to be the insurer of last resort and reallocate resources to financial actors who were imprudent in the first place.<sup>125</sup> Above all, TBTF facilitates hypocrisy: it extols the virtues of free markets and private profits, then conveniently comes begging to Washington to socialize the losses.<sup>126</sup>

At the root of TBTF is antitrust policy that over the past forty years has stood idly by and condoned the creation of large corporate behemoths in a variety of industries, including financial services.<sup>127</sup> Consider that by 1999 advocates of deregulation obtained the formal repeal of the Glass-Steagall Act, which had separated commercial from investment banking—successfully arguing that antitrust laws would forbid mergers unfriendly to consumers.<sup>128</sup> The following decade witnessed an explosion of bank mergers and acquisitions,<sup>129</sup> followed by our current bailout woes.<sup>130</sup>

Simply put, a first principles-based approach would enforce the antitrust laws.<sup>131</sup> Sadly enough, the current ethos has lost

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<sup>124</sup> Reza Dibadj, *How Does the Government Interact with Business?: From History to Controversies*, 5 ENTREPRENEURIAL BUS. L.J. 707, 722 (2010). Cf. Baxter, *supra* note 88, at 212 (“Despite their assertions of efficiencies of scale, these financial conglomerates have long ceased to be as efficient as their smaller counterparts. So their economic value is questionable. What is worse is that the value of the *de facto* public subsidies they enjoy is substantial.”).

<sup>125</sup> See *e.g.*, Schooner, *supra* note 27, at 1011 (“Ultimately, much of the costs of systemic crisis are borne by the taxpayer.”).

<sup>126</sup> Cf. Alan Freeman & Elizabeth Mensch, *The Public-Private Distinction in American Law and Life*, 36 BUFF. L. REV. 237, 249 (1987) (“Private companies rarely turn down the opportunity to feed greedily at the public trough.”).

<sup>127</sup> See, *e.g.*, Gary Minda, *Antitrust at Century's End*, 48 SMU L. REV. 1749, 1769 (1995); Frederick M. Rowe, *The Decline of Antitrust and the Delusions of Models: The Faustian Pact of Law and Economics*, 72 GEO. L.J. 1511, 1527–28 (1984). A leading antitrust monograph even declares that the “very ubiquity of merger-created efficiencies is why we evaluate mergers under a fairly benign set of rules.” HERBERT HOVENKAMP, *THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION* 219 (2005).

<sup>128</sup> See Aigbe Akhigbe & Ann Marie Whyte, 36 FIN. REV. 119, 120 (2001).

<sup>129</sup> See, *e.g.*, Wilmarth, *supra* note 51, (manuscript at 33) (“All of today’s four largest U.S. banks (BoFA, Chase, Citigroup and Wells Fargo) are the products of serial acquisitions and explosive growth since 1990.”).

<sup>130</sup> It is fascinating to observe how policymakers enamored of simplistic deregulation were able to assuage critics by casting off responsibility to antitrust. Later, when faced with deregulation’s shortcomings, the deregulators could conveniently shift the blame to lax antitrust enforcement like the child’s game of “hot potato.” See Reza Dibadj, *Saving Antitrust*, 75 U. COLO. L. REV. 745, 747 (2004).

<sup>131</sup> See, *e.g.*, Beale, *supra* note 72, (manuscript at 23) (“Rather than continue to encourage consolidation of financial institutions, we likely need to revamp our antitrust

sight of the fact that antitrust “was premised upon a political judgment that decentralized market power was essential to a free society.”<sup>132</sup> It is time to reconsider whether contemporary antitrust policy should be so demure. To the extent financial conglomerates are already too big, they would be disaggregated.<sup>133</sup> Note, by contrast, that “the emergency acquisitions of LCFIs [large, complex financial institutions] arranged by U.S. regulators have produced domestic financial markets in which the largest institutions hold even greater dominance.”<sup>134</sup> The supervening irony, of course, is that taxpayers have unwittingly funded the next round of consolidation.

Perhaps it is unsurprising by now to observe that Dodd-Frank does not take this straightforward structural approach;<sup>135</sup> rather, it is peppered with provisions that seem impressive at first glance but run the risk of being largely ineffectual. Overall, “Dodd-Frank sets forth no comprehensive plan for controlling the size or complexity of the mega-banks.”<sup>136</sup> Predictably, issues such as concentration limits<sup>137</sup> and the effect of size and complexity of financial institutions<sup>138</sup> are left to further study.

Reaching this pessimistic conclusion, however, requires a careful reading of Dodd-Frank’s multiple provisions that ostensibly seek to stop TBTF. To begin with, there are several measures that would appear to prevent another systemic meltdown by limiting size and enhancing capital requirements.

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policies to recognize that concentrated power in an industry that arises from sheer size, leverage, and interconnectedness may merit the trust-busting power of the anti-trust rules.”).

<sup>132</sup> Minda, *supra* note 127, at 1755.

<sup>133</sup> As two commentators suggest:

If a failing firm is deemed “too big” for that honor, then it should be explicitly nationalized, both to limit its effect on other firms and to protect the guts of the system. Its shareholders should be wiped out, and its management replaced. Its valuable parts should be sold off as functioning businesses to the highest bidders—perhaps to some bank that was not swept up in the credit bubble. The rest should be liquidated, in calm markets. Do this and, for everyone except the firms that invented the mess, the pain will likely subside.

Lewis & Einhorn, *supra* note 25, at WK10.

<sup>134</sup> Wilmarth, *supra* note 51, (manuscript at 34).

<sup>135</sup> *See id.* at 2 (“Dodd-Frank fails to make fundamental structural reforms that could largely eliminate the subsidies currently exploited by LCFIs [large, complex financial institutions].”).

<sup>136</sup> Karmel, *supra* note 43, at 48. *See also id.* at 7 (“[U]nder Dodd-Frank, functional regulation remains in place so that different agencies with different approaches continue to regulate financial institutions and markets, and the largest financial institutions have grown even large than they were before, thus increasing the risks and costs of their failure.”).

<sup>137</sup> *See* Dodd-Frank § 123.

<sup>138</sup> *See* Dodd-Frank § 622 (modifying § 14(e) of the Bank Holding Company Act of 1956).

First, the statute imposes a ten percent nationwide deposit cap.<sup>139</sup> However, a similar cap has been in existence since the 1994 Riegle-Neal Act<sup>140</sup>—Dodd-Frank merely extends the Riegle-Neal limits to mergers involving thrifts and industrial banks.<sup>141</sup> Crucially, as one scholar observes:

[Section] 623 leaves open the other Riegle-Neal loopholes because (1) it does not apply the nationwide deposit cap to intrastate acquisitions or mergers, (2) it does not apply the statewide deposit cap to interstate transactions involving thrifts or industrial banks or to any type of intrastate transaction, and (3) it does not impose any enhanced substantive or procedural requirements for invoking the failing bank exception.<sup>142</sup>

These loopholes, notably the “failing bank exception,” render the benefit of the ten percent cap largely illusory.<sup>143</sup>

Second, the so-called Kanjorski Amendment<sup>144</sup> “provides the FRB [Federal Reserve Board] with potential authority to require large BHCs [bank holding companies] or nonbank SIFIs [systemically important financial institutions] to divest high-risk operations.”<sup>145</sup> Unfortunately, however, this power is subject to strict procedural requirements<sup>146</sup> making it very unlikely to ever apply.<sup>147</sup>

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<sup>139</sup> See Dodd-Frank § 623.

<sup>140</sup> See Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (Sept. 29, 1994).

<sup>141</sup> See, e.g., Wilmarth, *supra* note 51, (manuscript at 40) (“Section 623 of Dodd-Frank does extend Riegle-Neal’s ten percent nationwide deposit cap to reach all interstate acquisitions and mergers involving any type of FDIC-insured depository institution. Thus, interstate acquisitions and mergers involving thrift institutions and industrial banks are now subject to the nationwide deposit cap to the same extent as interstate acquisitions and mergers involving commercial banks.”).

<sup>142</sup> *Id.*

<sup>143</sup> See *id.* (manuscript at 4) (“Congress did not adequately strengthen statutory limits on the ability of LCFIs to grow through mergers and acquisitions.”). Section 622 does impose a ten percent liability cap on mergers and acquisitions of financial companies “[s]ubject to the recommendations” of the FSOC. See Dodd-Frank § 622 (modifying § 14(c) of the Bank Holding Act of 1956). This concentration limit, however, maintains the failing bank exception. See Dodd-Frank § 622 (modifying § 14(c) of the Bank Holding Act of 1956). In addition, as one author suggests, “LCFIs [large, complex financial institutions] will almost certainly urge the FSOC to weaken or remove the liabilities cap under § 622.” Wilmarth, *supra* note 51, (manuscript at 42).

<sup>144</sup> See Wilmarth, *supra* note 51, (manuscript at 71). See also Dodd-Frank § 121(a) (codifying the “Kanjorski Amendment”).

<sup>145</sup> Wilmarth, *supra* note 51, (manuscript at 71).

<sup>146</sup> See Dodd-Frank § 121(b) (discussing various notice and hearing requirements).

<sup>147</sup> See, e.g., Wilmarth, *supra* note 51, (manuscript at 72) (“The FRB’s divestiture authority under § 121 is thus a last resort, and it is restricted by numerous procedural requirements (including, most notably, a two-thirds vote by the FSOC). . . . [Thus,] the prospects for an FRB-ordered breakup of a SIFI seem remote at best.”).

Third, the Collins Amendment outlines risk-based and leverage capital standards.<sup>148</sup> Even here, however, there are at least two problems. First, the amendment defers to agencies to establish parameters for both minimum leverage capital<sup>149</sup> and minimum risk-based capital.<sup>150</sup> Second, and more importantly, capital-based regulation has repeatedly been unsuccessful in preventing financial crises.<sup>151</sup> As one might expect, the statute even commissions a study on holding company capital requirements.<sup>152</sup>

Two other provisions, arguably more complex in scope, seek to limit interconnectedness rather than simply size or risky capital. At first glance, “the Volcker Rule generally prohibits banks from engaging in proprietary trading (that is, trading that is on its own behalf and not a customer’s) or acquiring or retaining an interest in a hedge fund or private equity fund.”<sup>153</sup> Closer reading, however, reveals a number of exceptions: non-bank financial companies,<sup>154</sup> certain financial instruments,<sup>155</sup> and “[r]isk-mitigating hedging activities”<sup>156</sup> are excluded; “proprietary” is a rather loose term of art;<sup>157</sup> and banks are

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<sup>148</sup> See Dodd-Frank § 171.

<sup>149</sup> See Dodd-Frank § 171(b)(1).

<sup>150</sup> See Dodd-Frank § 171(b)(2).

<sup>151</sup> See, e.g., Wilmarth, *supra* note 51, (manuscript at 100) (“Dodd-Frank (like Basel III) relies primarily on the same supervisory tool—capital-based regulation—that failed to prevent the banking and thrift crises of the 1980s as well as the current financial crisis.”).

<sup>152</sup> See Dodd-Frank § 174. Perhaps the one bright spot is the power given to the Federal Reserve to require financial entities “to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.” Dodd-Frank § 165(c)(1). See also Coffee, *Bail-Ins*, *supra* note 3, at 43 (“Contingent capital achieves two objectives at once: (1) avoidance of default, and (2) alteration of voting power.”).

<sup>153</sup> Greenberger, *supra* note 62, at 4. See also Dodd-Frank § 619 (prohibiting banks from engaging in proprietary trading).

<sup>154</sup> See Dodd-Frank § 619(a)(2) (amending § 13(a)(2) of the Bank Holding Company Act of 1956).

<sup>155</sup> See Dodd-Frank § 619 (amending § 13(d)(1)(A) of the Bank Holding Company Act of 1956). See also Malcolm S. Salter, *Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector* 23 (Harvard Bus. Sch., Working Paper No. 11-060, 2010), available at <http://ssrn.com/abstract=1726004> (“The act’s ban on proprietary trading also allows banks to engage in trade in several other types of instruments, such as those issued by Ginnie Mae, Fannie Mac, the Federal Home Loan Bank, two federal agricultural banking institutions, and states and municipalities.”).

<sup>156</sup> Dodd-Frank § 619(d)(1)(C) (amending § 13(d)(1)(A) of the Bank Holding Company Act of 1956).

<sup>157</sup> See, e.g., Dodd-Frank § 619(d)(1)(B) (revising § 13(d)(1)(B) of the Bank Holding Company Act of 1956) (permitting “[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . in connection with underwriting or market-making-related activities, to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties”); Dodd-Frank § 619(d)(1)(D) (revising § 13(d)(1)(D) of the Bank Holding Company Act of 1956) (permitting “[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers.”). See also SKEEL, *supra* note 33, at 10 (“Although the Volcker Rule is forcing banks to adjust their operations, the concept of

allowed to invest up to three percent of their capital in activities prohibited by the Volcker Rule<sup>158</sup>—a significant amount when it comes to a bank trading on its own behalf.<sup>159</sup> Par for the course, the statute defers to further study the real issues behind bank investment activities<sup>160</sup> and proprietary trading.<sup>161</sup>

The second provision seeking to limit interconnectedness is the Lincoln Amendment or “Push-Out” rule “which prohibits federal assistance to any bank operating as a swap dealer.”<sup>162</sup> Yet, once again, the rule contains numerous loopholes.<sup>163</sup>

Beyond these purported attempts to manage TBTF, and presumably as a last resort, Dodd-Frank establishes an orderly liquidation authority (OLA) to mitigate economic fallout if a systemically important financial institution fails.<sup>164</sup> OLA, however, is fraught with both obvious and subtle problems. It “does not require SIFIs [systemically important financial institutions] to pay risk-based assessments to pre-fund the Orderly Liquidation Fund (“OLF”), which will cover the costs of resolving failed SIFIs. Instead, the OLF will have to borrow the necessary funds in the first instance from the Treasury (i.e., the taxpayers).”<sup>165</sup> Like much of Dodd-Frank, OLA operates at the

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proprietary trading is so slippery that its application will depend on how, and how strictly, regulators interpret it.”). As one example of gamesmanship, consider the “view that the [Volcker Rule] could be gamed by having traders trade in contemplation of potential trades a client may want to do in order to have an inventory of financial assets readily available.” Beale, *supra* note 72, (manuscript at 24).

<sup>158</sup> See, e.g., Dodd-Frank § 619(d)(4)(B)(ii)(II) (“[I]n no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.”).

<sup>159</sup> See, e.g., Salter, *supra* note 155, at 23 (“The best way to understand the connection is to consider the 3 percent rule as a massive loophole that allows every banking entity in America to skirt the ban on risky proprietary trading by investing as much as 3 percent of their capital in such funds.”).

<sup>160</sup> See Dodd-Frank § 620.

<sup>161</sup> See Dodd-Frank § 989(b)(1).

<sup>162</sup> Greenberger, *supra* note 62, at 4. “Federal assistance is defined broadly to include, *inter alia*, federal deposit insurance or access to the Federal Reserve’s discount window.” *Id.* See also Dodd-Frank § 716(b)(1).

<sup>163</sup> As one scholar outlines:

As enacted, the Lincoln Amendment allows an FDIC-insured bank to act as a swaps dealer with regard to (i) “[h]edging and other similar risk mitigating activities directly related to the [bank’s] activities,” (ii) swaps involving interest rates, currency rates and other “reference assets that are permissible for investment by a national bank,” including gold and silver but not other types of metals, energy, or agricultural commodities, and (iii) credit default swaps that are cleared pursuant to Dodd-Frank and carry investment-grade ratings.

Wilmarth, *supra* note 51, (manuscript at 79–80) (quoting Dodd-Frank § 716(d)).

<sup>164</sup> See Dodd-Frank § 204(a) (“It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.”).

<sup>165</sup> Wilmarth, *supra* note 51, (manuscript at 4–5). See also *id.* (manuscript at 64) (“It is contrary to customary insurance principles to establish an OLF that is funded only

discretion of regulators<sup>166</sup>—notably, the Treasury.<sup>167</sup> More subtly, OLA may end up acting at a point when it is already too late to salvage a firm. John Coffee points out the irony:

Essentially, it [Dodd-Frank] denies bank regulators the ability to target funds to threatened financial institutions, except in cases where the financial institution is to be liquidated pursuant to the FDIC's resolution authority. Thus, the FDIC can advance funds, or guarantee debts, to those firms under the death sentence of liquidation, but neither it nor the Federal Reserve can do much to help the potentially solvent firm that is teetering on the brink. Because most financial firms are unlikely to concede that they are insolvent (but may readily acknowledge that they need liquidity), the central banker after Dodd-Frank is unlikely to perform its traditional "lender of last resort" function and must act more as a financial undertaker.<sup>168</sup>

In addition, OLA simply creates a parallel bankruptcy regime to Chapter 11. Not only is it unclear exactly to which financial entities OLA will apply,<sup>169</sup> "[b]ut by developing a new system for addressing financial distress, instead of integrating the new system into the existing structure of the Bankruptcy Code, the financial reform act simply recreates the prior problem in a new place."<sup>170</sup> In sum, "contrary to the statute's stated purpose, Dodd-Frank's OLA does not preclude future bailouts for creditors of TBTF institutions."<sup>171</sup> As is typical throughout Dodd-Frank, the issue of a bankruptcy process for financial institutions remains a subject for further study.<sup>172</sup>

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after a SIFI fails and must be liquidated."). The assessments the OLA contemplates are imposed *ex post*. See, e.g., Dodd-Frank § 210(o)(1)(D).

<sup>166</sup> See, e.g., Stephen J. Lubben, *The Risks of Fractured Resolution—Financial Institutions and Bankruptcy* 13 (Seton Hall Univ. Sch. of Law, Pub. Law Research Paper No. 1726944, 2010), available at <http://ssrn.com/abstract=1726944> ("[T]he new resolution authority is a process that must be invoked by regulators, and thus might be subject to delay or even neglect if the regulators disdain the new procedures.").

<sup>167</sup> See, e.g., *id.* at 17 ("The key player in initiation is the Treasury Secretary, an inherently political actor who is unlikely to be able to make commitments that will last beyond any particular Secretary's term in office."). For a discussion of Treasury as regulator, see *supra* notes 51–56, and accompanying text.

<sup>168</sup> Coffee, *Bail-Ins*, *supra* note 3, at 30.

<sup>169</sup> In the words of one bankruptcy scholar:

Save for when the Dodd-Frank Act's new resolution authority applies, chapter 11 remains the primary instrument for resolving financial institutions. Unless a specialized regime is in place, such as those for banks or insurance companies, chapter 11 will apply. Thus, hedge funds, private equity funds, investment banks, and the parent companies of banks and insurance companies will all face resolution under chapter 11 unless the entity in question can be resolved under the new resolution authority and the Secretary of the Treasury decides to invoke the authority . . . .

Lubben, *supra* note 166, at 7.

<sup>170</sup> *Id.* at 3.

<sup>171</sup> Wilmarth, *supra* note 51, (manuscript at 43).

<sup>172</sup> See Dodd-Frank § 216.

Overall, after Dodd-Frank, financial institutions will still be able to use their size to privatize profits and socialize losses. As David Skeel notes:

Unlike in the New Deal, there is no serious effort to break the largest of these banks up or to meaningfully scale them down. Because they are special, and because no one really believes the largest will be allowed to fail, they will have a competitive advantage over other financial institutions.<sup>173</sup>

In the words of Lawrence Baxter, a current academic and former bank executive, “as long as these LCFIs [large, complex financial institutions] operate at their current scale and complexity, the financial system will remain fragile and vulnerable to massive sudden shocks.”<sup>174</sup> Indeed, Baxter warns that “[i]f Congress, after the kind of crisis we have just been through, cannot itself impose scale limitations on very large financial institutions, I don’t think the regulators will ever be in a position to shut them down.”<sup>175</sup> Put bluntly, Dodd-Frank does precious little to prevent or even mitigate TBTF.

## II. POLITICAL ECONOMY OF FINANCIAL LEGISLATION

Why these ambiguities, deferrals, and further studies? In other words, why would sophisticated lawmakers choose largely to defer issues rather than confront them simply and directly? While there are benefits to delegating to agencies, the main factor underlying this voluminous legislation—which ironically postpones the major questions surrounding the financial crisis—lies in the political economy of twenty-first century politics and the jostling among interest groups.<sup>176</sup> By contrast, a path forward may lie in structural reform of the legislative process.

To begin with, it is important to recognize the potentially important benefits of delegating to administrative agencies. Congress obviously has a full agenda and cannot do everything itself. Agencies have access to information<sup>177</sup> and the resources

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<sup>173</sup> SKEEL, *supra* note 33, at 9. *See also* Baxter, *supra* note 88, at 213 (“One obvious way would have been to impose limitations on the size of financial institutions. An amendment proposed by two senators did indeed place such an option squarely before the Senate. Their amendment, however, met fierce opposition from the large banks and the Treasury Department and was eventually defeated.”); Wilmarth, *supra* note 51, (manuscript at 101) (“As an alternative to Dodd-Frank’s regulatory reforms, Congress could have addressed the TBTF problem directly by mandating a breakup of large financial conglomerates.”).

<sup>174</sup> Baxter, *supra* note 88, at 211.

<sup>175</sup> *Id.* at 214.

<sup>176</sup> *See, e.g., Cheques and Imbalances*, ECONOMIST, June 19, 2010, at 33, available at [http://www.economist.com/node/16380025?story\\_id=16380025&CFID=165030874&CFTO KEN=60263434](http://www.economist.com/node/16380025?story_id=16380025&CFID=165030874&CFTO KEN=60263434).

<sup>177</sup> *See, e.g.,* David B. Spence & Frank Cross, *A Public Choice Case for the*



needed to enforce the law,<sup>178</sup> while at the same time being less dependent on the vagaries of election cycles.<sup>179</sup> Theoretically, delegations of power to agencies can help overcome the Condorcet paradox<sup>180</sup> which leads to voting cycles.<sup>181</sup> Indeed, even a cursory glance at economic history suggests an important role for administrative agencies—both domestically<sup>182</sup> and internationally.<sup>183</sup> Phrased starkly, “the maintenance of a

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*Administrative State*, 89 GEO. L.J. 97, 110 (2000) (noting that agencies have “access to the largest amount of accurate information”).

<sup>178</sup> See, e.g., Felix S. Cohen, *The Problems of a Functional Jurisprudence*, 1 MOD. L. REV. 5, 21 (1937) (“[L]egislation designed to protect an oppressed class will not be effectively enforced unless it sets up some independent agency capable of representing the interests of that class in securing enforcement of the legislation.”).

<sup>179</sup> See, e.g., STEVEN P. CROLEY, REGULATION AND PUBLIC INTERESTS 305 (2008) (“In contrast to legislators, administrators as [sic] far less dependent upon the types of political resources so valuable to members of Congress. They are therefore less easily enlisted to advance the regulatory preferences of rent-seeking interests offering legislatively valuable resources.”); David B. Spence, *A Public Choice Progressivism, Continued*, 87 CORNELL L. REV. 397, 438 (2002) (“The ability to influence legislators’ reelection prospects through campaign contributions, issue advertising, and the like, offers well-heeled interest groups much greater leverage over legislators than over agency bureaucrats . . .”).

<sup>180</sup> The core of the paradox is that “absent clear majority support for one of three or more options presented to a collective decisionmaking body there may be no rational means of aggregating individual preferences . . .” Maxwell L. Stearns, *The Misguided Renaissance of Social Choice*, 103 YALE L.J. 1219, 1222 (1994).

<sup>181</sup> Jerry Mashaw explains:

As voting theorists seldom tire of telling us, whenever three or more alternative policies exist there is the ever present possibility of a voting cycle which can be broken only by resort to some form of “dictatorship” result. Legislators must, therefore, often delegate decisive authority somewhere in order to decide. There are any number of ways to deal with this problem—rules committees, forced deadlines, random selection, allocations of vetoes, or the like. Lumping alternatives together in a broad or vague statutory pronouncement and delegating choice to administrators is but another way of avoiding voting cycles through the establishment of dictators.

Jerry L. Mashaw, *Prodelegation: Why Administrators Should Make Political Decisions*, 1 J.L. ECON. & ORG. 81, 98 (1985) (citations omitted).

<sup>182</sup> As Steven Croley observes:

Americans have repeatedly turned to federal regulatory government in times of crisis to address the country’s most stubborn problems—from the banking crises and business corruption of the early twentieth century, through the Great Depression, stock market crisis, and labor unrest of the 1930s and 1940s, through the environmental crisis and civil rights revolutions of the 1960s and 1970s, to the threat of terrorism and the creation of the huge new Department of Homeland Security at the beginning of the twenty-first century, to name a few.

CROLEY, *supra* note 179, at 3.

<sup>183</sup> See, e.g., EZRA SULEIMAN, DISMANTLING DEMOCRATIC STATES 316 (2003) (“[T]he historical development of the U.S., Britain, France, Japan, Prussia, and, in recent times, Korea, Taiwan, and India indicates that the development of bureaucratic authority accompanied and facilitated the development of the state and the subsequent development of democracy.”).

democratic order . . . requires a trained, nonvenal bureaucratic machine.”<sup>184</sup>

In the case of Dodd-Frank, however, the concern is that less than noble motivations may underlie the delegations and deferrals. Researchers estimate that the financial services industry hired more than 3000 lobbyists to mold the legislation.<sup>185</sup> One cannot help but wonder what role these lobbyists played in fostering an elaborate, yet perhaps less effective, statute. One might argue that the political economy of financial reform simply involves a well-funded, relatively narrow interest group trumping the interests of widely dispersed groups of investors and consumers. The idea is not new and can be traced back to James Madison’s account of how “factions” can organize to push their own agenda to the detriment of society at large.<sup>186</sup> Mancur Olson’s research on public choice and group dynamics in the 1960s provides further elaboration:

The smaller groups—the privileged and intermediate groups—can often defeat the large groups—the latent groups—which are normally supposed to prevail in democracy. The privileged and intermediate groups often triumph over the numerically superior forces in the latent or large groups because the former are generally organized and active *while the latter are normally unorganized and inactive*.<sup>187</sup>

Olson’s point is particularly acute as it relates to the financial sector, which funds generous political contributions and benefits from a revolving door between government officials and industry leaders.<sup>188</sup>

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<sup>184</sup> *Id.* at 7.

<sup>185</sup> See, e.g., *Cheques and Imbalances*, *supra* note 176, at 33 (“The Centre for Public Integrity, a non-partisan research group, reckons the financial-services industries alone hired more than 3,000 lobbyists to influence the financial reform bill now before Congress.”). See also Salter, *supra* note 155, at 28 (“Lobbying is at the epicenter of most rule-making activities involving business.”).

<sup>186</sup> Madison defines factions as “a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion . . . adverse to the rights of other citizens, or to the permanent and aggregate interests of the community.” THE FEDERALIST NO. 10, at 57 (James Madison) (Jacob E. Cooke ed., 1961).

<sup>187</sup> MANCUR OLSON JR., THE LOGIC OF COLLECTIVE ACTION 128 (1965) (emphasis added). See also *id.* at 142–43 (“The number and power of the lobbying organizations representing American business is indeed surprising in a democracy operating according to the majority rule. . . . The high degree of organization of business interests, and the power of these business interests, must be due in large part to the fact that the business community is divided into a series of (generally oligopolistic) ‘industries,’ each of which contains only a fairly small number of firms.”) (emphasis omitted).

<sup>188</sup> See, e.g., Wilmarth, *supra* note 51, (manuscript at 60) (“[A]nalysts have pointed to strong evidence of ‘capture’ of financial regulatory agencies by LCFIs [large, complex financial institutions] during the two decades leading up to the financial crisis, due to factors such as (i) large political contributions made by LCFIs, (ii) an intellectual and policy environment favoring deregulation, and (iii) a continuous interchange of senior personnel between the largest financial institutions and the top echelons of the financial

As the product of such a political economy, Dodd-Frank's lapses become rather unsurprising. Perhaps the most concise depiction of the problem emerges from the work of Malcolm Salter who, fittingly enough, studies business strategy:

The Rule-Making (influence) Game involves sending campaign contributions to politicians and then lobbying them to include loopholes in new laws—and then exploiting those loopholes, even when such behavior subverts the laws' intent. More subtly, the Rule-Making Game also involves ensuring that new rules have either ambiguities or overly narrow regulations, offering rich opportunities for businesses to pursue innovative strategies to circumvent the rules in a murky legal environment.<sup>189</sup>

As such, the “game” Salter outlines is doubly advantageous to the financial services industry: taking advantage of existing loopholes<sup>190</sup> while simultaneously lobbying at the administrative agency level to ensure favorable future rulemaking. As one commentator observes: “The Dodd-Frank Wall Street Reform Act has generated more work for lawyers and lobbyists since being signed into law than during even the frenzied days leading up to its passage in the House and Senate last summer.”<sup>191</sup> Importantly, deferring important questions to further study is also beneficial to industry interests. Over time, as memories of the crisis fade there is an even greater opportunity for the financial services industry to influence the implementation of recommendations that may emerge from studies—a phenomenon John Coffee has dubbed the “regulatory sine curve.”<sup>192</sup>

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regulatory agencies.”).

<sup>189</sup> Salter, *supra* note 155, at 14.

<sup>190</sup> See also Kane, *supra* note 4, at 10 (“A complete diagnosis of modern financial crises must acknowledge that lobbyists for SIFs [systemically important private firms] have persuaded Congress to maintain a loophole-ridden regulatory structure.”). Cf. di Lorenzo, *supra* note 120, at 66 (“Research into industry compliance with regulatory standards has demonstrated that greater certainty in statutory or regulatory mandates increases the likelihood of compliance.”).

<sup>191</sup> Amanda Becker, *Multitudes of Lobbyists Weigh in on Dodd-Frank Act*, WASH. POST (Nov. 22, 2010), <http://www.washingtonpost.com/wp-dyn/content/article/2010/11/19/AR2010111906465.html>. See also Salter, *supra* note 155, at 3 (“[Dodd-Frank] has unleashed massive lobbying by the finance industry to determine how the remaining rules will read and how much ‘gaming’ these rules will allow.”); Kane, *supra* note 4, at 7 (“[T]he legislative framework Congress has asked regulators to implement gives a free pass to the dysfunctional ethical culture of lobbying that helped both to generate the crisis and to dictate the extravagant cost of the diverse ways that the financial sector was bailed out.”).

<sup>192</sup> See Coffee, *Bail-Ins*, *supra* note 3, at 13 (“It posits the inevitability of a ‘regulatory sine curve’ under which regulatory activism, while intense in the wake of a regulatory crisis, relaxes thereafter, as lobbying and the impact of regulatory arbitrage soften the resistance of regulators.”). See also Beale, *supra* note 72, (manuscript at 25) (“Moreover, even if there is an attitudinal shift that avoids regulatory capture, re-regulation can be expected to wane in importance over time, as economic conditions improve and memories of the Great Recession recede.”).

The overarching problem with all of this is “that gaming crosses the line of acceptability and becomes institutionally corrupt when such institution-sanctioned behavior subverts the intent of society’s rules, thereby harming the public interest, or weakens the capacity of the institution to achieve its espoused goals by undermining its legitimate procedures and core values.”<sup>193</sup> One could be forgiven for believing that an industry’s success should rest on its business acumen, not its ability to manipulate government.<sup>194</sup> Yet regrettably, this simple point remains understudied. As Amitai Etzioni suggests: “The economic literature is replete with references to distortions the government causes in the market. Comparable attention should be paid to manipulations of the government by participants in the market, and the effects of these manipulations on the internal structures of markets.”<sup>195</sup> In terms of reform, perhaps the single most urgent change would be to reform campaign finance “in a way that will stop the drift toward a plutocracy of one *dollar*, one vote?”<sup>196</sup> As if the struggle were not difficult enough, recent Supreme Court jurisprudence makes it even more difficult to separate politics from corporate power.<sup>197</sup>

#### CONCLUSION

At one level, the story of Dodd-Frank is simple. Given its vast delegation to regulators,<sup>198</sup> the legislation’s success will rest on how successfully the agencies will be able to implement its

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<sup>193</sup> Salter, *supra* note 155, at 3–4.

<sup>194</sup> See AMITAI ETZIONI, NEXT 65 (2001) (“But aside from its being unfair to cut the vulnerable members of the society off the dole while allowing huge corporations to feed from the public trough, one must note that corporate welfare is incompatible with a sound economic environment. It rewards those actors who are best at manipulating the government in their favor (often by providing campaign contributions to members of state and federal legislatures) rather than those who have proven themselves in the marketplace by better R&D, production, or marketing.”).

<sup>195</sup> AMITAI ETZIONI, THE MORAL DIMENSION 217 (1988). See also Warren J. Samuels, *Interrelations Between Legal and Economic Processes*, 14 J.L. & ECON. 435, 442 (1971) (“[T]he critical question is *who* uses the government for *what* ends.”).

<sup>196</sup> ETZIONI, *supra* note 194, at xi. As Steven Croley points out, if “the relationship between legislators and regulation-seeking interest groups constitutes the real lynchpin of the public choice theory—then reforms in the area of campaign [sic] finance, for one example, might go far to alleviate the problems that lead public choice theorists to call for deregulation.” Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 50–51 (1998).

<sup>197</sup> See *Citizens United v. Fed. Election Comm’n*, 558 U.S. \_\_\_ (2010) (slip op. No. 08-205) (Jan. 21, 2010). For an analysis of this opinion, see Reza Dibadj, *Citizens United as Corporate Law Narrative*, \_\_\_ NEXUS: CHAPMAN’S J.L. & PUB. POL’Y \_\_\_ (forthcoming 2011).

<sup>198</sup> See Karmel, *supra* note 43, at 52 (“Much of the implementation of Dodd-Frank has been left to the various functional regulators of financial institutions and some of the more controversial proposed provisions have been relegated to studies.”).

provisions and carry out and act upon the results of its innumerable and controversial studies.<sup>199</sup>

Yet, beyond the statute's artful nuances and deferrals, there lies potential for mischief. Dodd-Frank does not provide us with a new regulatory framework,<sup>200</sup> nor does it "sufficiently address the problem of agency discretion generally, or the problem of an agency's discretion to forebear, in particular."<sup>201</sup> As David Skeel has pointed out, such a fuzzy regulatory conception "invites the government to channel political policy through the big financial institutions by giving regulators sweeping discretion in the enforcement of nearly every aspect of the legislation."<sup>202</sup> Indeed, as Skeel asks:

The special treatment of the largest firms and the reliance on ad hoc intervention raises a perplexing puzzle. Given that this is precisely what so many Americans found offensive about the bailouts of 2008 and were so anxious to reform, how did we end up with legislation that has such similar qualities?<sup>203</sup>

In other words, how did we end up with legislation that in many ways still favors institutions that both precipitated the crisis and are out of public favor? Perhaps the answer lies in the reality that "individual citizens and voters have been steadily edged out of the public sphere"<sup>204</sup> with a concomitant rise in the influence of the financial sector.<sup>205</sup> One might argue that this state of affairs cannot persist in the long-run;<sup>206</sup> put simply, institutions need public trust to survive.

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<sup>199</sup> See, e.g., Pooran, *supra* note 53, at 24 ("[T]he true effectiveness of Wall Street Reform lies in the faithfulness of its implementation by national regulatory agencies in the US."); Salter, *supra* note 155, at 24 ("The success of financial reform depends largely on whether regulators write definitions and rules that support the intent of the act, and then, of course, enforce them."); Kane, *supra* note 4, at 3 ("The Act puts responsibility for avoiding future crises squarely on the competence and good intentions of future regulators.").

<sup>200</sup> See, e.g., Karmel, *supra* note 43, at 6–7 ("The regulatory reform legislation of 2010 also does not put any new regulatory system in place, but rather attempts to modify and reform the existing system, giving expanded authority to the same regulators that failed to prevent the crisis of 2008.").

<sup>201</sup> Schooner, *supra* note 27, at 994.

<sup>202</sup> SKEEL, *supra* note 33, at 11. See also *id.* at 8 ("The two themes that emerge, repeatedly and unmistakably, from the 2,000 pages of legislation are (1) government partnership with the largest financial institutions and (2) ad hoc intervention by regulators rather than a more predictable, rules-based response to crises.").

<sup>203</sup> *Id.* at 12.

<sup>204</sup> Salter, *supra* note 155, at 24.

<sup>205</sup> Cf. *id.* at 14 ("If ever a case could be made against such free-wheeling deregulation and confidence by policymakers in industry self-regulation, the 2008–09 financial crisis is it. Yet the veto power of the financial sector over public policy remains remarkably strong even as the sector has lost popular support.").

<sup>206</sup> See Kane, *supra* note 4, at 16 ("It is unreasonable for an industry to expect to skin taxpayers forever.").

Regardless of this precarious state of affairs, however, it is likely to remain unless more citizens enter the conversation. To be sure, thoughtful commentators have expressed justifiable concern that citizens have become generally disengaged from public discourse.<sup>207</sup> But the relative weight the polity has spent discussing economic issues is particularly troubling. Note, for instance, how much time we have spent considering social issues—abortion, guns, gay marriage, to name just a few. By contrast, observe how stunningly little time we have spent discussing economic issues that affect our everyday livelihood. Granted, economic topics are often not as glamorous as social ones; after all, one might argue, we all have better things to do with our time than worry about something as esoteric as financial reform legislation. Perhaps, but the stakes are simply too high. Our society faces a stark choice: we can continue to let the so-called financial experts make decisions for us as we stand by and await the next crisis. Or we can begin a dialogue by asking some simple questions that might return us to common sense and first principles.<sup>208</sup>

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<sup>207</sup> See, e.g., SULEIMAN, *supra* note 183, at 314 (“The citizen has been encouraged to view himself as a client purchasing the government’s services. What incentives does such a perception provide for participation in associational life?”).

<sup>208</sup> Cf. STEPHEN BREYER, *ACTIVE LIBERTY* 3 (2005) (“[L]iberty means not only freedom from government coercion but also the freedom to participate in the government itself.”).