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The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?

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The New Laws and Regulations for Financial Conglomerates: Will They
Better Manage the Risks than the Previous Ones?

**THE NEW LAWS AND REGULATIONS FOR
FINANCIAL CONGLOMERATES:
WILL THEY BETTER MANAGE THE RISKS
THAN THE PREVIOUS ONES?**

ELIZABETH F. BROWN*

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INTRODUCTION

Federal and state laws allow U.S. financial conglomerates to own securities, insurance and depository institutions through a holding company structure. Before the recent crisis, the federal or state agency responsible for regulating a financial conglomerate as a whole was determined by what subsidiaries the holding company owned, and in particular, the type of depository institution¹ was usually determinative as to which agency regulated the financial conglomerate on a consolidated basis.² For example, the Office of Thrift Supervision supervised American International Group, Inc. (AIG), instead of the Federal Reserve, because AIG owned a thrift, not a bank.³

The multiple regulators for financial conglomerates led to a number of problems that contributed to the recent financial crisis. Among the problems created were inconsistent supervisory and regulatory standards, particularly with regard to capital adequacy, a failure by regulators to undertake the risks (systemic, financial, operational, etc.) posed by subsidiaries in sectors outside of the primary responsibility of the regulator, regulatory arbitrage, and a

1. Depository institutions include commercial banks, thrifts, credit unions and industrial banks. *See* 12 U.S.C. § 461(b)(1)(A) (2006). All of these entities accept deposits and make loans. *See id.* § 1841(c). The differences between these entities are based on their ownership structures, the range of services that they provide, and the regulatory requirements that they must meet. *See id.* § 1841.

2. *See* discussion *infra* Part IA–F.

3. *See infra* notes 60–64 and accompanying text.

failure to address the problems of increasingly interconnected and larger financial conglomerates that posed systemic risks that made regulators opposed to letting them fail.⁴ This last problem is generally referred to as the “too big to fail” problem.

The Dodd-Frank Wall Street Reform and Consumer Protection Act⁵ (the “Dodd-Frank Act” or “Act”) attempts to correct some of these problems. This Article discusses how the different financial conglomerate regulations contributed to the recent financial crisis and whether the reforms in the Dodd-Frank Act corrected these problems. Part I will outline the prior regulatory structure. Part II will address the problems created by this structure that contributed to the recent financial crisis. Part III will describe the reforms contained in the Dodd-Frank Act and analyze to what extent they correct the problems present in the prior regulatory regime. Finally, the Conclusion will point out what additional reforms might be taken to build on the reforms in the Dodd-Frank Act.

I. PRE-CRISIS REGULATORY STRUCTURE FOR FINANCIAL CONGLOMERATES

The United States has over 115 federal and state agencies regulating some aspect of financial services within the United States.⁶ These regulators include the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC) in the Treasury Department, the Office of Thrift Supervision (OTS) in the Treasury Department, the National Credit Union Administration (NCUA), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Federal Housing Finance Agency (FHFA), the Securities Investor Protection Corporation (SIPC), and the Pension Benefit Guaranty

4. See discussion *infra* Part II.A–F.

5. Dodd-Frank Wall Street and Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 12 U.S.C. § 5301) [hereinafter Dodd-Frank Act].

6. The number of state agencies regulating banking, securities, and insurance equals 110 because some states have incorporated the regulation of banks and securities firms or banks and insurance companies or firms from all three sectors into one agency. See Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 6 n.7 (2005). The Federal Housing Finance Agency (FHFA) replaced the Office of Federal Housing Enterprise Oversight and was created by the Housing and Economic Recovery Act of 2008, 110 Pub. L. No. 289, 122 Stat. 2654 (to be codified at 42 U.S.C. § 4501). See also 12 U.S.C. § 4511 (section of U.S.C. amended by § 1101 of the Housing and Economic Recovery Act).

Corporation (PBGC), as well as state insurance, banking, and securities regulatory agencies in all fifty states plus the District of Columbia.⁷

Immediately prior to the current financial crisis, financial conglomerates could be regulated by the Federal Reserve, the OCC, the OTS, the SEC, the FHFA, and state regulators. Which federal regulator supervised a financial conglomerate depended in large part on whether the financial conglomerate owned a depository institution and what type of depository institution they owned.⁸

Depository institutions include commercial banks, thrifts, credit unions, and industrial banks.⁹ All of these entities accept deposits and make loans.¹⁰ The differences between these entities are based on their ownership structures, the range of services that they provide, and the regulatory requirements that they must meet. In addition, the type of entity that may own certain depository entities is restricted by law. The federal Bank Holding Company Act of 1956¹¹ (BHCA) mandates that the holding companies for “banks,” as defined within the BHCA, must only be involved in activities that are related to banking or financial services.¹² With certain exceptions, the BHCA defines a “bank” as an insured bank as defined under section 3(h) of the Federal Deposit Insurance Act¹³ or an institution which accepts demand deposits and makes commercial loans.¹⁴ Among the entities exempted from the definition of a “bank” under the BHCA are thrifts, credit unions, industrial loan companies, limited purpose banks that engage solely in trust or fiduciary activities, entities that engage solely in credit card operations, and foreign bank subsidiaries.¹⁵ As a result, the holding company for an industrial bank is not limited to engaging only in activities related to banking or financial services because an industrial bank is not considered a

7. See Brown, *supra* note 6, at 5–6 (describing the “balkanized regulatory structure” of the U.S. financial services); see also 12 U.S.C. § 4511 (creating the FHFA).

8. See *infra* notes 9–15, 32–38, 60, 65–69, 76–86 and accompanying text.

9. See *supra* note 1 and accompanying text.

10. 12 U.S.C. § 1841(c).

11. *Id.* §§ 1841–49.

12. Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. § 225.21 (2010).

13. 12 U.S.C. §§ 1811–35.

14. *Id.* § 1841(c). Section 3(h) of the Federal Deposit Insurance Act defines an “insured bank” as “any bank (including a foreign bank having an insured branch) the deposits of which are insured in accordance with the provisions of this chapter; and the term ‘noninsured bank’ means any bank the deposits of which are not so insured.” *Id.* § 1813(h).

15. *Id.* § 1841(a)(5).

“bank” under the BHCA. The state laws governing industrial bank holding companies also do not put any such limitations on them.¹⁶ As a result, commercial and retail businesses, like Target, can own industrial banks.¹⁷

Before discussing in more depth how the federal and state holding company regulators operated, it is worth noting that some financial conglomerates were not regulated by either a federal or state holding company regulator. If a conglomerate did not own a bank, a thrift, or an industrial loan company, but owned other financial companies, such as commercial finance companies or investment companies, federal and state holding company regulators might lack any authority to regulate the conglomerate as a whole.¹⁸ The individual subsidiaries within such a conglomerate would be regulated by their respective functional or institutional regulators,¹⁹ to the extent that they existed, but no regulator would have been examining how those

16. The Competitive Equality Banking Act of 1987 carved out an exemption from the definition of “bank” in the Bank Holding Company Act for industrial loan companies and industrial banks. *See id.* § 1841(c)(2)(H); Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. § 225.21 (2010). For an example of state laws governing industrial bank holding companies, see CAL. FIN. CODE §§ 18438–54 (West 1999); UTAH CODE ANN. § 7-8-16 (LexisNexis 2006).

17. Target owns Target Bank, a Utah state chartered industrial bank. *See Business Credit Card Services Help*, TARGET, <http://www.target.com/Business-Card-Credit-Services-Help/b?ie=UTF8&node=14052341> (last visited Apr. 10, 2011). Nevertheless, prior to the crisis in 2007, the ten largest industrial banks by assets were owned by firms involved in financial services. *See* INS. INFO. INST., THE FINANCIAL SERVICES FACT BOOK 2009, at 68 (2009). The top ten industrial banks by assets and their parents (as noted by parentheses) as of March 31, 2008 were as follows: 1. Merrill Lynch Bank USA (Merrill Lynch), 2. Morgan Stanley Bank (Morgan Stanley), 3. GMAC Bank (Cerberus/GMAC), 4. UBS Bank USA (UBS), 5. Goldman Sachs Bank (Goldman Sachs), 6. American Express Centurion Bank (American Express), 7. Capmark Bank (Capmark Financial Group/GMAC), 8. Lehman Brothers Commercial Bank (Lehman Brothers Holdings, Inc.), 9. Fremont Investment & Loan (Fremont General Corporation/Diamond A. Ford), and 10. USAA Savings Bank (USAA Life Company). *Id.* The top eight of these ten industrial banks were chartered in Utah. *See id.*

18. *See* discussion *infra* Part I.A–F (concerning the regulation of holding companies for banks, thrifts, and industrial loan companies). Entities falling outside of those regulations are not regulated on a consolidated basis as a holding company.

19. Under functional regulation, a regulator focuses on regulating a particular category of financial products or services being provided, rather than the institution providing those products or services. PATRICIA A. MCCOY, BANKING LAW MANUAL § 12.02[2] (2d ed. 2003). Under functional regulation, the SEC would regulate the securities regardless of whether they were offered to investors by banks or securities firms. *See id.* Historically, under institutional regulation, federal and state bank regulators regulated securities offered by banks. *Id.* Historically, federal and state legislators created regulators to regulate particular financial institutions. *Id.* This type of regulation is called institutional or entity regulation. *Id.* The Gramm-Leach-Bliley Act was designed to move the U.S. regulatory system away from institutional regulation towards functional regulation. *See id.* The U.S. regulatory system prior to the financial crisis, however, was not a pure functional regulatory scheme but rather a mixture of institutional and functional regulation. *See* Brown, *supra* note 6, at 19.

subsidiaries interacted with the other subsidiaries owned by the conglomerate or the interconnectedness of all of a particular conglomerate's operations with the rest of the financial system. Berkshire Hathaway Inc. is an example of a large financial conglomerate (over 80% of its total revenues in 2009 came from financial services) that has no federal holding company regulator.²⁰ Its insurance subsidiaries, however, are regulated by state insurance commissions for the states in which they operate.²¹

If all financial conglomerates that lacked a holding company regulator operated like Berkshire Hathaway, perhaps such regulators would not be needed. Enron Corp., however, illustrates why the absence of a financial services holding company regulator might matter. No federal or state financial services holding company regulator oversaw Enron's business despite the fact that it was a financial conglomerate.²² One of Enron's core businesses was derivatives trading.²³ According to its 2000 financial statements, about 7% of Enron's total revenues and one-third of its assets came from its derivative business.²⁴ In addition, in its 2000 annual report to the SEC, Enron reported that it owned a controlling interest in dozens of finance and investment companies in the United States and across the globe.²⁵ Its consolidated financial statements included the revenues, assets and liabilities of these subsidiaries. Enron, however, had more than 3000 off-balance sheet subsidiaries and partnerships, many of whom engaged in derivatives deals with Enron.²⁶ According to one study, Enron's derivatives book had a notional value of \$758

20. Berkshire Hathaway Inc., Annual Report, (Form 10-K), at 28 (Feb. 26, 2010).

21. *See id.* at 1–3.

22. *See* Enron Corp., Annual Report, (Form 10-K), Ex. 21 (April 2, 2001) [hereinafter Enron 2000 10-K Report] (listing Enron's subsidiaries). Enron did not own a bank, a thrift, or an industrial loan company. As a result, it did not have a federal or state financial services holding company regulator. *See* discussion *infra* Part I.A–F (highlighting pre-crisis regulating structures). In addition, Enron's annual report discussed being regulated as a public utility holding company and other types of federal regulation, but did not discuss being regulated as a financial services holding company. *See* Enron 2000 10-K Report, *supra*, at 15–21.

23. *See Enron and the Use of Derivatives: Testimony before the Senate Committee on Governmental Affairs*, 107th Cong. (2002) [hereinafter Partnoy Hearing] (statement of Prof. Frank Partnoy) (highlighting Enron's trading derivatives in the year 2000, which made more money alone than Long-Term Capital Management made in its entire history), available at http://reg-markets.org/admin/authorpdfs/redirect-safely.php?fname=./pdffiles/testimony_02_03.pdf; ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON 6 (2002).

24. BRYCE, *supra* note 23, at 241; Enron 2000 10-K Report, *supra* note 22, at F-3, F-4.

25. Enron 2000 10-K Report, *supra* note 22, at Ex. 21.

26. *See* Partnoy Hearing, *supra* note 23, at 3.

billion at the end of 2000.²⁷ To put this in perspective, Enron's book represented slightly less than 1% of the approximately \$109.2 trillion derivatives market at the end of 2000, but this book was about three-fourths of the notional value of the derivatives positions of Long Term Capital Management (LTCM), a hedge fund, when the Federal Reserve arranged for fourteen banks to bail out LTCM in 1998.²⁸

Not only did Enron escape regulation on a consolidated basis as a holding company for various financial services, but many of its subsidiaries were not subjected to either functional or institutional regulation. Neither the SEC, the CFTC, nor any other federal or state agency regulated the over-the-counter derivatives trading conducted by Enron and its subsidiaries.²⁹ The Commodities Futures Modernization Act of 2000³⁰ exempted such derivatives from regulation.³¹ Consequently, functional or institutional regulation sometimes failed to provide adequate protection for the financial system from financial conglomerates that lacked a holding company regulator.

A. *Office of the Comptroller of the Currency*

The OCC regulates national banks that owned subsidiaries that sell insurance or securities.³² These financial subsidiaries can only engage in financial activities that the bank could engage in directly. Thus, these subsidiaries cannot engage in annuities or insurance

27. BRYCE, *supra* note 23, at 242 (citing a study by Randall Dodd and Jason Hoody of the Derivatives Study Center).

28. See Partnoy Hearing, *supra* note 23, at 2 (providing a figure for the derivatives market that includes both the \$14 trillion in exchange traded derivatives and the \$95.2 trillion in over-the-counter derivatives); see also BRYCE, *supra* note 23, at 324–25 (describing the LTCM's \$1 trillion derivatives position and its bailout); KEVIN DOWD, CATO INST., TOO BIG TO FAIL? LONG TERM CAPITAL MANAGEMENT AND THE FEDERAL RESERVE 1–5 (1999) (describing LTCM's bailout).

29. See Partnoy Hearing, *supra* note 23, at 2–3.

30. 7 U.S.C. § 1 (2006).

31. See Partnoy Hearing, *supra* note 23, at 3.

32. See 12 U.S.C. §§ 21, 23, 26, 27, 93a (2006) (outlining the OCC's authority to charter and regulate national banks); 12 U.S.C. § 24a(a)(2), (g)(5)–(6) (discussing types of subsidiaries that a national bank may operate). “Well-capitalized” for these purposes is defined as having the same meaning as in section 38 of the Federal Deposit Insurance Act. *Id.* § 1831o(b)(1)(A). For a bank that has been examined, “well-managed” means that the bank has received a composite rating of one or two under the Uniform Financial Institutions Rating System and at least a rating of two for management. *Id.* § 24a(g)(6). For banks that have not been examined, “well-managed” means that the bank's managerial resources are deemed satisfactory by the appropriate Federal banking agency. *Id.* The OCC will send a notice to any national bank failing to meet these requirements that orders it to correct the deficiencies. *Id.* § 24a(e)(1). If the bank fails to correct these deficiencies within 180 days after receiving the notice, then the OCC may order the bank to divest control of any financial subsidiary. *Id.* § 24a(e)(4).

underwriting, insurance company portfolio investments, real estate investment or development, or merchant banking.³³ In addition, the national bank cannot allow the aggregate consolidated total assets of all of its financial subsidiaries to exceed the lesser of \$50 billion or 45% of the national bank's consolidated total assets.³⁴

B. Federal Reserve

The Federal Reserve regulates two types of financial conglomerates—bank holding companies (“BHC”) and financial holding companies (“FHC”).³⁵ The BHCA mandates that the holding companies for “banks,” as defined within the Act, must only be involved in activities that are related to banking or financial services.³⁶ With certain exceptions, the BHCA defines a “bank” as an insured bank as defined under section 3(h) of the Federal Deposit Insurance Act³⁷ or an institution which accepts demand deposits and makes commercial loans.³⁸ The BHCA allows BHCs to own subsidiaries that engage in nonbank activities only if those activities are closely related to banking activities.³⁹ These nonbank activities include, among others, to act as insurance agents or brokers primarily in connection with credit extensions, to underwrite credit life, accident, and health insurance, to act as a futures commission merchant, and to act as a discount brokerage.⁴⁰

In 2008 as the crisis was breaking, large BHCs⁴¹ only comprised a little over 9% of the total number of BHCs, but they held 93.3% of the total assets held by all BHCs.⁴² In 2009, the large BHCs continued to grow even as the number of small BHCs declined. The number of

33. *Id.* § 24a(a)(2)(B).

34. *Id.* § 24a(a)(2)(D).

35. *Id.* § 1841(a)(1), (p).

36. Bank Holding Companies and Change in Bank Control (Regulation Y), 12 C.F.R. § 225.21(a) (2010).

37. 12 U.S.C. §§ 1811–35.

38. *Id.* § 1841(c). Section 3(h) of the Federal Deposit Insurance Act defines an “insured bank” as “any bank (including a foreign bank having an insured branch) the deposits of which are insured in accordance with the provisions of this chapter”; and the term “noninsured bank” as “any bank the deposits of which are not so insured.” *Id.* § 1813(h).

39. *Id.* §§ 1841(c)(2), 1843(c)(8), (13); ALAN GART, REGULATION, DEREGULATION, REREGULATION: THE FUTURE OF THE BANKING, INSURANCE, AND SECURITIES INDUSTRIES 66–67 (1994).

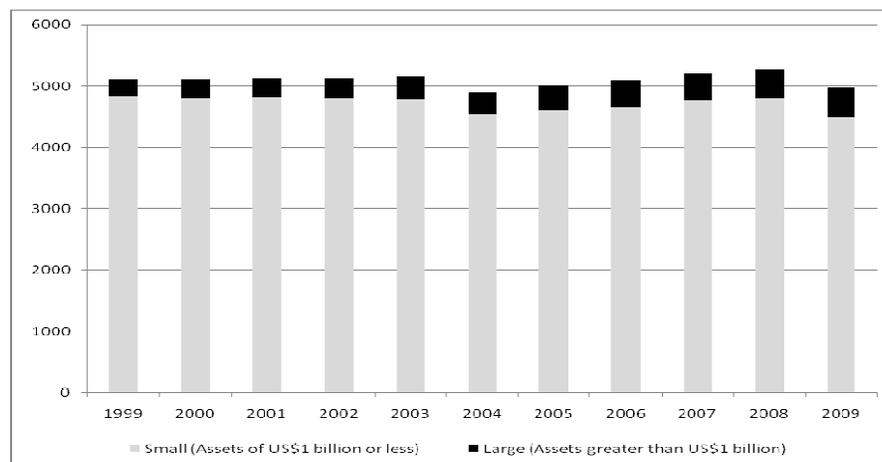
40. GART, *supra* note 39, at 66.

41. The Federal Reserve defines large BHCs as those with more than \$1 billion in total assets. U.S. BD. OF GOVERNORS OF THE FED. RESERVE SYS., 95TH ANNUAL REPORT 98 (2008) [hereinafter FEDERAL RESERVE ANNUAL REPORT 2008], available at <http://www.federalreserve.gov/boarddocs/RptCongress/annual08/pdf/AR08.pdf>.

42. *Id.*

large BHCs had increased by three while the number of small BHCs had declined by fifty-nine, and the large BHCs' share of the total assets held by all BHCs increased to 93.9%.⁴³

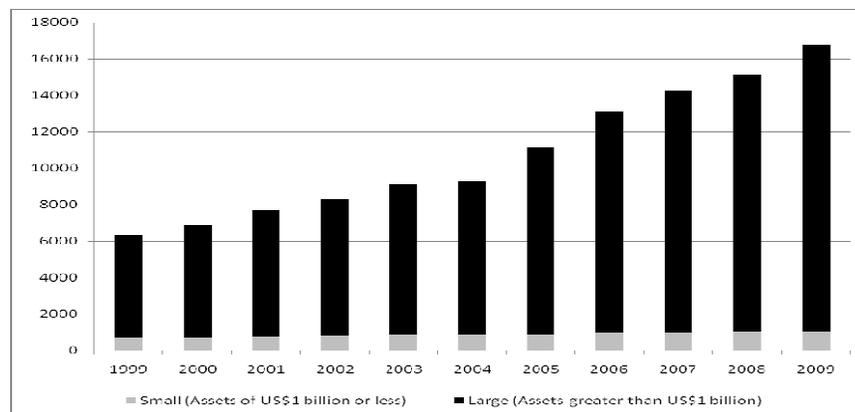
Figure 1: Number of Bank Holding Companies⁴⁴



43. U.S. BOARD OF GOVERNORS OF THE FED. RESERVE SYS., 96TH ANNUAL REPORT 102 (2009) [hereinafter FEDERAL RESERVE ANNUAL REPORT 2009], available at <http://www.federalreserve.gov/boarddocs/rptcongress/annual09/default.htm>.

44. U.S. Bd. OF GOVERNORS OF THE FED. RESERVE SYS., 94TH ANNUAL REPORT 86 (2003) [hereinafter FEDERAL RESERVE ANNUAL REPORT 2003], available at <http://www.federalreserve.gov/boarddocs/rptcongress/annual03/ar03.pdf>; FEDERAL RESERVE ANNUAL REPORT 2008, *supra* note 41, at 98; FEDERAL RESERVE ANNUAL REPORT 2009, *supra* note 43, at 102.

Figure 2: Total Assets of Bank Holding Companies
(in billions of U.S. dollars)⁴⁵



Companies that own a bank and want to offer a wider range of financial services than permitted under the BHCA must qualify as a FHC. The Gramm-Leach-Bliley Act⁴⁶ (“GLBA”) created the category of FHC under which it permitted banks, securities firms and insurance companies and other entities engaged in financial services to become affiliated with one another and to cross sell each other’s products.⁴⁷ In order to create the FHC structure, GLBA had to repeal significant portions of the Glass-Steagall Act of 1933, the BHCA and other federal banking laws.⁴⁸

In order for a BHC to become a FHC, all of its depository institution subsidiaries must be well managed and well capitalized and have at least a “satisfactory” rating under the Community Reinvestment Act.⁴⁹ FHCs may engage in certain activities that are financial in nature, including securities underwriting and dealing, insurance underwriting, insurance agency activities, and merchant banking.⁵⁰ A FHC also may engage in any activity that the Federal Reserve, in consultation with the Secretary of the Treasury,

45. FEDERAL RESERVE ANNUAL REPORT 2003, *supra* note 44, at 86; FEDERAL RESERVE ANNUAL REPORT 2008, *supra* note 41, at 98; FEDERAL RESERVE ANNUAL REPORT 2009, *supra* note 43, at 102.

46. Pub. L. No. 106-102, § 1, 107 Stat. 1338 (1999) (codified at 12 U.S.C. § 1831 (2006)).

47. 12 U.S.C. § 1843(k) (2006).

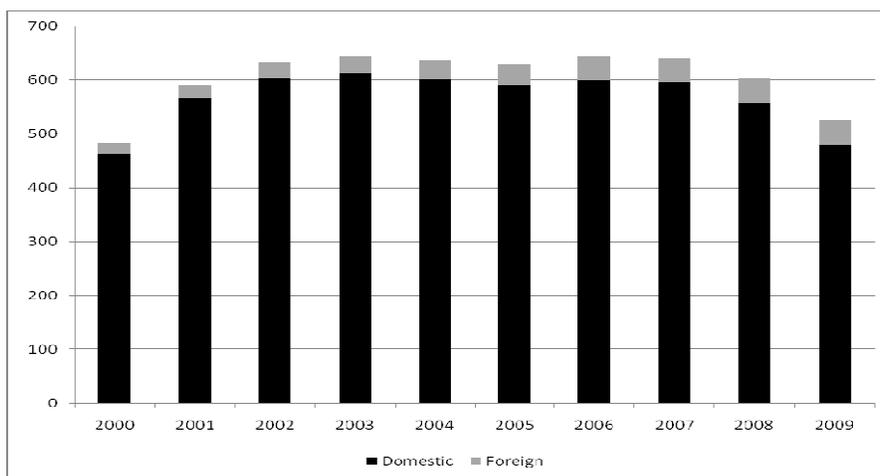
48. 12 U.S.C. §§ 78, 377 (1935) (repealed 1999).

49. Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901–08.

50. *See generally* 12 U.S.C. § 1843 (describing alternative activities allowed and exceptions thereto).

determines to be financial in nature, incidental to finance, or complementary to a financial activity, provided that such activity does not pose a substantial risk to the safety and soundness of the FHC.⁵¹ A FHC generally may not engage in nonfinancial activities.⁵²

Figure 3: Number of Financial Holding Companies⁵³



Only a minority of the BHCs that existed before the enactment of GLBA chose to become FHCs. The total number of FHCs peaked at 644 in 2003 as shown in Figure 3 above.⁵⁴ This number represented only a little over 10% of the BHCs in existence in 1999.⁵⁵ In addition, very few non-BHC financial conglomerates chose to become FHCs. For example, in 2003 when the number of FHCs was at its peak, FHCs

51. *Id.*

52. See 12 U.S.C. § 1843(n) (describing the extent to which BHCs may retain nonfinancial affiliations). The GLBA only permitted FHCs that were not BHCs or foreign banks before becoming FHCs after Nov. 12, 1999 to continue to engage in any nonfinancial activities that they were lawfully engaged in on September 30, 1999 under certain circumstances and for a limited period. *Id.* Such FHCs were to cease such nonfinancial activities by November 12, 2009, unless granted a five year extension by the Federal Reserve Board. *Id.*

53. FEDERAL RESERVE ANNUAL REPORT 2003, *supra* note 44, at 86; FEDERAL RESERVE ANNUAL REPORT 2008, *supra* note 41, at 98; FEDERAL RESERVE ANNUAL REPORT 2009, *supra* note 43, at 102.

54. Compare FEDERAL RESERVE ANNUAL REPORT 2003, *supra* note 44, at 86 (644 FHCs in 2003), with FEDERAL RESERVE ANNUAL REPORT 2008, *supra* note 41 at 98, and FEDERAL RESERVE ANNUAL REPORT 2009, *supra* note 43, at 102 (illustrating a gradual decrease in the number of FHCs from 2003 to 2009).

55. See FEDERAL RESERVE ANNUAL REPORT 2003, *supra* note 44, at 86; FEDERAL RESERVE ANNUAL REPORT 2008, *supra* note 41, at 98; FEDERAL RESERVE ANNUAL REPORT 2009, *supra* note 43, at 102.

that had not been registered as BHCs prior to the GLBA represented only 22% of the registered FHCs.⁵⁶ These financial conglomerates included Charles Schwab & Co., MetLife and Franklin Resources.⁵⁷

The GLBA did not require financial conglomerates to register as BHCs or FHCs if they did not own banks subject to the Bank Holding Company Act. As a result, many of the largest financial conglomerates chose not to register as FHCs, including American Express, AIG, Bear Stearns, Goldman Sachs, and Merrill Lynch.⁵⁸ In many cases, these firms did own other types of depository institutions. For example, AIG owned AIG Federal Savings Bank, a thrift, Goldman Sachs owned Goldman Sachs Bank USA, an industrial loan company, and Morgan Stanley owned Morgan Bank, an industrial loan company, Morgan Stanley Trust, a federal savings association, Morgan Stanley Trust National Association, a limited purpose national bank, and certain foreign bank subsidiaries.⁵⁹

C. Office of Thrift Supervision

Financial conglomerates that own thrifts, like AIG, are classified as thrift holding companies (“THCs”) and are regulated by the OTS.⁶⁰ At the end of 2007, the OTS was supervising 475 thrift holding companies.⁶¹ Those thrift holding companies own about 35% of all of the thrifts in the United States and more than half of the thrifts regulated by the OTS in 2007.⁶² Those thrift holding companies held

56. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & U.S. DEP’T OF THE TREASURY, REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM-LEACH-BLILEY ACT 2–3 (2003) (noting that FHCs “represent 78 percent of the total assets of all bank holding companies” in 2003).

57. *Id.*

58. Brown, *supra* note 6, at 13 n.42.

59. See *About AIG Bank*, AIGBANK,

<https://www.aigbank.com/aigbank/aboutaig.jsp> (last visited Apr. 10, 2011); Press Release, U.S. Bd. of Governors of the Fed. Reserve Sys., Order Approving the Formation of Bank Holding Companies—Goldman Sachs, Inc. (Sept. 22, 2008), *available at*

<http://www.federalreserve.gov/newsevents/press/orders/orders20080922a1.pdf>; Press Release, U.S. Bd. of Governors of the Fed. Reserve Sys., Order Approving the Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities—Morgan Stanley (Sept. 22, 2008), *available at* <http://www.federalreserve.gov/newsevents/press/orders/orders20080922a2.pdf>.

60. See Home Owners’ Loan Act, 12 U.S.C. §§ 1461, 1467a (2006) (setting forth specific regulations concerning financial conglomerates); OFFICE OF THRIFT SUPERVISION, U.S. DEP’T OF THE TREASURY, 2008 FACT BOOK 77 n.17 (2009) [hereinafter OTS FACT BOOK].

61. OTS FACT BOOK, *supra* note 60, at 71. Some savings associations are owned by more than one holding company, which is why there are more holding companies than savings associations that own them.

62. *Id.* at 5–6, 71. THCs owned 435 thrifts out of the 1252 thrifts in the United States, of which the OTS regulated only 827 in 2007. *Id.*

US \$8.4 trillion in assets, of which only about 15% were thrift assets and the remainder came from other enterprises.⁶³ The OTS supervised some very large conglomerates as THCs, including AIG, Countrywide Financial, General Electric Company, General Motors Corporation, IndyMac Bancorp Inc., Merrill Lynch, Morgan Stanley, and Washington Mutual.⁶⁴

D. Securities and Exchange Commission

Section 231 of the GLBA amended section 78q of the Securities Exchange Act to give the SEC authority to act as a holding company regulator for financial conglomerates that were not regulated as bank or thrift holding companies by the Federal Reserve or the OTS.⁶⁵ Under section section 78q(i), however, the SEC could only regulate those holding companies that voluntarily elected to be subject to its regulation.⁶⁶ The SEC did not set up any procedures for regulating financial conglomerates under this provision until 2004.⁶⁷ Under the regime created by the SEC, a financial conglomerate could elect to be supervised by the SEC as either consolidated supervised entity (“CSE”) or as supervised investment bank holding company (“SIBHC”).⁶⁸ The SEC’s Division of Market Regulation acted as the prudential supervisor for both CSEs and SIBHCs.⁶⁹

Seven firms voluntarily became CSEs—the Bear Stearns Companies, Citigroup Inc., Goldman Sachs Group Inc., JPMorgan Chase & Co., Lehman Brothers Holdings Inc., Merrill Lynch Bank & Trust Co., and Morgan Stanley.⁷⁰ The SEC was the sole consolidated

63. *Id.* at 71.

64. U.S. GOV’T ACCOUNTABILITY OFFICE, FINANCIAL MARKET REGULATION: AGENCIES ENGAGED IN CONSOLIDATED SUPERVISION CAN STRENGTHEN PERFORMANCE MEASUREMENT AND COLLABORATION 12 (2007) [hereinafter GAO FINANCIAL MARKET REGULATION REPORT], available at <http://www.gao.gov/new.items/d07154.pdf>; Countrywide Financial Corporation, Annual Report, (Form 10-K), at 17 (Feb. 28, 2007); IndyMac Bancorp, Inc., Annual Report, (Form 10-K), at 10 (Mar. 1, 2007); Washington Mutual Inc., Annual Report, (Form 10-K), at 7 (Mar. 1, 2007).

65. 15 U.S.C. § 78q(i) (2006).

66. *Id.*

67. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. pt. 200) [hereinafter CSE Final Rule]; Supervised Investment Bank Holding Companies, 69 Fed. Reg. 34,472 (Aug. 20, 2004) (to be codified at 17 C.F.R. pt. 200) [hereinafter SIBHC Final Rule].

68. See CSE Final Rule, *supra* note 67, at 34,428; SIBHC Final Rule, *supra* note 67, at 34,474–76 (setting forth Rule 17i-2).

69. See Commodity and Securities Exchanges, 17 C.F.R. § 200.30-3 (2010).

70. U.S. SEC. AND EXCH. COMM’N, OFFICE OF THE INSPECTOR GEN., OFFICE OF AUDITS, SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM iv (Sept. 25, 2008) [hereinafter SEC IG’S CSE REPORT], available at <http://www.sec.gov/about/oig/audit/2008/446-a.pdf>.

supervisor for only four of these firms. The Federal Reserve supervised Citigroup Inc. and JP Morgan Chase & Co., which were registered FHCs, and the OTS supervised parts of Lehman Brothers, Merrill Lynch and Morgan Stanley, as THCs.⁷¹

The SEC finally created the CSE and SIBHC regime in 2004 because it had been subject to intense lobbying from U.S. financial conglomerates that did not have a primary federal regulator and were concerned about being subject to regulation by European financial supervisors under the European Union's Financial Conglomerates Directive ("EU FCD").⁷² The EU FCD was adopted in 2002 and required supervisors and financial groups to measure on a consolidated basis the prudential soundness of groups with significant business in the banking, securities and insurance sectors and that are operating within the European Union.⁷³ The EU FCD also required non-EU financial conglomerates operating within the European Union to have their home country supervisors provide a form of consolidated supervision that is equivalent to that provided by the EU FCD or be supervised on a consolidated basis by a financial supervisor within one of the EU member nations.⁷⁴ The directive required member states to adopt the laws necessary to implement the directive by August 11, 2004.⁷⁵

E. State Holding Company Regulators

In addition to these federal regulators for holding companies, the state banking and financial institution regulators also regulate holding companies. As a result, holding companies can be subject to duplicative state and federal regulation.

For example, Capital One Financial Corporation owns Capital One Bank, which was a Virginia state chartered bank until March 2008 when it converted to a national bank charter.⁷⁶ As a result, Capital One Financial Corporation is a BHC regulated by the Federal Reserve.⁷⁷ In 2005, Capital One Financial Corporation elected to become a FHC regulated by the Federal Reserve so that it could offer a wider range of financial products.⁷⁸ Because Capital One Bank was

71. *Id.* at v.

72. Council Directive 2002/87, 2002 O.J. (L 35) 1 (EC) [hereinafter Financial Conglomerates Directive]; SEC IG'S CSE REPORT, *supra* note 70, at 4.

73. *See* Financial Conglomerates Directive, *supra* note 72, at arts. 5–9.

74. *Id.* art. 18, at 12.

75. *Id.* art. 34, at 23.

76. Capital One Fin. Corp., Annual Report, (Form 10-K), at 45 (Feb. 26, 2010).

77. *Id.* at 8.

78. *Id.* at 8–9.

originally a Virginia state chartered bank, Capital One Financial Corporation is registered as a financial institution holding company under Virginia law and subject to regulation by the Virginia Bureau of Financial Institutions.⁷⁹

Holding companies that own industrial loan companies or industrial banks, but do not own a bank subject to the Bank Holding Company Act, a thrift, or a broker-dealer firm do not have a federal supervisor.⁸⁰ The state agencies that chartered an industrial bank or an industrial loan company also supervise the industrial bank holding company or industrial loan holding company that owns them.⁸¹ Unlike BHCs, holding companies of industrial banks may be commercial enterprises and may own subsidiaries that are commercial businesses. Industrial bank holding companies are not restricted to only engaging in financial activities.

F. Office of Federal Housing Enterprise Oversight

The government sponsored entities (“GSEs”) comprise a special category of financial conglomerate because they were originally chartered by the federal government to help increase stability and liquidity in the U.S. housing markets.⁸² The Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal National

79. *Id.* at 9, 12; *see* VA. CODE ANN. § 6.2-702 (2010).

80. Bank Holding Company Act, 12 U.S.C. § 1841(c) (2006); Home Owners’ Loan Act, 12 U.S.C. §§ 1461, 1467(a); 17 C.F.R. § 240.15c3-1g (2010).

81. *See, e.g.*, ALA. CODE § 8-6-56 (LexisNexis 2010); CAL. FIN. CODE § 18390 (West 1999); COLO. REV. STAT. § 11-101-401 (2010); UTAH CODE ANN. § 7-8-16 (LexisNexis 2006).

82. For purposes of this Article, GSEs only refers to the Federal National Mortgage Association, also known as Fannie Mae, and the Federal Home Loan Mortgage Corporation, also known as Freddie Mac. Fed. Nat’l Mortg. Ass’n, Annual Report, (Form 10-K), at 1 (Feb. 28, 2008) [hereinafter Fannie Mae 2007 10-K Report]; Fed. Home Loan Mortg. Corp., Annual Report, (Form 10-K), at 1, 3 (Feb. 24, 2010) [hereinafter Freddie Mac 2011 10-K Report]. Other entities that are also classified as GSEs, but which will not be discussed in this Article include the Federal Home Loan Banks, the Farm Credit System, and the Federal Agricultural Mortgage Corporation, also known as Farmer Mac. U.S. GEN. ACCOUNTING OFFICE, GAO-04-269T, GOV’T SPONSORED ENTERPRISES: A FRAMEWORK FOR STRENGTHENING GSE GOVERNANCE AND OVERSIGHT I (2004). Some commentators classify the Government National Mortgage Association, also known as Ginnie Mae, as a GSE, but it is not a privately owned entity that is “sponsored” by the federal government like Fannie Mae, Freddie Mac, and the other GSEs but is, in fact, an entity that is wholly-owned by the federal government. GOV’T NAT’L MORTG. ASS’N, 2010 ANNUAL REPORT 7 (2010), *available at*

http://www.ginniemae.gov/about/ann_rep/annual_report10.pdf. SLM Corporation, also known as Sallie Mae, started out as a GSE in 1972 when its name was the Student Loan Marketing Association. SLM Corp., Annual Report, (Form 10-K), at 2 (Feb. 28, 2011). It was completely privatized and ceased to be classified as a GSE in 1997. *Id.*

Mortgage Association, (Fannie Mae), are the two largest of these entities. In 2007, the GSEs were ranked as two of the twenty largest U.S. financial conglomerates based on revenues by Fortune magazine.⁸³

Prior to July 30, 2008, the Office of Federal Housing Enterprise Oversight (OFHEO) in the Department of Housing and Urban Development (HUD) supervised Freddie Mac and Fannie Mae.⁸⁴ On July 30, 2008, the Federal Housing Finance Authority was created when President George W. Bush signed the Housing and Economic Recovery Act of 2008.⁸⁵ Prior to the financial crisis, OFHEO was the prudential regulator for the GSEs and conducted periodic examinations to ensure their safety and soundness.⁸⁶

The SEC, HUD and the Treasury Department also regulated certain aspects of Freddie Mac's and Fannie Mae's business. Fannie Mae voluntarily registered its common stock with the SEC in March 2003 and Freddie Mac voluntarily registered its common stock with the SEC in July 2008.⁸⁷ Since those registrations, the GSEs have been subject to the periodic reporting requirements under the Securities Exchange Act of 1934.⁸⁸ The securities issued by the GSEs are classified as "exempted securities" and are exempt from the registration requirements under the Securities Act of 1933.⁸⁹ HUD must approve any new programs offered by Freddie Mac and Fannie Mae and it conducts investigations to verify that they are complying with the requirements of their charters and other regulations.⁹⁰ The GSEs can only issue certain types of debt securities with the approval of the Treasury Department.⁹¹

83. INS. INFO. INST., *supra* note 17, at 9.

84. OFHEO, 2008 REPORT TO CONGRESS 53 n.2 (2008), *available at* <http://www.fhfa.gov/webfiles/2097/OFHEOReporttoCongress2008.pdf>; FHFA, 2009 REPORT TO CONGRESS 101 (2009), *available at* http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf.

85. FHFA, *supra* note 84, at 101.

86. Fannie Mae 2007 10-K Report, *supra* note 82, at 16–19; Freddie Mac 2011 10-K Report, *supra* note 82, at 29.

87. Fannie Mae 2007 10-K Report, *supra* note 82, at 14; *SEC Filings*, FREDDIE MAC, http://www.freddiemac.com/investors/sec_filings/index.html (last visited Apr. 10, 2011).

88. Fannie Mae 2007 10-K Report, *supra* note 82, at 14; Freddie Mac 2011 10-K Report, *supra* note 82, at 16.

89. Fannie Mae 2007 10-K Report, *supra* note 82, at 14; *see also* Freddie Mac 2011 10-K Report, *supra* note 82, at 16.

90. Fannie Mae 2007 10-K Report, *supra* note 82, at 14–16; Freddie Mac 2011 10-K Report, *supra* note 82, at 6, 30.

91. Fannie Mae 2007 10-K Report, *supra* note 82, at 14; Freddie Mac 2011 10-K Report, *supra* note 82, at 9, 30.

G. *Supervision of Holding Company Subsidiaries*

Holding company regulators, like the Federal Reserve, generally were required to use the reports generated by the regulators for the subsidiaries.⁹² For example, under GLBA, the Federal Reserve could only examine a “functionally regulated subsidiary” of a FHC or a BHC if:

- (i) the Board has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution;
- (ii) the Board reasonably determines, after reviewing relevant reports, that examination of the subsidiary is necessary to adequately inform the Board of the systems described in subparagraph (A)(ii)(II) [systems for monitoring and controlling financial and operational risks that may threaten the safety and soundness of any depository institution subsidiary of the holding company]; or
- (iii) based on reports and other available information, the Board has reasonable cause to believe that a subsidiary is not in compliance with this chapter or any other Federal law that the Board has specific jurisdiction to enforce against such subsidiary, including provisions relating to transactions with an affiliated depository institution, and the Board cannot make such determination through examination of the affiliated depository institution or the bank holding company.⁹³

Even if the Federal Reserve did conduct an examination of one or more of the subsidiaries of a FHC or a BHC, it had limited authority to impose new regulations on the subsidiaries. Under GLBA, the Federal Reserve was prohibited from imposing any capital requirements on any functionally regulated subsidiary of a FHC or BHC.⁹⁴ In addition, the Federal Reserve could not prescribe other types of regulations for functionally regulated subsidiaries of a FHC or BHC unless:

- (1) the action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty by such subsidiary that poses a material risk to—

92. See 12 U.S.C. § 1476a(b)(4) (2006) (“The Director [of OTS] shall, to the extent deemed feasible, use for the purposes of this subsection reports filed with or examinations made by other Federal agencies or the appropriate State supervisory authority.”); *id.* § 1844(c)(2)(E) (requiring the Federal Reserve to use reports on registered brokers, dealers, and investment advisers prepared by the SEC and state regulators, insurance companies prepared by state insurance regulators, and on any other subsidiary supervised by a federal or state authority).

93. *Id.* § 1844(c)(2)(B).

94. *Id.* § 1844(c)(3).

(A) the financial safety, soundness, or stability of an affiliated depository institution; or

(B) the domestic or international payment system; and

(2) the Board finds that it is not reasonably possible to protect effectively against the material risk at issue through action directed at or against the affiliated depository institution or against depository institutions generally.⁹⁵

As a result, the Federal Reserve and other holding company regulators generally deferred to the functional regulator of a particular subsidiary rather than conduct their own independent examination. This meant that they had to rely on dozens of state and federal regulators for information about the subsidiaries of a single financial conglomerate. Not surprisingly, the types of reports produced by these agencies vary greatly just as the entities that they supervise vary greatly in terms of their size and product offerings.

II. PROBLEMS RESULTING FROM THE PRE-CRISIS REGULATORY STRUCTURE

The pre-crisis regulatory structure contained a number of problems associated with financial conglomerates that ultimately contributed to the financial crisis, particularly the high leverage of many financial conglomerates. The most serious of these problems were: (1) the lack of uniform standards for financial conglomerates, particularly in the area of capital requirements, (2) the lack of coordination amongst regulators to ensure risks (systemic, financial, operational, etc.) associated with financial conglomerates were handled consistently and to share information and expertise, (3) the failure of regulators to understand the risks posed by the functional businesses in which the financial conglomerates engaged, (4) the ability of some financial conglomerates to engage in regulatory arbitrage through their ability to pick their regulator, and (5) the failure of regulators to address the growth and concentration of financial conglomerates within the financial services industry, which allowed some firms to become too-big-to-fail, and created the moral hazard problem that led to the bailouts. Each of these factors will be examined in more detail.

95. *Id.* § 1848a(a).

A. *Lack of Uniform Supervisory and Regulatory Standards*

The lack of uniform supervisory and regulatory standards arose across a range of issues. The most serious problem, however, was the different standards for capital adequacy.

All of the holding company regulators in the United States focused on the capital adequacy of the holding companies on a consolidated basis as well as the credit risks, market risks, and operational risks that they posed. All of them were influenced in their approach to these risks by the release by the Basel Committee on Banking Supervision (“Basel Committee”) in June 2004 of new capital adequacy standards under the title, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, which came to be known as Basel II.⁹⁶

Basel II is based on three pillars that must be met for a bank to be adequately capitalized. Pillar I sets forth the minimum capital required based on the bank’s total risk weighted assets, which would be calculated using a formula that took into account credit risk, market risk, and operational risk.⁹⁷ Pillar II defines the supervisory activities of each national authority and allows them to mandate that banks hold additional capital to cover risks not appropriately accounted for under Pillar one.⁹⁸ Pillar III outlines the reporting and public disclosure requirements for banks in an effort to use disclosure and market discipline to encourage appropriate risk management by banks.⁹⁹

Basel II gave banks a choice of making their capital adequacy calculations in one of three ways. They could use a simplified approach that employed fixed weights set by the Basel Committee.¹⁰⁰ Alternatively, they could use a standardized approach that relied on external ratings provided by credit agencies to adjust the weights of the assets.¹⁰¹ Finally, they could use an internal ratings-based (“IRB”) approach based upon their own internal risk models.¹⁰²

The difference between the capital required under Basel I and Basel II was striking. For example, Basel II would allow banks using

96. BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), *available at* <http://www.bis.org/publ/bcbs107.pdf?noframes=1>.

97. *Id.* at 12.

98. *Id.* at 158.

99. *Id.* at 175.

100. *Id.* at 12–14.

101. *Id.* at 15.

102. *Id.* at 48.

the simplified approach to cut the risk weight of mortgages from 50% under Basel I to 35% under the simplified approach of Basel II.¹⁰³

In the United States, the Federal Reserve and the other banking regulators agreed that only a handful of large, internationally active banks would be required to use the IRB approach and that another group of large banks would be allowed to voluntarily adopt the IRB approach.¹⁰⁴ All other banks in the United States would continue to use the capital adequacy standards imposed by the Basel I Capital Accord.¹⁰⁵ The SEC also allowed the CSEs that it regulated to use internal risk models when calculating their capital requirements and gave them far more flexibility than the Federal Reserve gave to the FHCs and BHCs that it regulated.¹⁰⁶

The average leverage ratio for U.S. commercial banks in 2008 was 12 to 1.¹⁰⁷ The firms regulated by the SEC as CSEs were allowed to be substantially more leveraged than the firms regulated by the Federal Reserve as FHCs or BHCs. The average leverage ratio for Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley was 25.3 to 1, or more than double the average leverage ratio for U.S. commercial banks.¹⁰⁸

OHFEO, which regulated the GSEs, also allowed them to be considerably more leveraged than commercial banks were allowed to

103. Adrian Blundell-Wignall & Paul Atkinson, *The Sub-Prime Crisis: Causal Distortions and Regulatory Reform*, in LESSONS FROM THE FINANCIAL TURMOIL OF 2007 AND 2008 55, 72 (Paul Bloxham & Christopher Kent eds., 2008), available at <http://www.oecd.org/dataoecd/33/6/42031344.pdf>.

104. See Risk Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Final Rule, 72 Fed. Reg. 69,288, 69,290, 69,297 (Dec. 7, 2007) (to be codified at 12 C.F.R. pt. 3, pt. 208 and 225, pt. 325, pt. 559, 560, 563, 567) (discussing the circumstances under which IRB adoption would be mandatory or permissive).

105. *Id.* at 69,297.

106. CSE Final Rule, *supra* note 67, at 34,428, 34,461; SIBHC Final Rule, *supra* note 67, at 34,480–85; SEC IG's CSE REPORT, *supra* note 70, at 19–20.

107. See Niall Ferguson, *The Descent of Finance*, HARV. BUS. REV., July–Aug. 2009, at 44, 45, 48.

108. THE BEAR STEARNS COMPANIES, INC., 2006 ANNUAL REPORT 46 (2006), available at <http://www.slideshare.net/QuarterlyEarningsReports3/bear-stearns-annual-report-2006>; GOLDMAN SACHS, 2008 ANNUAL REPORT i (2008), available at <http://www2.goldmansachs.com/our-firm/investors/financials/archived/annual-reports/2008-annual-report.html>; LEHMAN BROS. HOLDINGS, INC., 2007 ANNUAL REPORT 59 (2007), available at <http://fclass.vaniercollege.qc.ca/~larocagg/FOV1-00043009/FOV1-00051364/Lehman%20Brothers%20yr%202007%20Annual%20Report.pdf?FCItemID=S002288FE&Plugin=Loft>; MERRILL LYNCH, 2007 ANNUAL REPORT 56 (2007), available at <http://www.ml.com/annualmeetingmaterials/2007/ar/download.asp>; Morgan Stanley, Annual Report, (Form 10-K), at 80 (2006), available at <http://www.morganstanley.com/about/ir/shareholder/10k2006/10k11302006.pdf>.

be. In 2006, the leverage ratios for Fannie Mae and Freddie Mac were 20.3 to 1 and 28.7 to 1.¹⁰⁹

Below is a sample of some of the major financial conglomerates in the United States and their leverage ratios between 2000 and 2008.

109. FANNIE MAE, 2006 ANNUAL REPORT 1 (2006), *available at* http://www.fanniemae.com/ir/pdf/annualreport/2006/2006_annual_report.pdf; FREDDIE MAC, 2006 ANNUAL REPORT 22 (2006), *available at* <http://www.freddiemac.com/investors/ar/pdf/2006annualrpt.pdf>.

Table 1: Leverage Ratios of a Sample of Large Financial Conglomerates¹¹⁰

Financial Institution (Country)	Leverage Ratio (Total Assets divided by Shareholders' Equity (Deficit))								
	2008	2007	2006	2005	2004	2003	2002	2001	2000
American International Group (US) ¹¹¹	16.3	10.9	9.6	9.9	9.9	9.6	9.5	9.5	7.7
Bank of America Corp. (US) ¹¹²	10.3	11.7	10.8	12.7	12.4	15.2	13.7	13.2	14.2
Bear Stearns (US) ¹¹³	—	32.8	26.5	26.0	27.7	26.4	26.6	29.0	27.8
Citigroup (US) ¹¹⁴	13.7	19.3	15.7	13.3	13.6	12.9	12.7	12.9	13.6
Countrywide Financial (US) ¹¹⁵	—	14.4	14.0	13.7	12.5	12.1	11.2	9.1	5.5
Fannie Mae (US) ¹¹⁶	—	19.0	20.3	21.2	26.2	31.7	28.4	44.1	32.4

110. Any numbers in parentheses are negative.

111. Am. Int'l Group, Inc., Annual Report, (Form 10-K), at 192–93 (Mar. 2, 2009); Am. Int'l Group, Inc., Annual Report, (Form 10-K), at 102–03 (Mar. 1, 2007); Am. Int'l Group, Inc., Annual Report, (Form 10-K), at 102–103 (May 27, 2005); Am. Int'l Group, Inc., Annual Report, (Form 10-K), at 60–61 (Mar. 31, 2003); Am. Int'l Group, Inc., Annual Report, (Form 10-K), at 43–44 (Apr. 2, 2001).

112. BANK OF AM. CORP., 2008 ANNUAL REPORT 26 (2008), available at <http://phx.corporate-ir.net/phoenix.zhtml?c=71595&p=irol-reportsannual>; BANK OF AM. CORP., 2006 ANNUAL REPORT 38 (2006), available at <http://phx.corporate-ir.net/phoenix.zhtml?c=71595&p=irol-reportsannual>; BANK OF AM. CORP., 2004 ANNUAL REPORT 37 (2004), available at <http://phx.corporate-ir.net/phoenix.zhtml?c=71595&p=irol-reportsannual>.

113. The Bear Stearns Companies, Inc., Annual Report (Form 10-K), at F-4 (Jan. 29, 2008); THE BEAR STEARNS COMPANIES, INC., 2006 ANNUAL REPORT, *supra* note 108, at 46; The Bear Stearns Companies, Inc., Annual Report (Form 10-K), at F-4 (Feb. 14, 2005); The Bear Stearns Companies, Inc., Annual Report (Form 10-K), at F-4 (Feb. 28, 2003); The Bear Stearns Companies, Inc., Annual Report (Form 10-K), at 49 (Feb. 28, 2001). Bear Stearns was acquired by J.P. Morgan Chase & Co. in 2007. As result, there is no annual data for its leverage ratio in 2008.

114. CITIGROUP INC., 2008 ANNUAL REPORT 4 (2008), available at <http://www.citigroup.com/citi/corporategovernance/ar.htm>; Citigroup Inc., Current Report (Form 8-K), Ex. 99.01, at 3 (Sept. 9, 2005).

115. Countrywide Fin. Corp., Annual Report (Form 10-K), at 48 (Feb. 28, 2008); Countrywide Fin. Corp., Annual Report (Form 10-K), at F-4 (Mar. 19, 2003); Countrywide Fin. Corp., Annual Report (Form 10-K), at F-45 (Mar. 20, 2002). Countrywide was acquired by Bank of America in 2008 and as a result, there is no annual data for its leverage ratio in 2008. See BANK OF AM. CORP., 2008 ANNUAL REPORT, *supra* note 112, at 5.

116. Fed. Nat'l Mortg. Ass'n, Annual Report (Form 10-K), at F-3 (Feb. 26, 2000) [hereinafter Fannie Mae 10-K 2008 Report]; FANNIE MAE, 2006 ANNUAL REPORT, *supra*

Financial Institution (Country)	Leverage Ratio (Total Assets divided by Shareholders' Equity (Deficit))								
	2008	2007	2006	2005	2004	2003	2002	2001	2000
Freddie Mac (US) ¹¹⁷	—	29.7	28.7	29.7	25.3	25.5	24.0	32.7	26.7
GMAC (US) ¹¹⁸	8.6	16.0	20.3	15.0	14.5	14.2	12.8	12.0	12.0
Goldman Sachs Group (US) ¹¹⁹	13.7	26.2	23.4	25.2	21.2	18.7	18.7	17.1	17.5
J.P. Morgan Chase & Co. (US) ¹²⁰	13.0	12.7	11.7	11.2	11.0	16.7	17.9	16.9	16.9

note 109, at 1; Fed. Nat'l Mortg. Ass'n, Annual Report (Form 10-K), at 89, F-3 (2004); FANNIE MAE, 2001 ANNUAL REPORT 1 (2001), *available at* <http://www.fanniemae.com/global/pdf/ir/annualreport/2001/fullreport.pdf?sessionid=WDJ1IWA5ZG4OPJ2FECISFGA>. Fannie Mae had no shareholders' equity in 2008 but, in fact, had a shareholders' deficit. Fannie Mae 10-K 2008 Report, *supra*, at F-3. The Financial Crisis Inquiry Commission found that Fannie Mae's and Freddie Mac's combined leverage ratio, including all of the loans that they owned and had guaranteed, equaled 75 to 1. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xx (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [hereinafter FCIC REPORT].

117. Fed. Home Loan Mortg. Co., Annual Report (Form 10-K), at 58 (Mar. 11, 2009), [hereinafter Freddie Mac 2008 10-K Report]; FREDDIE MAC, 2006 ANNUAL REPORT, *supra* note 109, at 22; FREDDIE MAC, 2004 ANNUAL REPORT 19 (2004). Freddie Mac had no shareholders' equity in 2008 but, in fact, had a shareholders' deficit. Freddie Mac 2008 10-K Report, *supra* at 58. As noted in above, the Financial Crisis Inquiry Commission found that Fannie Mae's and Freddie Mac's combined leverage ratio, including all of the loans that they owned and guaranteed, equaled 75:1. FCIC REPORT, *supra* note 116, at xx.

118. GMAC, LLC, Annual Report (Form 10-K), at 26 (Feb. 27, 2009); GMAC, LLC, Annual Report (Form 10-K), at 7 (Mar. 16, 2005).

119. GOLDMAN SACHS, 2008 ANNUAL REPORT, *supra* note 108, at i; GOLDMAN SACHS, 2005 ANNUAL REPORT i (2005), *available at* <http://www2.goldmansachs.com/our-firm/investors/financials/archived/annual-reports/2005-annual-report.html>; GOLDMAN SACHS, 2002 ANNUAL REPORT 43 (2002), *available at* <http://www2.goldmansachs.com/our-firm/investors/financials/archived/annual-reports/attachments/2002-annual-report.pdf>; GOLDMAN SACHS, 2000 ANNUAL REPORT 37 (2000), *available at* <http://www2.goldmansachs.com/our-firm/investors/financials/archived/annual-reports/2000-annual-report.html>.

120. J.P. MORGAN CHASE & CO., 2008 ANNUAL REPORT 38 (2008), *available at* <http://investor.shareholder.com/jpmorganchase/annual.cfm>; J.P. MORGAN CHASE & CO., 2003 ANNUAL REPORT 83 (2003), *available at* <http://investor.shareholder.com/jpmorganchase/annual.cfm>; J.P. MORGAN CHASE & CO., 2000 ANNUAL REPORT I (2000), *available at* <http://www.ba.hokkai-s-u.ac.jp/~aono/30jpanual2000.pdf>.

Financial Institution (Country)	Leverage Ratio (Total Assets divided by Shareholders' Equity (Deficit))								
	2008	2007	2006	2005	2004	2003	2002	2001	2000
Lehman Brothers Holdings (US) ¹²¹	24.3	30.7	26.2	24.4	23.9	23.7	29.1	29.3	28.9
Merrill Lynch (US) ¹²²	33.4	27.8	19.9	17.9	18.5	16.3	17.6	18.5	19.4
Morgan Stanley (US) ¹²³	11.4	32.6	30.4	30.5	26.8	23.0	24.5	23.6	22.1
Wachovia Corp. (US) ¹²⁴	—	10.2	10.1	10.9	12.1	11.2	10.7	11.6	16.6
Washington Mutual (US) ¹²⁵	—	13.3	12.8	12.6	14.7	14.2	13.3	17.2	19.2

121. LEHMAN BROS. HOLDINGS, INC., 2007 ANNUAL REPORT, *supra* note 108, at 29; Lehman Bros. Holdings, Inc., Annual Report (Form 10-K), at 28 (Feb. 14, 2005). The leverage ratio for 2008 is for the quarter ending May 31, 2008. Lehman Bros. Holdings, Inc., Quarterly Report (Form 10-Q), at 55 (July 10, 2008).

122. Merrill Lynch & Co., Annual Report (Form 10-K), at 53–54 (Feb. 24, 2009) (leverage ratio for 2008 calculated by dividing total assets by total shareholders' equity); MERRILL LYNCH & CO., 2007 ANNUAL REPORT, *supra* note 108, at 56; MERRILL LYNCH & CO., 2005 ANNUAL REPORT 47 (2005), *available at* <http://www.ml.com/annualmeetingmaterials/2005/ar/download.asp>; MERRILL LYNCH & CO., 2003 ANNUAL REPORT 34 (2003), *available at* <http://www.ml.com/annualmeetingmaterials/2003/ar/pdf.asp>; MERRILL LYNCH & CO., 2001 ANNUAL REPORT 32 (2001), *available at* <http://www.ml.com/annualmeetingmaterials/annrep2001/ar-pdf/ml-annual.pdf>.

123. Morgan Stanley, Annual Report (Form 10-K), at 75 (Jan. 28, 2009); MORGAN STANLEY, 2007 ANNUAL REPORT *supra* note 108, at 80; Morgan Stanley, Annual Report (Form 10-K), at 68 (Feb. 10, 2005); Morgan Stanley, Annual Report (Form 10-K), at 51 (Feb. 19, 2003); Morgan Stanley Dean Witter & Co., Annual Report (Form 10-K), at 22 (Feb. 16, 2001) (leverage ratio for 2000 calculated by dividing total assets by total shareholders' equity).

124. WACHOVIA, 2007 ANNUAL REPORT, at 1 (2007), *available at* https://www.wachovia.com/file/2007_Wachovia_Annual_Report.pdf; WACHOVIA, 2004 ANNUAL REPORT 68 (2004), *available at* https://www.wachovia.com/file/2004_annualreport.pdf; WACHOVIA, 2002 ANNUAL REPORT 1 (2002), *available at* <https://www.wachovia.com/file/WB2002annualreport.pdf>; WACHOVIA, 2000 ANNUAL REPORT 1 (2000), *available at* https://www.wachovia.com/common_files/fullar2000.pdf (Wachovia was formed by the merger of First Union and the former Wachovia, First Union changed its name to Wachovia after the merger). Wachovia was acquired by Wells Fargo in 2008 and as a result, it did not publish a 2008 annual report containing its 2008 leverage ratio. For information about its acquisition by Wells Fargo, *see* WELLS FARGO & CO., 2008 ANNUAL REPORT 3 (2008), *available at* https://www.wellsfargo.com/downloads/pdf/invest_relations/wf2008annualreport.pdf.

125. Washington Mut., Inc., Annual Report (Form 10-K/A), at 9 (May 22, 2008); Washington Mut., Inc., Annual Report (Form 10-K), at 78 (Mar. 13, 2003);

Financial Institution (Country)	Leverage Ratio (Total Assets divided by Shareholders' Equity (Deficit))								
	2008	2007	2006	2005	2004	2003	2002	2001	2000
Wells Fargo (US) ¹²⁶	13.2	12.1	10.5	11.8	11.3	11.3	11.5	11.3	10.3

The above ratios are based on firms' publicly disclosed financial statements, which frequently obscured the true levels of leverage at these institutions because accounting rules allowed these entities to exclude a host of off-balance sheet commitments. When these commitments are taken into account, the picture can change dramatically. For example, according to the Bridgewater Financial Group, Bank of America's leverage ratio in September 2008 was 134 to 1 when its off-balance sheet commitments were taken into account.¹²⁷

In addition, some institutions deliberately manipulated their balance sheets to inflate the value of assets and engaged in other accounting irregularities.¹²⁸ For example, Lehman Brothers parked \$50 billion off of its balance sheets by using Repo 105 transactions, a type of repurchase agreement.¹²⁹ According to Martin Kelly, Lehman

Washington Mut., Inc., Annual Report (Form 10-K), at 56 (Feb. 20, 2001). Washington Mutual was acquired by J.P. Morgan Chase & Co. in 2008 and as a result, it did not publish a 2008 annual report containing its 2008 leverage ratio. For information about its acquisition by J.P. Morgan Chase, see J.P. MORGAN CHASE & CO., 2008 ANNUAL REPORT, *supra* note 120, at 10–11.

126. WELLS FARGO & CO., 2008 ANNUAL REPORT *supra* note 124, at 87; WELLS FARGO & CO., 2006 ANNUAL REPORT 69 (2006), *available at* https://www.wellsfargo.com/downloads/pdf/invest_relations/wf2006annualreport.pdf; WELLS FARGO & CO., 2004 ANNUAL REPORT 63 (2004), *available at* http://www.wellsfargo.com/downloads/pdf/invest_relations/wf2004annualreport.pdf; WELLS FARGO & CO., 2002 ANNUAL REPORT 61 (2002), *available at* <http://www.wellsfargo.com/annual2002.pdf>; WELLS FARGO & CO., 2001 ANNUAL REPORT 55 (2001), *available at* https://www.wellsfargo.com/pdf/invest_relations/wf_2001narrative.pdf.

127. See Ferguson, *supra* note 98, at 44, 48.

128. Mike Spector, Susanne Craig, & Peter Lattman, *Examiner: Lehman Torpedoed Lehman*, WALL ST. J., Mar. 11, 2010, http://online.wsj.com/article/SB10001424052748703625304575115963009594440.html?mod=WSJ_hps_LEFTWhatsNews.

129. *Id.* A repo is a repurchase agreement. Under a repo, one party sells assets to another and agrees that it will buy back those assets within a fixed period of time. See Gary Gorton, *Questions and Answers About the Financial Crisis* (Feb. 20, 2010), *available at* <http://online.wsj.com/public/resources/documents/crisisqa0210.pdf>; Gary Gorton & Andrew Metrick, *Haircuts 1* (forthcoming, Yale ICF, Working Paper No. 09-15, 2010), *available at* <http://ssrn.com/abstract=1447438>. Repos are effectively loans of money for very short periods of time with the assets sold serving as collateral, which the buyer can sell to someone else if the original seller defaults on its promise to repurchase the assets. U.S. generally accepted accounting practices (U.S. GAAP) allow the entity selling the assets to treat the transaction as a "sale" and move the

Brothers' global financial controller, the Repo 105 transactions had "no substance" and "the only purpose or motive for the transactions was reduction in balance sheet."¹³⁰

Lehman Brothers was not the only financial conglomerate that relied heavily on repos and took substantial haircuts¹³¹ on the repos into which it entered. All of the financial conglomerates that were regulated by the SEC as CSEs relied heavily on repos for funding. In 2007 Goldman Sachs had repo transactions on its balance sheet worth 3.7 times its total shareholders' equity or \$159.2 billion.¹³² After becoming a BHC in 2008, Goldman Sachs reduced the amount of repo agreements on its balance sheet to less than its total shareholders' equity, which represented a 60% reduction to \$62.9 billion.¹³³

Even some FHCs and BHCs regulated by the Federal Reserve used repos extensively, although not as much as the CSEs. Citigroup had repo transactions on its balance sheet worth 2.7 times the value of its total shareholders' equity, or \$304.2 billion.¹³⁴ Bank of America had repo transactions on its balance sheet worth 1.5 times the value of its total shareholders' equity, or \$221.4 billion.¹³⁵

The heavy reliance of many financial conglomerates on repos for funding and to hide how leveraged they were made them particularly vulnerable in the event of a liquidity crisis because if a financial firm's counterparties decided not to renew or rollover the repurchase agreements, it could easily bankrupt a firm that relied heavily on these agreements as a source of funds. Lehman Brothers illustrated this. At the end of 2007, Lehman Brothers disclosed that it had

assets given as collateral off of its balance sheet if the value of the assets exceeds 102% of the cash received for them and a law firm has issued a true sale opinion that the transactions meets all of the legal requirements for a sale. See Spector, Craig, & Lattman, *supra* note 128. The difference between the value of the assets exchanged and the cash received is called a "haircut." Gorton, *supra*, at 12; Gorton & Metrick, *supra*, at 2. Larger haircuts are required the riskier the buyer considers the transaction or the seller. Gorton, *supra*, at 12; Gorton & Metrick, *supra*, at 2. A Repo 105 transaction is one in which the value of the assets given as collateral equaled 105% of the cash received in exchange for the assets. Spector, Craig, & Lattman, *supra* note 128.

130. *Id.*

131. The difference between the value of the assets exchanged and the cash received as part of a repurchase agreement is called a "haircut". Gorton, *supra* note 129, at 12; Gorton & Metrick, *supra* note 129, at 2.

132. GOLDMAN SACHS, 2007 ANNUAL REPORT 87 (2007), available at <http://www2.goldmansachs.com/our-firm/investors/financials/archived/annual-reports/2007-annual-report.html>.

133. GOLDMAN SACHS, 2008 ANNUAL REPORT *supra* note 108, at 77.

134. Citigroup, Annual Report (Form 10-K), at 106 (Feb. 22, 2008).

135. BANK OF AMERICA, 2007 ANNUAL REPORT 39 (2007), available at http://media.corporate-ir.net/media_files/irol/71/71595/reports/2007_AR.pdf.

\$181.7 billion in repo transactions on its balance sheet, up 36% from the amount that it held at the end of 2006.¹³⁶ These repos were worth eight times as much as Lehman Brothers' total shareholders' equity.¹³⁷ As a result, Lehman Brothers could be, and was, bankrupted overnight when its counterparties refused to renew or enter into new repurchase agreements with it.¹³⁸

Empirical research has found evidence of how the reliance on repos put pressure on the financial stability of other conglomerates.¹³⁹ This research discovered that, during the financial crisis, repos experienced "runs" as counterparties demanded significantly larger haircuts in order to enter into such agreements or to renew them.¹⁴⁰ By January 2009, the average repo haircut on securitized bonds and other structured debt was about 45%.¹⁴¹ The larger haircuts forced many firms to sell assets at the same time, which depressed the prices for those assets.¹⁴² The firms forced to take these haircuts and engage in these sales found themselves in precarious financial positions.

Repos did not play a direct role in the financial problems of THCs like Washington Mutual (WaMu) and of BHCs like Wachovia because they did not rely on repos for a significant portion of their funding.¹⁴³ Repos, however, did play an indirect role in the troubles of those financial institutions because repos helped cause Lehman Brothers' collapse, which in turn led to silent bank runs on WaMu and

136. LEHMAN BROS. HOLDINGS, INC., 2007 ANNUAL REPORT, *supra* note 108, at 79.

137. *Id.* at 79.

138. See Gorton, *supra* note 129, at 12–13 (discussing the increasing size of haircuts as creating a run on the repo); Morgan Housel, *Lehman Brothers and the Age of Stupidity*, THE MOTLEY FOOL (Sept. 11, 2009), <http://www.fool.com/investing/general/2009/09/11/lehman-brothers-and-the-age-of-stupidity.aspx>.

139. Gorton & Metrick, *supra* note 129, at 1.

140. Gorton, *supra* note 129, at 13. Haircuts mean that the firms were getting a smaller amount of cash for the collateral that they were putting up. *Id.* at 12–14. For example, if the firms were putting up \$1 trillion but taking a 45% haircut, then they would only be receiving \$550 billion in exchange for the collateral that they put up. In order to make up the \$450 billion cash short fall, the firms would have to borrow those funds from other sources or sell assets.

141. *Id.* at 13.

142. *Id.* at 5, 12–14.

143. WASHINGTON MUTUAL, INC., 2007 ANNUAL REPORT AND FORM 10-K 104 (2007) (demonstrating that Washington Mutual had only US \$4.1 billion in repos at the end of 2007, a figure less than half the amount it had at the end of 2006, and representing only about 17% of its total shareholders' equity); WACHOVIA, 2007 ANNUAL REPORT, *supra* note 124, at 71, 101 (demonstrating that Wachovia also had a small amount of repos, only US \$29.3 billion, on its balance sheet at the end of 2007, which represented less than 40% of its total shareholders' equity).

Wachovia.¹⁴⁴ As a result of these runs, J.P. Morgan Chase & Co. purchased WaMu and Wells Fargo purchased Wachovia.¹⁴⁵

B. Lack of Coordination Among Regulators

The United States did not have a forum or a body to coordinate the regulatory and supervisory activities of its vast array of financial services regulators to address the unique problems posed by financial conglomerates.¹⁴⁶ It did have several forums that brought together some, but not all, of the financial regulators: the Federal Financial Institutions Examination Council (FFIEC), the President's Working Group on Financial Markets ("the President's Working Group"), the Financial and Banking Information Infrastructure Committee (FBIIC), the Financial Literacy and Education Commission, the North American Securities Administrators' Association (NASAA), the Conference of State Bank Supervisors (CSBS), and National Association of Insurance Commissioners (NAIC).¹⁴⁷

None of these groups had the authority, jurisdiction or resources to ensure the systematic sharing of information between all of holding company regulators and the relevant functional or institutional regulators. As a result, it was difficult for the plethora of agencies to coordinate their activities and to assess the systemic risks

144. Washington Mutual ("WaMu") failed after depositors pulled US \$16.7 billion out of the bank in the ten days following Lehman Brothers' collapse. Robin Sidel, David Enrich & Dan Fitzgerald, *WaMu is Seized, Sold Off to J.P. Morgan*, in *Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, <http://online.wsj.com/article/SB122238415586576687.html>. That represented almost 9% of the bank's total deposits as of its last quarterly report on June 30, 2008. *Id.* WaMu was in a weakened state before Lehman's failure as it had posted a second quarter 2008 loss of US \$3.3 billion and was predicted to lose US \$19 billion between 2008 and 2010 because it held US \$53 billion in option adjustable rate mortgages and US \$16.1 billion in mortgages to subprime borrowers that were some of the most vulnerable to defaults. *Id.* After the bankruptcies of Lehman Brothers and WaMu, Wachovia experienced a silent run on the bank as depositors withdrew billions of dollars in deposits, including US \$5 billion in a single day on September 26, 2008. Rick Rothacker, *\$5 Billion Withdrawn in One Day in Silent Run*, CHARLOTTE OBSERVER, Oct. 11, 2008, <http://www.charlotteobserver.com/2008/10/11/246983/5-billion-withdrawn-in-one-day.html>.

145. Press Release, Wells Fargo, Wells Fargo and Wachovia Merger Completed (Jan. 1, 2009), *available at* https://www.wellsfargo.com/press/2009/20090101_Wachovia_Merger.

146. See Brown, *supra* note 6, at 28–30.

147. See Brown, *supra* note 6, at 29; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-61, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 97–108 (2004) [hereinafter GAO FINANCIAL REGULATION]. NAIC, NASAA and CSBS are the associations for the state insurance, securities, and banking regulators, respectively. The Financial Literacy and Education Commission was created by Congress to coordinate efforts to educate the public on financial matters and is composed of 20 federal agencies, including all of the federal financial regulators. GAO FINANCIAL REGULATION, *supra*, at 108.

to the financial industry as a whole.¹⁴⁸ In fact, inter-agency rivalries had undermined efforts to expand the scope and composition of these groups in order to provide that kind of strategic assessment of the financial industry's risks.¹⁴⁹

With regard to these inter-agency forums, the President's Working Group came the closest to creating a forum for strategically addressing the issues facing the financial services industry. It was this entity to which President George W. Bush turned in August 2007 to investigate the underlying causes of the financial crisis.¹⁵⁰ The President's Working Group was comprised of the Treasury Department, the Federal Reserve, the SEC, and the CFTC.¹⁵¹ It did not contain any representatives from the OTS nor from any of state banking, securities, or insurance regulators.¹⁵²

FFIEC was created on March 10, 1979 as a result of the Financial Institutions Regulatory and Interest Rate Control Act of 1978.¹⁵³ FFIEC is comprised of the Federal Reserve, the FDIC, the NCUA, the OCC, and the OTS, but it does not include the SEC, the CFTC, or any representatives from the state securities or insurance regulators.¹⁵⁴ In 2006, the FFIEC added a representative from the State Liaison Committee, which includes representatives from the state banking, thrift, and credit union regulators, as a new voting member.¹⁵⁵ Consequently, the FFIEC could only deal effectively with a limited range of issues because not all state and federal financial regulators are members of FFIEC.¹⁵⁶

The FFIEC had limited authority to recommend regulations to govern the regulation and supervision of holding companies.¹⁵⁷ Its mission is to prescribe uniform principles and standards for the examination of depository institutions and to coordinate their

148. GAO FINANCIAL MARKET REGULATION REPORT, *supra* note 64, at 97.

149. Brown, *supra* note 6, at 30.

150. THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS i (2008), *available at* http://www.ustreas.gov/press/releases/reports/pwgpolicystatemkkturmoil_03122008.pdf.

151. Working Group on Financial Markets, 53 Fed. Reg. 9421 (Mar. 22, 1988).

152. *See id.* (denoting the participants of the President's Working Group: the Federal Reserve, the SEC, the Treasury Department, and the CFTC).

153. Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat. 3641 (codified at 12 U.S.C. 226 (2006)).

154. BANKING AGENCY OFFICES OF INSPECTOR GENERAL, DEP'T OF THE TREASURY, FED. DEPOSIT INS. CORP., BD. OF GOVERNORS OF THE FED. RESERVE SYS., JOINT EVALUATION OF THE FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL 3-4 (2002) [hereinafter OIG FFIEC REPORT].

155. FED. FIN. INST. EXAMINATION COUNCIL, (Mar. 25, 2011), <http://www.ffiec.gov>.

156. OIG FFIEC REPORT, *supra* note 154, at 10.

157. *Id.* at 9.

regulatory efforts.¹⁵⁸ Thus, it could only recommend holding company regulations to the extent that they pertained to the regulation of depository institutions. In addition, the FFIEC could not compel its members to adopt a particular proposal, but served only as a coordinating and policy-making entity for its members.¹⁵⁹ Because FFIEC lacked rulemaking authority, each of the relevant agencies had to agree to jointly issue rules for any projects requiring inter-agency cooperation.¹⁶⁰

Finally, FFIEC's effectiveness on the issues with which it does deal has been contingent on who the members are at a given time.¹⁶¹ A 2002 joint report of the banking agencies' Offices of Inspectors General evaluating the performance of the FFIEC noted:

A number of the officials noted that the Council's success depended in large part on the individual principal's interaction and level of commitment to the FFIEC. One senior agency official indicated that while the FFIEC exists in law, in practice the FFIEC exists at the consent of the Council and task force members. One principal stated that personal relationships are important at all levels of the FFIEC and that without good relationships there is no basis for completing interagency projects.¹⁶²

As a result, the effectiveness of the FFIEC could be, and on occasion was, undermined by cooperation and coordination problems.

FBIIC was created following the September 11, 2001 attacks and was tasked with ensuring the preparedness and stability of the financial sector in the event of future threats.¹⁶³ FBIIC drew its members from a wider range of financial regulators than either the President's Working Group or FFIEC. FBIIC is comprised of representatives from the Federal Reserve, FDIC, OCC, OTS, SEC, CFTC, NCUA, NAIC, CSBS, OFHEO, the Federal Housing Finance Board, the Office of Homeland Security, and the Office of Cyberspace Security.¹⁶⁴

Nevertheless, FBIIC's narrow mission prevented it from having much say in how agencies should regulate financial conglomerates. FBIIC's mission is: "Working with appropriate members of financial

158. *Id.* at 3.

159. 12 U.S.C. § 3305 (2006).

160. OIG FFIEC REPORT, *supra* note 154, at 9.

161. *Id.* at 7.

162. *Id.*

163. Critical Infrastructure Protection in the Information Age, 66 Fed. Reg. 53,063-71 (Oct. 18, 2001).

164. GAO FINANCIAL REGULATION, *supra* note 147, at 107.

institution regulatory agencies, coordinate efforts to improve the reliability and security of financial information infrastructure.¹⁶⁵ It focuses on protecting the financial information infrastructure, which only tangentially touches upon financial conglomerate regulation.

As a result of the absence of any forum encouraging the holding company regulators to coordinate their regulations, the holding company regulators made little effort to do so. Consequently, they missed opportunities to learn from each other's experiences and to develop a set of best practices for regulating financial conglomerates. In addition, the holding company regulators, particularly the OTS and the SEC, used the differences in regulatory regimes to compete with one another for firms.¹⁶⁶ This competition exacerbated the regulatory arbitrage problem.

C. Failure to Understand Risks Posed by Functional Subsidiaries

The regulatory agencies generally examined the holding companies under their supervision on a consolidated basis and deferred to the relevant agencies to examine the functional subsidiaries in more detail. This situation was mandated in the laws outlining the duties of the agencies under GLBA and other laws. When Congress enacted the GLBA, it attempted to preserve the regulatory authority of the functional regulators.

The problem with this system is that the functional regulators were not tasked with examining whether the entities that they regulated posed risks to the larger financial groups in which they were members, or whether they potentially could pose systemic risks. The holding company regulators, who were responsible for determining whether the financial conglomerates posed systemic risks, were forced to rely on reports concerning subsidiaries by agencies that were not drafting them with these risks in mind. This gap between the goals of these different agencies meant that subsidiaries could pose systemic risks that would go unnoticed by the relevant regulators.

In addition, as already noted in the case of Enron's derivative subsidiaries, some subsidiaries lacked a functional regulator. In those cases, the financial services holding company regulators had some ability to examine those subsidiaries. The problem in those cases was that the financial services holding company regulators often lacked

165. *About FBIIC, Mission*, FIN. AND BANKING INFORMATION INFRASTRUCTURE COMM. (Oct. 15, 2007), <http://www.fbiic.gov/about/mission.htm>.

166. FCIC REPORT, *supra* note 116, at 154.

personnel with the expertise to understand those subsidiaries and how they operated.

AIG Financial Products Corp. provides an example of this problem. AIG was regulated by the OTS, but its subsidiary, AIG Financial Products Corp., was subject to regulation by the SEC. The SEC, however, was only responsible for regulating those parts of its business that dealt with securities. The SEC did not regulate AIG Financial Product's derivative products, such as credit default swaps. Prior to 2000, the CFTC was considering regulating derivatives, but, as already mentioned, the Commodities Futures Modernization Act of 2000 specifically prevented the CFTC or any other federal agency from regulating derivatives. As a result, AIG Financial Products had no functional regulator for its derivatives business.

Evaluating the risks posed by AIG Financial Products' derivatives business fell to the OTS examiners, who supervised AIG as a THC. Unfortunately, the OTS lacked personnel with the necessary expertise to adequately evaluate the risks posed by the derivatives being traded by AIG Financial Products. The personnel at the OTS primarily dealt with savings and loans associations, which offered products and services similar to banks. In connection with evaluating these entities, OTS examiners needed to have some understanding of derivatives because federal regulations permitted savings and loans associations to use derivatives under certain circumstances.¹⁶⁷ In general, the regulations allowed a savings association to invest in financial derivatives if it was "authorized to invest in the assets underlying the financial derivative, the transaction is safe and sound," and it met any other requirements in the regulations.¹⁶⁸ Savings and loans could only invest in derivatives for the purpose of reducing their risk exposure.¹⁶⁹ The definition of financial derivatives included "futures, forward commitments, options, and swaps" but expressly excluded all mortgage derivative securities, including collateralized mortgage obligations.¹⁷⁰ In addition, to the guidance provided by these regulations, OTS examiners were given an Examination Handbook that provided additional directions for what they were to look for with regard to derivatives when examining a savings association.¹⁷¹ Even though the regulations excluded mortgage

167. 12 C.F.R. § 563.172 (2010).

168. *Id.*

169. *Id.*

170. *Id.*

171. *See* OFFICE OF THRIFT SUPERVISION, EXAMINATION HANDBOOK 660.1-32 (2001) [hereinafter OTS, EXAMINATION HANDBOOK] (demonstrating that this handbook was

derivative securities from the definition of financial derivatives, the Examination Handbook did provide some guidance for how examiners should evaluate the use of such instruments by a savings association.¹⁷² Unfortunately, this guidance was slightly less than a page long.¹⁷³

The OTS's Holding Companies Handbook did not provide significantly more guidance than that offered by the Examination Handbook. The Holding Companies Handbook was designed to provide guidance for OTS examiners who were evaluating risks posed by the THCs supervised by OTS. The handbook contains fewer than ten pages that even refer to derivatives.¹⁷⁴ Even when it does refer to derivatives, it provides little guidance regarding how OTS examiners should evaluate the risks posed by such products. For example, in the Risk Management section, the Holding Companies Handbook advises examiners that:

Risk limits are a necessary component of an effective risk management program. You should identify board-approved risk limits and ensure that senior management adopts, communicates, and monitors operations to ensure compliance with those limits. You should verify that the risk limits are commensurate with the goals and objectives of the enterprise as well as its financial strength and staff expertise.¹⁷⁵

The only time that the Risk Management section specifically mentions derivatives is when it notes that it is common for the board of directors of the holding company to place size limits on the derivatives portfolio.¹⁷⁶ In the Earnings section, the handbook instructs examiners to look for "high risk, cyclical or off-balance sheet activities that could adversely affect the company, causing additional pressure on other subsidiaries, including the thrift" and notes that derivatives usually fall within this category.¹⁷⁷ The section on financial conglomerates in the OTS's Holding Companies Handbook discusses derivatives on four of its eighteen pages and in those instances, it is

designed only to provide guidance for an examination of the savings association and for evaluating a THC and all of its subsidiaries). OTS did have another handbook that provided guidance for holding company examinations. OFFICE OF THRIFT SUPERVISION, HOLDING COMPANIES HANDBOOK 100 (2009) [hereinafter OTS, HOLDING COMPANIES HANDBOOK].

172. OTS, EXAMINATION HANDBOOK, *supra* note 171, at 660.30.

173. *Id.*

174. *See* OTS, HOLDING COMPANIES HANDBOOK, *supra* note 171, at 400.12, 500.7, 600.4-.5, 940.9, 940.15, 940.17-.18 (demonstrating that the portions of the handbook dealing with derivatives date from November 2003 to March 2009).

175. *Id.* at 500.6-.7.

176. *Id.* at 500.7.

177. *Id.* at 600.4-.5.

mainly suggesting generic questions that examiners should ask about the conglomerate's derivative positions.¹⁷⁸

The derivatives rules for savings associations found in the Examination Handbook and the Holding Companies Handbook did not prepare OTS examiners adequately for dealing with the complex derivative products offered by AIG Financial Products. Not only did AIG Financial Products invest in collateralized debt obligations ("CDOs") that were similar to collateralized mortgage obligations because they were partly backed by mortgage securities, but it provided credit default swaps ("CDSs") for CDOs to protect against the decline in value of the mortgage-backed securities upon which the CDOs were based.¹⁷⁹

The section of the OTS's Holding Companies Handbook dealing with financial conglomerates recognizes that financial conglomerates pose unique challenges and encourages examiners to adopt a broader view when examining financial conglomerates. It notes: "[t]his shift from managing along legal entity lines to functional lines means that the information and conclusions drawn during the examinations of individual entities within the conglomerate may be incomplete unless understood in the context of the examination findings of other related legal entities or centralized functions."¹⁸⁰ It later notes that "[t]he rapidly changing environment of a conglomerate means that we will need to increase planning and offsite monitoring" but in the very next paragraph it states that OTS "will use a more formalized annual supervisory planning process in supervising conglomerates."¹⁸¹ These two statements are at odds with one another. The former would suggest that OTS recognized that circumstances of some financial businesses, like derivatives, might change rapidly. Unfortunately, the later statement seems to indicate that OTS did not really follow through with this flexible approach but relied instead on a rigid, formalistic examination process.

Even with this formal, annual process, OTS should have been put on notice of troubles in AIG Financial Products if it had understood the derivatives business. AIG's board of directors had requested that AIG's CEO Martin Sullivan impose tighter controls on AIG Financial

178. *See id.* at 940.9, 940.15, 940.17–18 (this part of the handbook dates from November 2003 because it was not updated when other sections, like the Risk Management section, were updated in March 2009).

179. *See* FCIC REPORT, *supra* note 116, at xxiv–xxv, 273–74 (describing AIG's financial portfolio and its effect on the financial stability of AIG).

180. OTS, HOLDING COMPANIES HANDBOOK, *supra* note 171, at 940.1.

181. *Id.*

Products as early as 2005, but he never did.¹⁸² In addition, AIG Financial Products began receiving significant collateral calls in connection with its derivatives over a year before AIG's collapse.¹⁸³ AIG Financial Products had invested in subprime mortgage-backed securities that became impossible to sell in 2007.¹⁸⁴ The OTS, however, does not appear to have considered the derivatives business of AIG Financial Products as posing a serious threat to the existence of AIG and its other subsidiaries during the period from 2005 and 2008.¹⁸⁵ OTS conducted an examination of AIG in March 2008 and downgraded its composite rating from a "2" ("fundamentally sound") to a "3" ("moderate to severe supervisory concern") but concluded that it was likely that AIG would remain a viable business.¹⁸⁶ Within six months, however, AIG had collapsed and been taken over by the U.S. government.¹⁸⁷

The lesson from AIG is that holding companies regulators need to have the ability to examine all of the subsidiaries of the holding companies that they regulate and need to have personnel with the requisite expertise to understand these subsidiaries' businesses. If they had those two things, then they might have uncovered and dealt with the problems brewing in some of the troubled conglomerates before those problems severely imperiled the firms.

D. Regulatory Arbitrage

Prior to the crisis, regulatory arbitrage was cast as "regulatory competition" and advocated as a positive feature of the U.S. regulatory structure.¹⁸⁸ Alan Greenspan argued that regulatory arbitrage prevented overregulation because regulators that placed "excessive" burdens on firms would lose those firms to other agencies.¹⁸⁹

Regulatory arbitrage, however, did not always lead to the right amount of regulation; in many instances, it resulted in underregulation. In the case of holding company regulators, regulatory arbitrage allowed firms to find the regulator that would be most

182. BETHANY MCLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE* 329 (2010).

183. *Id.* at 330–41.

184. *Id.* at 328.

185. *See id.* at 94–95 (showing that in general, OTS had a blind spot with regard to subprime mortgages because while the OCC discouraged the entities that it supervised from making subprime loans, the OTS did nothing to deter the thrifts and THCs that it supervised from doing so).

186. FCIC REPORT, *supra* note 116, at 274.

187. *Id.*

188. *Id.* at 54.

189. *Id.*

accommodating to their needs, which usually translated into the regulator offering the weakest level of regulation.¹⁹⁰ AIG chose to own a thrift, rather than a bank, because the OTS would then regulate the company as a THC. AIG perceived the OTS to be a weaker regulator than the Federal Reserve.¹⁹¹ The investment banks, Goldman Sachs and Morgan Stanley, chose to own industrial loan companies or thrifts rather than banks because they wanted to be subject to the voluntary regulatory regime of the SEC, which was significantly weaker than the regime imposed by the Federal Reserve on FHCs and BHCs or the regime imposed by the OTS on THCs.¹⁹² In a survey conducted by the Federal Reserve, the CSEs stated that they did not want to be regulated by the Federal Reserve because its regulation was more comprehensive than either the SEC's or the OTS's approach.¹⁹³

The federal agencies had incentives to compete for firms because their budgets and prestige were tied up with how many firms they regulated and who they regulated.¹⁹⁴ The OTS's budget was directly tied to the assessments that it levied on the firms that it regulated.¹⁹⁵ The SEC also collects fees from the firms that it regulates but it does not get to control what portion of those fees that it keeps for budgetary purposes.¹⁹⁶ The SEC's budget is set by Congress.¹⁹⁷ The firms regulated by the SEC have shown no hesitation about aggressively lobbying Congress to curtail the SEC's budget if they believe that the SEC is considering imposing regulations that they view as burdensome.¹⁹⁸

The Federal Reserve had few incentives to compete with the OTS and the SEC because even though fees collected from the banks and holding companies regulated by the Federal Reserve help fund its operations, the vast majority of the Federal Reserve's revenues come from earnings on its portfolio of government securities.¹⁹⁹ In

190. *Id.* at 40, 352.

191. *Id.* at 352.

192. *See id.* at 150–54 (describing the decision of the five major U.S. investment banks to choose to be regulated by the SEC as opposed to other regulating entities).

193. *Id.* at 154.

194. *Id.* at 54.

195. *Id.*

196. U.S. SEC. EXCH. COMM'N, FY 2010 PERFORMANCE AND ACCOUNTABILITY REPORT 92 (2010).

197. *Id.*

198. Brown, *supra* note 6, at 51 (describing the lobbying efforts aimed at the SEC's budget in the 1990s to head off new regulations).

199. U.S. BD. OF GOVERNORS OF THE FED. RESERVE SYS., ANNUAL REPORT: BUDGET REVIEW 1, 25 (2008).

addition, the Federal Reserve has complete control over its budget²⁰⁰ and, therefore, is not subject to the pressures faced by the SEC. These two factors made the Federal Reserve less prone to agency capture than either the OTS or the SEC. Consequently, it is not surprising that the Federal Reserve would impose stronger regulations on the holding companies that it regulated than either the OTS or the SEC.

The impact of regulatory arbitrage can be seen in Table 2, which lists the twenty largest financial conglomerates by revenues in 2007. Eight of these twenty conglomerates were regulated by either the SEC, the OTS, or both, and not by the Federal Reserve. The OTS and the SEC lacked the budgetary resources, the personnel, and the experience of the Federal Reserve. These eight financial conglomerates deliberately chose the OTS and the SEC because they believed that the OTS and the SEC would allow them to engage in activities, such as higher levels of leverage in the case of the SEC and the CSEs under its supervision, than the Federal Reserve would have allowed.²⁰¹

200. See CONG. BUDGET OFFICE, THE BUDGETARY IMPACT AND SUBSIDY COSTS OF THE FEDERAL RESERVE'S ACTION DURING THE FINANCIAL CRISIS 3 (2010) (noting that the Federal Reserve is not subject to the appropriations process and it is able to operate independently from government influence).

201. See FCIC REPORT, *supra* note 116, at 151–54 (discussing the positive reaction of the investment banks to the creation of the CSE program and how it differed from banking regulations); see also SEC IG'S CSE REPORT, *supra* note 70, at 4 (“The firms agreed to consolidated supervision because of the preferential capital treatment under the alternative method and international requirements.”); *id.* at 19–20 (noting that the SEC had not imposed a leverage limit on the CSEs unlike the banking regulators who had imposed leverage limits on banks).

Table 2: Twenty Largest Financial Conglomerates by Revenue in 2007²⁰²

Name	Primary Industry Sector	Revenues as of 2007 (\$ millions)	Profits as of 2007 (\$ millions)	Federal Holding Company Regulators
General Electric Company	Diversified Financial	176,656	22,208	OTS
Citigroup	Banking	159,229	3,617	Federal Reserve, SEC
Bank of America Corp.	Banking	119,190	14,982	Federal Reserve
Berkshire Hathaway	Insurance	118,245	13,213	None
JP Morgan Chase & Co.	Banking	116,353	15,365	Federal Reserve, SEC
American International Group	Insurance	110,064	6,200	OTS
Goldman Sachs Group	Securities	87,968	11,599	SEC
Morgan Stanley	Securities	87,879	3,209	SEC, OTS
Merrill Lynch	Securities	64,217	(7,777)	SEC, OTS
State Farm Insurance Cos.	Insurance	61,612	5,464	Federal Reserve
Lehman Brothers Holdings	Securities	59,003	4,192	SEC, OTS
Wachovia Corp.	Banking	55,528	6,312	Federal Reserve
Wells Fargo	Banking	53,593	8,057	Federal Reserve
MetLife	Insurance	53,150	4,317	Federal Reserve
Fannie Mae	Diversified Financial	43,355	(2,050)	OHFEO

202. INS. INFO. INST., *supra* note 17, at 9; *Bank Holding Companies Name List*, FED. RESERVE BANK OF CHICAGO, http://www.chicagofed.org/digital_assets/others/banking/financial_institution_reports/bhc_name.txt (last visited Apr. 25, 2011); *Financial Holding Companies as of Mar 23, 2011*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/generalinfo/fhc/> (last visited Apr. 10, 2011); GAO FINANCIAL MARKET REGULATION REPORT, *supra* note 64, at 12; *Institution Directory*, FDIC, <http://www2.fdic.gov/idasp/main.asp> (last visited Apr. 10, 2011).

Name	Primary Industry Sector	Revenues as of 2007 (\$ millions)	Profits as of 2007 (\$ millions)	Federal Holding Company Regulators
Freddie Mac	Diversified Financial	43,104	(3,094)	OHFEO
Allstate	Insurance	36,769	4,636	Federal Reserve
Prudential Financial	Insurance	34,401	3,704	OTS
American Express	Diversified Financial	32,316	4,012	Federal Reserve
GMAC	Diversified Financial	31,490	(2,332)	OTS

At the end of the day, domestic regulatory arbitrage provides a partial explanation regarding why competing firms were regulated by different agencies and subject to different regulatory standards, as discussed in Part II.A above. Another part of the puzzle comes from international regulatory arbitrage.

During the decade leading up to the crisis, the competition among U.S. domestic regulators was made more contentious by the fact that the United States and the United Kingdom were engaged in a struggle to see who would be the primary financial services marketplace in the world. Private groups and government officials conducted major studies on competitiveness to assess the relative advantages of the United Kingdom and the United States.²⁰³

203. For some examples of these reports, see HM TREASURY, FINANCIAL SERVICES IN LONDON: GLOBAL OPPORTUNITIES AND CHALLENGES (2006), *available at* http://web.archive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/media/1E0/E6/bud06_cityoflondon_262.pdf [hereinafter UK TREASURY FINANCIAL SERVICES REPORT]; MCKINSEY & CO. & NEW YORK CITY ECON. DEV. CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), *available at* http://apps.americanbar.org/buslaw/committees/CL116000pub/materials/library/NY_Schumer-Bloomberg_REPORT_FINAL.pdf; COMM. ON CAPITAL MKTS. REG., INTERIM REPORT (2006); COMM. ON CAPITAL MKTS. REG., THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET (2007) [hereinafter COMM. ON CAPITAL MKTS., COMPETITIVE POSITION REPORT]; COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS (2007); RICHARD M. KOVACEVICH ET. AL., THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS (2007); Elizabeth F. Brown, *The Tyranny of the Multitude is a Multiplied Tyranny: Is the Financial Regulatory Structure Undermining U.S. Competitiveness?*, 2 BROOK. J. CORP. FIN. & COM. L. 369 (2008); Chris Brummer, *Stock Exchanges and the New Market for Securities Laws*, 75 U. CHI L. REV. 1435 (2008); Stephen J. Choi, *Channeling Competition in the Global Securities Market*, 16 TRANSNAT'L LAW. 111 (2002); John C. Coffee, Jr., *Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM L. REV. 1757 (2002); James D. Cox, *Rethinking U.S.*

This competition between the United Kingdom and the United States tended to focus on a relatively narrow range of financial products and services, such as securities and stock exchanges.²⁰⁴ It frequently was reduced to nothing more than a competition between London and New York for which had the most listed companies on its stock exchanges.

Because of this focus on securities, the SEC was particularly keen to help U.S. financial conglomerates, like the investment banks Bear Stearns, Goldman Sachs, Lehman Brothers, and Morgan Stanley. It not only created the CSE regulatory structure for them so that they could avoid being regulated under the EU Financial Conglomerate Directive, but it set significantly lower capital requirements for them than those imposed by the Federal Reserve on FHCs and BHCs.²⁰⁵

It is worth noting that this competition was not really about competition between American and British financial firms. American financial conglomerates often were the ones pushing this competition—and the deregulation that it sought to foster—on both sides of the Atlantic. Prior to the financial crisis, branches or subsidiaries of foreign banks, many of which were American, comprised over 75% of the banks authorized to do business within the United Kingdom.²⁰⁶ In the wake of the Big Bang, pursuant to which the U.K. government significantly deregulated the country's financial markets, foreign firms acquired or put out of business most of the major U.K. investment banks.²⁰⁷ Barclays' acquisition of large

Securities Laws in the Shadow of International Regulatory Competition, 55 LAW & CONTEMP. PROBS. 157 (1992); Steven M. Davidoff, *Regulating Listings in a Global Market*, 86 N.C. L. REV. 89 (2007); Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2007); Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 MICH. L. REV. 1858 (2007); Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, 1 REV. L. & ECON. 7 (2005); Peter Hostak et al., *An Examination of the Impact of the Sarbanes-Oxley Act on the Attractiveness of U.S. Capital Markets for Foreign Firms* (Apr. 30, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=956020>; Eric J. Pan, *Why the World No Longer Puts its Stock in Us* (forthcoming, Cardozo Sch. of Law Jacob Burns Inst. for Advanced Legal Studies, Working Paper No. 176, 2006), available at <http://ssrn.com/abstract=951705>.

204. See COMM. ON CAPITAL MKTS., COMPETITIVE POSITION REP., *supra* note 203; Brummer, *supra* note 203; Choi, *supra* note 203; Coffee, *supra* note 203; Cox, *supra* note 203; Davidoff, *supra* note 203; Litvak, *supra* note 203; Ribstein, *supra* note 203.

205. See FCIC REPORT, *supra* note 116, at 151 (discussing the lobbying of the investment banks for the creation of the CSE program because of concerns about the EU Conglomerates Directive); see also SEC IG'S CSE REPORT, *supra* note 70, at 4 (discussing the creation of the CSE program as a result of the EU Conglomerates Directive); *id.* at 19–20 (noting that the SEC had not imposed a leverage limit on the CSEs unlike the banking regulators who had imposed leverage limits on banks).

206. UK TREASURY FINANCIAL SERVICES REPORT, *supra* note 203, at 8.

207. DAVID KYNASTON, THE CITY OF LONDON, VOLUME IV: A CITY NO MORE 1945–2000, at 735, 782–83 (2001).

portions of Lehman Brothers following its financial collapse in September 2008 was the only major deviation from this trend.²⁰⁸ Thus, if Congress or the U.S. regulatory agencies truly wanted to decrease regulatory arbitrage, they would need to focus both on domestic regulatory arbitrage and on international regulatory arbitrage.

Addressing international regulatory arbitrage would require new international agreements, not just domestic legislation. International agreements, like Basel II Capital Accord,²⁰⁹ are helpful because they attempt to harmonize the regulatory requirements across countries and thus reduce the ability of firms to play national regulators off each other and reduce the incentives for firms to switch regulators. Several international forums already exist to promote financial regulatory harmonization. Among the major ones in the areas of banking, insurance, and securities are the Basel Committee on Banking Supervision, which focuses on banking regulations,²¹⁰ the International Association of Insurance Supervisors (IAIS), which focuses on insurance,²¹¹ and the International Organization of Securities Commissions (IOSCO), which focuses on securities regulation.²¹² These organizations are international standards-setting bodies. The agreements that they have produced are considered “soft law” because the standards that they set are nonbinding.²¹³ Nevertheless, these organizations have helped push the national standards of their member countries towards a uniform set of standards in the areas of banking, insurance, and securities.

208. Press Release, Lehman Brothers, Barclays to Acquire Lehman Brothers' Businesses and Assets (Sept. 16, 2008), *available at* http://www.lehman.com/press/pdf_2008/0916_barclays_acquisition.pdf.

209. See BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS—A REVISED FRAMEWORK 7 n. 5 (June 2004).

210. BANK FOR INT'L SETTLEMENTS, *About the Basel Committee*, <http://bis.org/bcbs/> (last visited Mar. 10, 2011).

211. INT'L ASS'N OF INS. SUPERVISORS, <http://iaisweb.org> (last visited Mar. 10, 2011).

212. INT'L ORG. OF SEC. COMM'NS, *General Information*, <http://www.iosco.org/about/> (last visited Mar. 10, 2011).

213. See Kern Alexander, *Global Financial Standard Setting, the G10 Committees, and International Economic Law*, 34 BROOK. J. INT'L L. 861, 869, 877 (2009) (discussing the Basel Committee's use of soft law and use of standards by IAIS and IOSCO); Elizabeth F. Brown, *The Development of International Norms for Insurance Regulation*, 34 BROOK. J. INT'L L. 953, 963–70 (2009) (discussing IAIS standards); Henry Deeb Gabriel, *The Advantages of Soft Law in International Commercial Law: The Role of UNIDROIT, UNCITRAL, and the Hague Conference*, 34 BROOK. J. INT'L L. 655, 658–60 (2009) (definition of soft law); Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulations*, 34 BROOK. J. INT'L L. 883, 898–900 (2009) (discussing IOSCO's use of standards and recommendations).

E. Failure to Adequately Address the “Too Big to Fail” Problem

In recent decades, a large number of mergers and acquisitions were taking place within the financial services industry. As a result, the assets in each of the major sectors—banking, securities, and insurance—became concentrated within fewer firms. This trend began in the 1990s and accelerated after the enactment of GLBA and the adoption of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994,²¹⁴ which eliminated the barriers to interstate banking. Table 3 chronicles the hundreds of financial sector mergers worth almost \$1.7 trillion during the decade prior to the financial crisis. Such mergers allow BHCs to be more diversified both geographically and across economic sectors.²¹⁵ Regulators thought that this would be advantageous as it tended to make them less vulnerable to regional or sectoral slumps.²¹⁶ They tended, however, to ignore or underestimate the potential downsides of such growth.

*Table 3: Number and Value of Announced Financial Mergers and Acquisitions*²¹⁷

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total no. of mergers	1178	988	913	820	765	875	865	971	1036	938
Total value of mergers (\$ billions)	148.5	223.6	144.5	59.0	163.3	171.5	159.4	204.2	207.2	186.5

214. Pub. L. No. 103-328, 108 Stat. 2338 (codified at 12 U.S.C. § 1811 (1997)).

215. Dean Foust, *Commentary: If This Safety Net Snaps, Who Pays?*, BUS. WK., Apr. 27, 1998, <http://www.businessweek.com/1998/17/b3575005.htm>.

216. *Id.*

217. INS. INFO. INST., THE FINANCIAL SERVICES FACT BOOK 2005, at 3 (2005); INS. INFO. INST., THE FINANCIAL SERVICES FACT BOOK 2010, at 3 (2010).

One of those downsides was the growing belief among large financial firms and their creditors that national politicians would not allow the firms to fail because the politicians and regulators would deem the economic and politic costs of doing so to be too great.²¹⁸ This phenomenon is called the “too big to fail” problem. The phrase, “too big to fail,” should not be taken literally because it does not refer only to extremely large banks. “Too big to fail” also covers firms that may not be very large, but are so highly intertwined with other financial institutions that their failure would start a cascade of failures throughout the financial system that would be catastrophic for the economy.²¹⁹

What are some of the potential costs of allowing “too big to fail” institutions to go bankrupt? They include the failure of other banks and financial institutions, a seizing up of the basic functions of the financial system, and a decline in the economy.²²⁰

On the other hand, not allowing large or highly interconnected firms to fail creates a moral hazard problem as creditors no longer feel the need to adequately monitor and assess the risks posed by such financial firms.²²¹ If creditors properly evaluated the risks posed by such institutions, they would charge them higher prices as the firms’ activities become riskier.²²² Because the creditors fail to properly monitor firms that they believe are too big to fail, those firms receive the wrong price and quantity signals, which in turn leads them to engage in excessive risk-taking and a misallocation of resources.²²³ Being considered too big to fail, thus, is beneficial for firms because it lowers the firm’s cost of capital, which raises its profits or reduces its losses.

In light of this, it is not surprising that one of the motivations posited for the large number of mergers in the 1990s was that banks were actively seeking to become too big to fail. When looking solely at the information embedded in share prices, the evidence that this

218. GARY H. STERN & RON FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 1–2, 12–17 (2004). “We have created financial institutions that are too big to fail,” says Henry Kaufman, the former Salomon Brothers economist known as ‘Dr. Doom’ for saying things the Street doesn’t like to hear. ‘They are not submitted to the full discipline of the marketplace,’ he adds.” Michelle Celarier, *The God That Failed*, INVESTMENT DEALERS’ DIGEST, Sept. 9, 2002, at 26.

219. STERN & FELDMAN, *supra* note 218, at 16.

220. *Id.* at 12–13.

221. *Id.* at 17.

222. *Id.*

223. *Id.* at 17–18.

was, in fact, a motivation for bank mergers was mixed.²²⁴ When looking at bond prices, however, evidence was found that the desire to become too big to fail was a motivating factor.²²⁵ Research on the relationship between bank mergers and bond prices from 2001 illustrated that medium-size banks (those with between \$30 billion and \$100 billion in assets) experienced significant bond returns and realized reductions in costs of funds following announcements that they intended to merge with another bank, particularly when the merger would result in the combined bank's assets exceeding \$100 billion.²²⁶ On the other hand, this research also showed that megabanks (those that can be considered already too big to fail at the time of the merger) and smaller banks (combined mean asset size of \$30 billion or less) earned less return than bondholders of medium-size banks.²²⁷

In the case of commercial banks, the “too big to fail” belief was created by the federal assistance given to Continental Illinois National Bank and Trust Company, which was the seventh-largest U.S. bank at the time when it failed in 1984.²²⁸ In order to stop a run on Continental Illinois, the Federal Reserve, the FDIC, and the OCC agreed that they would put together a package that included a \$2 billion capital infusion, of which \$1.5 billion came from the FDIC and the remaining \$500 million from a group of commercial banks organized by the FDIC, a promise by the Federal Reserve that it would meet Continental Illinois's liquidity needs, and a promise by the FDIC to ignore its \$100,000 cap on deposit insurance and to

224. See George J. Benston, William C. Hunter & Larry D. Wall, *Motivations for Bank Mergers and Acquisitions: Enhancing the Deposit Insurance Put Option versus Earnings Diversification*, 28 J. MONEY, CREDIT & BANKING 777, 778 (1995) (finding that acquirers would not pay more for riskier banks whose returns are correlated with the acquirer's returns in order to become too big to fail as opposed to banks that offered earnings diversification); Gayle L. DeLong, *Stockholder Gains From Focusing versus Diversifying Bank Mergers*, 59 J. FIN. ECON. 221, 226, 250 (2001) (reporting no significant relationship between combined bank size and abnormal equity returns realized at the time of the merger announcement for bank mergers occurring in the period from 1988 to 1995); Edward J. Kane, *Incentives for Banking Megamergers: What Motives Might Regulators Infer from Event-Study Evidence?*, 32 J. MONEY, CREDIT & BANKING 671, 673 (2000) (arguing that evidence showing a positive correlation between equity returns of acquirer and the size of its target supports the view that one motive for bank mergers is to become too big to fail).

225. Maria Fabiana Penas & Haluk Unal, *Gains in Bank Mergers: Evidence from the Bond Markets*, 74 J. FIN. ECON. 149, 150–51 (2004).

226. *Id.*

227. *Id.*

228. STERN & FELDMAN, *supra* note 218, at 13; FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE vol. 1, 235–36 (1997), available at http://www.fdic.gov/bank/historical/history/235_258.pdf.

protect all of Continental Illinois's deposits.²²⁹ In addition, the federal regulators tried to find a merger partner for Continental Illinois but when those efforts failed, they put the bank into a unique resolution process, which included the FDIC buying \$4.5 billion in bad loans from the bank and acquiring \$1 billion in preferred stock in Continental Illinois's holding company, Continental Illinois Corporation.²³⁰ The FDIC required the holding company to give the \$1 billion that it had received in exchange for the stock, to Continental Illinois.²³¹ Effectively, through this resolution process, the federal government had acquired an 80% ownership interest in the firm.²³²

The assistance provided to Long Term Capital Management ("LTCM") extended the pool of firms deemed to be "too big to fail" beyond banking to any financial service firm that was considered too large or too interconnected with other firms to be allowed to go bankrupt.²³³ Such interconnectedness might cause a ripple effect throughout the financial system, which would force other firms to collapse. LTCM was a hedge fund that initially specialized in high-volume arbitrage trades in bond and bond-derivatives markets, but eventually began to engage in other markets and in speculation.²³⁴ By the end of 1997, LTCM had developed an impressive track record with an average annual rate of return of approximately 40%.²³⁵ LTCM's assets had grown to \$120 billion and its capital had grown to about \$7.3 billion by 1997, making it one of the largest hedge funds in the United States.²³⁶

When the financial markets deteriorated in the summer of 1998, LTCM suffered substantial losses, which led to a 33% decline in the firm's assets to \$80 billion and a 92% decline in the firm's capital to \$600 million by September 19, 1998.²³⁷

Amidst growing concerns about the likely failure of LTCM, the Federal Reserve arranged for fourteen banks, which were also major creditors of LTCM, to provide LTCM with a rescue package that allowed shareholders to retain a 10% holding in LTCM, which was

229. FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE, *supra* note 228, at 243–44.

230. *Id.* at 244.

231. *Id.*

232. *Id.* at 247–48.

233. DOWD, *supra* note 28, at 2.

234. *Id.* at 3.

235. *Id.*

236. *Id.*

237. *Id.* at 3–4.

valued at \$400 million, while the consortium invested an additional \$3.65 billion in equity capital in LTCM in exchange for 90% of the firm's equity.²³⁸

The bailout of LTCM was without precedent as the Federal Reserve had no authority to regulate hedge funds. Hedge funds at that time did not have a functional regulator.²³⁹ The SEC could not regulate LTCM because it fit within exemptions from regulation under the Securities Act of 1933,²⁴⁰ the Securities Exchange Act of 1934,²⁴¹ and the Investment Company Act of 1940²⁴² for hedge funds with fewer than 100 shareholders.²⁴³ In fact, the majority of U.S. hedge funds restricted the number of their shareholders to fewer than 100 to avoid being regulated.²⁴⁴ In addition, no other federal agency had the authority to regulate hedge funds.²⁴⁵

The LTCM rescue created the perception that the Federal Reserve has assumed responsibility for bailing out all large financial firms when they got themselves into financial difficulties, even when the Federal Reserve lacked any statutory authority to do so.²⁴⁶ This position allowed large financial conglomerates to take huge risks that the Federal Reserve and other regulators could do little to prevent.²⁴⁷

This perception that the Federal Reserve would bail out financially troubled institutions was not affected by the refusal of the Federal Reserve to intervene to save Enron in 2001. Why did the failure of the Federal Reserve to help Enron not lower market expectations regarding future government bailouts? This question is relevant because, from the viewpoint of some commentators, Enron's failure posed a greater risk to the economy than LTCM's failure would have.²⁴⁸ Frank Partnoy testified before the U.S. Senate Committee on Government Affairs that "Enron makes Long-Term Capital Management look like a lemonade stand" because Enron made more

238. *Id.* at 4–5.

239. *Id.* at 2–3.

240. Securities Act of 1933, 15 U.S.C. § 78a (2006).

241. Securities Exchange Act of 1934, 15 U.S.C. § 78a (2006).

242. Investment Advisers Act of 1940, 15 U.S.C. § 80a-1 (2006).

243. DOWD, *supra* note 28, at 2–3.

244. *Id.* at 3.

245. See JOHN HUNT, HEDGE FUND REGULATION: THE PRESIDENT'S WORKING GROUP COMMITTEES' BEST PRACTICE REPORTS—RAISING THE BAR BUT MISSING RISKS 4–6 (Berkeley Center for Law, Business and the Economy, June 2008) (discussing history of proposed hedge fund regulations since LTCM and the lack of new mandatory regulations prior to 2008); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 979–90 (2006) (discussing the SEC as the sole regulator of hedge funds).

246. DOWD, *supra* note 28, at 3.

247. *Id.*

248. Partnoy Hearing, *supra* note 23, at 2–3.

money trading derivatives in 2000 than LTCM made during its existence, Enron had 100 times as many employees as LTCM (Enron had 20,000 while LTCM had only 200), and Enron lost over \$70 billion in shareholders' equity plus billions in funds owed to creditors while LTCM only lost \$4.6 billion.²⁴⁹

Given those metrics, if the Federal Reserve felt justified in intervening to save LTCM, why did it reach a different conclusion with Enron? The answer probably rests on four factors. First, Enron was not primarily viewed as a financial firm, unlike LTCM.²⁵⁰ Enron had started out as an energy company when it was created in 1985, and, while its derivatives business was extremely large, Enron still earned over 90% of its total revenues from other sources in 2000.²⁵¹

Second, each of the fourteen financial firms that interceded to save LTCM had large exposures because they had lent sizable sums to LTCM that they stood to lose if LTCM went under.²⁵² The major U.S. and European financial firms did not have the same exposures to Enron and, thus, would not have suffered the same level of losses if Enron failed.²⁵³

Third, by the time Enron sought federal aid in October of 2001, its assets and derivatives position were nowhere near what they had been at the end of 2000.²⁵⁴ By the end of its third quarter of 2001, Enron's derivatives position equaled only \$19 billion, roughly one-fifth of the \$1 trillion derivatives book that LTCM had.²⁵⁵ As a result, federal regulators probably concluded that Enron's collapse did not pose the same threat that LTCM's potential collapse had posed.

Fourth, Enron's headquarters was located in Houston, not New York, which meant that Enron did not have the access to cultivate the same types of cozy relationships with the Federal Reserve that LTCM had.²⁵⁶ Kenneth Lay, the Chairman of Enron, had certainly sought help from both the Federal Reserve and the Treasury Department to secure Enron the same treatment that LTCM had received, but to no avail.²⁵⁷

249. *Id.*

250. BRYCE, *supra* note 23, at 324–26.

251. *Id.* at 241; Partnoy Hearing, *supra* note 23, at 2.

252. BRYCE, *supra* note 23, at 325.

253. *Id.*

254. *Id.*

255. *Id.*

256. *Id.* From February 2000 to January 2002, Jeff Skilling, Enron's CEO, was on the Houston branch of the Federal Reserve Bank of Dallas. *Id.* at 324.

257. *Id.* at 324–26. Lay had spoken with Alan Greenspan, the Federal Reserve Chairman, and Paul O'Neill, the U.S. Treasury Secretary, but neither apparently were willing to come to Enron's aid. *Id.*

The significant differences between Enron and LTCM probably enabled at least some market participants to write off Enron as an aberration. Thus, they continued to believe that firms that were generally viewed by the financial markets as “too big to fail” would be bailed out by the federal government. This belief was confirmed when the Federal Reserve and the U.S. Treasury engineered J.P. Morgan Chase’s acquisition of Bear Stearns for \$2 per share in March of 2008.²⁵⁸ As a result, the financial markets expected that the federal government would provide assistance to any financial conglomerate that was at least as large as Bear Stearns, which was the fifth-largest investment banking conglomerate in the United States.²⁵⁹

The upending of those expectations when the federal government allowed the bankruptcy of Lehman Brothers, the second largest investment banking conglomerate in the United States, contributed to the panic in the financial markets.²⁶⁰ Ultimately, Lehman Brothers was the only large U.S. financial conglomerate that was allowed to fail. For all of the others, the Treasury and the Federal Reserve either provided bailout funds or assisted in arranging a merger of the struggling firm with a healthier firm. Consequently, the financial crisis has solidified the proposition that the federal government would rescue “too big to fail” financial firms for financial markets and in the minds of the public.

F. These Problems Were Foreseen

All of these problems could have been and, in many cases, were foreseen well in advance of the recent financial crisis. The Financial Crisis Inquiry Commission listed as its first conclusion that the

258. MCLEAN & NOCERA, *supra* note 182, at 347–48.

259. *See id.* at 349–51, 357, 359; ANDREW ROSS SORKIN, TOO BIG TO FAIL 6, 239–44 (2009).

260. FCIC REPORT, *supra* note 116, at xxi. Prior to Lehman Brothers’ collapse, major market participants, like J.P. Morgan Chase, held some expectation that the federal government might arrange a rescue package for Lehman Brothers like the one that they had provided for LTCM. *See* SORKIN, *supra* note 259, at 242–43 (discussing telephone conversations between Steven Black of J.P. Morgan Chase and Richard Fuld of Lehman Brothers concerning federal aid for Lehman Brothers). Barclays and Bank of America specifically asked for government assistance as a condition for them to go forward with an acquisition of Lehman Brothers. *Id.* at 278–79. Treasury Secretary Paulson, however, was not willing to provide federal government funds to bail out Lehman Brothers in the same manner that the federal government had bailed out Bear Stearns, Fannie Mae, and Freddie Mac because the political backlash that had erupted over the bailouts for the GSEs. *Id.* at 282–83. In the end, Lehman Brothers was unable to arrange a merger with either Barclays or Bank of America and filed for bankruptcy. The financial markets reacted with panic. *Id.* at 390, 393–94.

financial crisis was “avoidable” because there were “warning signs.”²⁶¹ These warning signs included the excessive risks that financial firms had undertaken such as the “explosion in risky subprime lending and securitization,” “egregious and predatory lending practices,” and the “exponential growth in financial firms’ trading activities, unregulated derivatives, and short-term ‘repo’ lending markets.”²⁶² Most of the major financial conglomerates had engaged in all of these practices.²⁶³

Not only were there signs of danger, but government officials and academics had warned about these problems well before the crisis broke. For instance, the U.S. Government Accountability Office (GAO) published reports for more than a decade warning about the need for regulatory reform to deal with systemic risks posed by financial conglomerates, inconsistent financial regulations, regulatory arbitrage, a lack of coordination among regulators, and other problems that contributed to the crisis.²⁶⁴ Another example is Gary H. Stern, then the president and CEO of the Federal Reserve Bank of Minnesota, and Ron Feldman, then a vice-president of the Federal Reserve Bank of Minnesota, who in 2004 published, *Too Big to Fail: The Hazards of Bank Bailouts*, in which they discussed the hazards posed to the financial system of creditors’ expectations that large financial firms would be bailed out by the federal government.²⁶⁵ Paul Volcker, the former Chairman of the Federal Reserve from 1979 to 1987, wrote the foreword to this book and noted that:

The broader concern is the perceived sense of growing “moral hazard,” specifically the possibility that confident expectations of creditor “bailouts” will dull normal market discipline. Inherently, a protected creditor will have less incentive for “due diligence,” with

261. FCIC REPORT, *supra* note 116, at xvii.

262. *Id.*

263. *Id.* at xvii, xix–xx, 31–32, 68–71, 150–51.

264. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO/GGD-95-214, BANKS’ SECURITIES ACTIVITIES: OVERSIGHT DIFFERS DEPENDING ON ACTIVITY AND REGULATOR 4–5 (1995) (noting different levels of oversight, weak enforcement by Federal Reserve for noncompliance of firewall protections between securities and banking, and lack of training for FDIC examiners dealing with securities subsidiaries); GAO FINANCIAL REGULATION, *supra* note 147, at 8, 10 (discussing problems with sharing of information and coordinating regulatory responses among multiple agencies, regulatory arbitrage, and the dangers posed by systemic risks); U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-08-32, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE 26 (2007) (reiterating some of the findings of the 2004 report and noting the problems posed by the federal agencies handled consolidated supervision of financial conglomerates).

265. STERN & FELDMAN, *supra* note 218, at 60–79.

the perverse result of encouraging excessive risk-taking and failure itself.²⁶⁶

As noted above, scholars found evidence in the bond markets of creditors' expectations that large financial institutions would be bailed out by the federal government.²⁶⁷ The reason that they were not dealt with was not a lack of imagination but a lack of political will and pressure from the financial services to preserve the regulatory status from which they profited immensely.²⁶⁸

III. PROPOSED SOLUTIONS IN THE DODD-FRANK ACT

The Dodd-Frank Act took three steps to address the problems posed by financial conglomerates. First, it reduced the ability of financial conglomerates to engage in regulatory arbitrage and provided mechanisms to ensure that systemically important financial conglomerates are regulated by the Federal Reserve. Second, it improved supervision of financial conglomerates by, among other things, establishing uniform capital adequacy standards for financial conglomerates. Third, it took some steps to minimize the "too big to fail" problem. Each one of these actions will be addressed in more detail below.

A. *Reduced Ability of Financial Conglomerates to Pick Their Regulator*

The Dodd-Frank Act reduced the ability of financial conglomerates to pick their regulator by making it extremely unlikely that financial conglomerates, at least systemically important financial conglomerates, would be regulated on a consolidated basis by any agency other than the Federal Reserve. It accomplishes this by taking four actions.

1. *Eliminating the OTS as a holding company regulator*

The Enhancing Financial Institution Safety and Soundness Act of 2010, which comprises Title III of the Dodd-Frank Act, transfers all of the power of the OTS to regulate thrifts to OCC and transfers all of the power of the OTS to regulate thrift holding companies to the

266. Paul A. Volcker, *Foreword* to STERN & FELDMAN, *supra* note 218, at ix.

267. Penas & Unal, *supra* note 225, at 150–51.

268. See FCIC REPORT, *supra* note 116, at xviii, 41–42, 55 (stating that between 1999 and 2008 the financial sector spent over \$2.7 billion on lobbying); MCLEAN & NOCERA, *supra* note 182, at 40–42, 63–68, 174–76 (discussing the amount of lobbying done by the GSEs and the firms trading derivatives to prevent stricter regulation of their activities).

Federal Reserve.²⁶⁹ This transfer is to be completed within one year of the date of the enactment of the Dodd-Frank Act, unless the Treasury Secretary, the Comptroller of the Currency, the Director of the OTS, the FDIC Chairperson, and the Chairman of the Federal Reserve Board of Governors all agree to an extension.²⁷⁰ Any extension is limited to an additional six months.²⁷¹ In other words, this transfer must take place by July 21, 2011, unless an extension is granted and if an extension is granted, by no later than January 21, 2012.²⁷² This action addresses the way some investment banks and other financial firms, like Merrill Lynch and AIG, avoided being regulated by the Federal Reserve as FHCs or BHCs while still being able to offer banking products by acquiring a thrift. Closing down the OTS effectively kills that option.

2. *Eliminating the SEC as a holding company regulator*

The Dodd-Frank Act ends any remaining authority of the SEC to regulate financial conglomerates as holding companies. It does this by eliminating the ability of investment banking holding companies to voluntarily select the SEC to regulate them on a consolidated basis and by requiring securities holding companies to be regulated by the Federal Reserve.²⁷³ This change is not as significant as the closing of

269. Dodd-Frank Act, Pub. L. No. 111-203, § 312, 124 Stat. 1376, 1521–22 (2010) (to be codified at 12 U.S.C. § 5412).

270. *Id.* § 311, at 1520–21 (to be codified at 12 U.S.C. § 5411).

271. *Id.*

272. The Dodd-Frank Act was signed by the President and became law on July 21, 2010. *H.R. 4173: Dodd-Frank Wall Street Reform and Consumer Protection Act*, GOVTRACK.US, <http://www.govtrack.us/congress/bill.xpd?bill=h111-4173> (last visited Apr. 7, 2011) (tracking legislative history of the Dodd-Frank Act).

273. Dodd-Frank Act § 617, 124 Stat. 1616 (to be codified at 15 U.S.C. § 78q) (eliminating 15 U.S.C. § 78q(i) and giving the Federal Reserve the power to regulate securities holding companies). A “securities holding company” is defined in the statute as:

(i) a person (other than a natural person) that owns or controls 1 or more brokers or dealers registered with the Commission; and

(ii) the associated persons of a person described in clause (i); and

(B) does not include a person that is—

(i) a nonbank financial company supervised by the Board under title I;

(ii) an insured bank (other than an institution described in subparagraphs (D), (F), or (H) of section 2(c)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)(2)) or a savings association;

(iii) an affiliate of an insured bank (other than an institution described in subparagraphs (D), (F), or (H) of section 2(c)(2) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)(2)) or an affiliate of a savings association;

(iv) a foreign bank, foreign company, or company that is described in section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a));

the OTS and the transferring of its powers to the Federal Reserve and the OCC. The SEC had ended its CSE program on September 26, 2008 after the SEC's Inspector General released a report documenting how the program had contributed to the financial difficulties of Bear Stearns.²⁷⁴ At that time, all of the investment banking conglomerates that the SEC had regulated had either been acquired by FHCs regulated by the Federal Reserve (Bear Stearns and Merrill Lynch), collapsed (Lehman Brothers), or had voluntarily subjected themselves to the regulatory authority of the Federal Reserve by beginning the process to become FHCs (Goldman Sachs and Morgan Stanley).²⁷⁵ Section 617 of the Dodd-Frank Act merely prevents the SEC from ever resurrecting its CSE program or creating any similar program in the future.

3. *Preventing certain BHCs from evading regulation by the Federal Reserve*

The Dodd-Frank Act prevents any financial conglomerate that became a FHC or BHC and received TARP funds from avoiding regulation by the Federal Reserve by spinning off or changing the charter of any banking subsidiary.²⁷⁶ The summary of the Act released by the Senate Committee on Banking, Housing and Urban Affairs nicknames this provision the "Hotel California" provision, which seems to refer to the last lines of the title song of the Eagles' Hotel California album ("You can check out any time you like, but you can never leave"), but other commentators have referred to it as the "roach motel" provision because you can check in, but you can't check out.²⁷⁷

(v) a foreign bank that controls, directly or indirectly, a corporation chartered under section 25A of the Federal Reserve Act (12 U.S.C. 611 et seq.); or

(vi) subject to comprehensive consolidated supervision by a foreign regulator.

Id. § 618(a)(4), at 1617 (codified at 12 U.S.C. § 1850a).

274. Press Release, Securities and Exchange Commission, Chairman Cox Announces End of Consolidated Supervised Entity Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

275. Carrick Mollenkamp et al., *Crisis on Wall Street as Lehman Totters, Merrill is Sold, AIG Seeks to Raise Cash*, WALL ST. J., Sept. 15, 2008, at A1; Robert Schroeder, *Goldman, Morgan to Become Holding Companies*, MARKETWATCH (Sept. 21, 2008), <http://www.marketwatch.com/story/goldman-sachs-morgan-stanley-to-become-bank-holding-companies>; Andrew Ross Sorkin & Landon Thomas Jr., *JPMorgan Acts to Buy Ailing Bear Stearns at Huge Discount*, N.Y. TIMES, Mar. 18, 2008, http://www.nytimes.com/2008/03/16/business/16cnd-bear.html?_r=1&scp=1&sq=JP%20morgan%20to%20acquire%20bear%20stearns%202008&st=cse.

276. Dodd-Frank Act § 617, 124 Stat. 1616 (to be codified at 15 U.S.C. § 78q).

277. S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 111ST CONG., BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT,

This provision applies to any BHC or FHC that had more than \$50 billion in total consolidated assets on January 1, 2010 and received any funds under the TARP program and any successor entity.²⁷⁸ If such a BHC or FHC divests itself of its bank, changes its charter to that of another depository institution that is not subject to the Bank Holding Company Act, or ceases to be a BHC by any other means, it would continue to be subject to supervision by the Federal Reserve as a “nonbank financial company.”²⁷⁹

The Act defines a “nonbank financial company” as a company that is “predominantly engaged in financial activities.”²⁸⁰ Under the Act, a firm will be deemed to be “predominantly engaged in financial activities” if 85% of its gross revenues on a consolidated basis or 85% of its total assets on a consolidated basis are derived from “financial activities” as that term is defined in subsection 4(k) of the BHCA.²⁸¹ The Act does not specify during what time period that company must

available

at
http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf; Edmund L. Andrews, *Financial Regulation—Not as Ugly as it Looks*, CAPITALGAINsandGAMES (Mar. 16, 2010), <http://www.capitalgainsandgames.com/blog/edmund-l-andrews/1579/financial-regulation-not-ugly-it-looks>; THE EAGLES, *Hotel California*, on HOTEL CALIFORNIA (Elektra Entertainment 1976).

278. Dodd-Frank Act § 117(a), 124 Stat. 1406–07 (to be codified at 15 U.S.C. § 5327).

279. *Id.* § 117(b), at 1407 (to be codified at 12 U.S.C. § 5327). The term, “nonbank financial company,” is defined as any foreign company that would not be classified as a BHC and that is “predominantly” engaged in any financial activities within the United States and any U.S. company that would not be classified as a BHC or Farm Credit System institution, national securities exchange, clearing agency, security-based swap execution facility, or security-based swap data repository registered with the SEC, board of trade designated as a contract market, a derivatives clearing organization, swap execution facility or a swap data repository registered with the CFTC, or any parents of such entities, except in certain circumstances when the parent is a BHC, and that is “predominantly engaged in financial activities.” *Id.* § 102(a)(4), at 1391 (to be codified at 12 U.S.C. § 5311).

280. *Id.* § 102(a)(6), at 1391–92 (to be codified at 12 U.S.C. § 5311).

281. *Id.* Section 4(k) of BHCA states:

(k) Engaging in activities that are financial in nature

(1) In General

Notwithstanding subsection (a) of this section, a financial holding company may engage in any activity, and may acquire and retain the shares of any company engaged in any activity, that the [Federal Reserve] Board, in accordance with paragraph (2), determines (by regulation or order)—

(A) to be financial in nature or incidental to such financial activity; or

(B) is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

12 U.S.C. § 1843(k)(1) (2006). Section (k)(4) of the BHCA also provides an extensive laundry list of activities that the act considers to be “financial in nature.” *Id.* § 1843(k)(4). These activities encompass all of the activities generally associated with the banking, securities, and insurance businesses.

possess this level of gross revenues or total assets from financial activities. The Federal Reserve issued a proposed rulemaking in February that would make the determination of how much of a company's gross revenues or total assets came from financial activities based on the data available in the most recent two years of the company's consolidated financial statements.²⁸²

The Financial Stability Oversight Counsel (FSOC), an interagency body created by the Dodd-Frank Act to promote financial stability, normally must approve classifying an entity as a nonbank financial company subject to supervision by the Federal Reserve.²⁸³ This FSOC approval, however, would not be required to classify any of the firms covered by the Hotel California provision as a nonbank financial company subject to supervision by the Federal Reserve if it ceases to be a BHC or FHC.²⁸⁴

Only thirty-six FHCs and BHCs had more than \$50 billion in total assets on December 31, 2010.²⁸⁵ Of these holding companies, only twenty-four of them accepted TARP funds through the Capital Purchase Program.²⁸⁶ Thus, only those twenty-four firms and their successors will be subject to the Hotel California provision.

The differences in the amount of total assets of each of the firms subject to the Hotel California provision is rather wide, with the largest firm controlling more than forty-four times the total assets

282. Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 76 Fed. Reg. 7731 (proposed Feb. 11, 2011) (to be codified at 12 C.F.R. pt. 255).

283. See Dodd-Frank Act § 113, 124 Stat. 1398 (to be codified at 12 U.S.C. § 5323) (imposing only Federal Reserve supervision on nonbank financial companies after at least a two-thirds vote of the members of the Financial Stability Oversight Council).

284. *Id.* § 113(d), at 1401 (to be codified at 12 U.S.C. § 5323(d)).

285. FED. FIN. INST. EXAMINATION COUNCIL, TOP 50 BHCs, <http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx> (last visited Mar. 25, 2011) [hereinafter TOP 50 BHCs].

286. U.S. DEP'T OF THE TREASURY, TARP TRANSACTION REPORT (Mar. 24, 2011), available at <http://www.treasury.gov/initiatives/financial-stability/briefing-room/reports/tarp-transactions/Pages/default.aspx> (click on hyperlink dated March 24, 2011) [hereinafter TARP TRANSACTION REPORT]; PROPUBLICA, BAILOUT RECIPIENTS, <http://projects.propublica.org/bailout/list/index> (last visited Mar. 26, 2011). The eight firms from the top BHCs that did not accept any TARP funds include Taunus Corporation, HSBC North America Holdings Inc., TD Bank US Holding Company, Citizens Financial Group, Inc., UnionBanCal Corporation, BancWest Corporation, Harris Financial Corp., and BBVA USA Bancshares, Inc. TARP TRANSACTION REPORT, *supra*; TOP 50 BHCs, *supra* note 285. Ally Financial Inc., formerly known as GMAC Inc, accepted \$16.29 billion in TARP funds under the Automotive Industry Financing Program, not the Capital Purchase Program. TARP TRANSACTION REPORT, *supra*; TOP 50 BHCs, *supra* note 285; Press Release, Ally Financial Inc., Ally Financial Statement on New Corporate Brand (May 10, 2010), available at <http://media.ally.com/index.php?s=43&item=401>.

controlled by the smallest firm in the group.²⁸⁷ Bank of America Corporation has the largest amount with approximately \$2.3 trillion worth of total assets, while Marshall & Ilsley Corporation has the smallest with only \$50.2 billion worth of total assets.²⁸⁸

The Hotel California provision seems to have been drafted with Goldman Sachs, Morgan Stanley, and American Express in mind. All of those firms converted to BHCs during the financial crisis.²⁸⁹

Goldman Sachs's actions illustrate the concerns behind this provision. Goldman Sachs avoided being subject to regulation by the Federal Reserve by owning an industrial loan company and a foreign bank, both of which are exempt from the definition of "bank" in the Bank Holding Company Act and thus, Goldman Sachs was not classified as a BHC subject to regulation by the Federal Reserve under that Act.²⁹⁰ Goldman Sachs only became a BHC in September 2008 when financial firms were facing liquidity crises in the wake of Lehman's collapse, and having greater access to the Federal Reserve's lending facilities, particularly its discount window, was deemed highly desirable.²⁹¹ In order to become a BHC, Goldman Sachs had to become an owner of a bank and it did so by merging its industrial loan company with Goldman Sachs Trust Company and converting the charter of the resulting firm into a New York state-chartered bank.²⁹² In addition, as a BHC, Goldman Sachs received \$10 billion in TARP funds, which also helped ease any financial problems that it was facing in the depths of the crisis.²⁹³ A little over a year later,

287. See TOP 50 BHCs, *supra* note 285 (listing total assets of largest BHCs).

288. *Id.*

289. Goldman Sachs, Morgan Stanley, and American Express all became BHCs in order to access government assistance programs. Eric Dash, *American Express Becomes a Bank Holding Company*, N.Y. TIMES, Nov. 11, 2008, <http://www.nytimes.com/2008/11/11/business/worldbusiness/11iht-amex.4.17725805.html>; Schroeder, *supra* note 275.

290. See 12 U.S.C. § 1841(c)(2) (2006); Goldman Sachs, Annual Report, (Form 10-K), at Ex. 21.1 (2007), available at <http://www2.goldmansachs.com/our-firm/investors/financials/archived/10k/docs/2007-form-10-k-file.pdf>; *Goldman Sachs Gets its N.Y. Banking License*, N.Y. TIMES, Nov. 29, 2008, http://www.nytimes.com/2008/11/29/business/29bizbriefs-GOLDMAN_BRF.html?dbk.

291. Ben White, *Starting a New Era at Goldman and Morgan*, N.Y. TIMES, Sept. 22, 2008, <http://www.nytimes.com/2008/09/23/business/23wall.html?scp=9&sq=Goldman+Sachs+to+become+bank+holding+company&st=nyt>.

292. *Goldman Sachs Gets its N.Y. Banking License*, *supra* note 290.

293. Joe Nocera, *Short Memories at Goldman*, N.Y. TIMES, Oct. 23, 2009, at B1, B5. Goldman also took advantage of other government programs to help out distressed financial firms, including the FDIC's commercial paper guarantee program, the repayment of 100 cents on the dollar to all of AIG's counterparties including Goldman Sachs, and the Term-Asset Backed Securities Loan Facility, which allowed participating financial firms to buy distressed securities and sell them at a profit. *Id.*

Goldman Sachs was claiming that it had not needed the TARP funds and that it resented the strings that seemed to have come attached with taking that money in terms of the criticisms that it endured for setting aside \$5.3 billion to pay out year-end bonuses in 2009.²⁹⁴ These actions created the impression in some quarters that Goldman Sachs would reorganize itself to cease to be a BHC under the Federal Reserve's supervision as soon as the economy recovered and it determined that it no longer needed the government's assistance.²⁹⁵ Section 117 would prevent this type of regulatory arbitrage by requiring Goldman Sachs, Morgan Stanley, American Express and other similar large firms that took advantage of government assistance programs in troubled economic times by reorganizing themselves as BHCs to continue to be regulated by the Federal Reserve even if they cease to be bank holding companies at some point in the future.²⁹⁶

4. *Forcing certain nonbank financial companies to be supervised by the Federal Reserve*

As mentioned above, the Dodd-Frank Act gives the FSOC the power to classify any entity that is not already a FHC, a BHC, or a THC subject to supervision by the Federal Reserve as a nonbank financial company supervised by the Federal Reserve.²⁹⁷ In order to classify a firm as a nonbank financial company supervised by the Federal Reserve, two-thirds of the voting members then serving on the FSOC must conclude that it warrants such supervision because the firm is a nonbank financial company and that its "material financial distress" or "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of the company "could pose a threat to the financial stability of the United States."²⁹⁸ To help the FSOC make this determination, the Dodd-Frank Act lists ten factors that they should consider as well as concluding that they may

294. *Id.*

295. Courtney Comstock, *Senator Corker Says He Made a Specific "Hotel California" Provision in Dodd's New Bill for Goldman Sachs*, BUSINESS INSIDER (Mar. 17, 2010), <http://www.businessinsider.com/corker-says-he-made-the-hotel-california-provision-in-dodds-new-bill-for-goldman-sachs-2010-3>; Steve Eder & Karey Wutkowski, *Goldman Could Be a Bank, For Better or Worse*, REUTERS (Mar. 16, 2010), <http://www.reuters.com/article/2010/03/16/us-goldman-reform-analysis-idUSTRE62F4TG20100316>.

296. Dodd-Frank Act § 117, 124 Stat. 1406–07 (to be codified at 12 U.S.C. § 5327).

297. *Id.* § 113, at 1398 (to be codified at 12 U.S.C. §5323).

298. *Id.* § 113(a)(1), at 1398 (to be codified at 12 U.S.C. §5323).

consider “any other risk-related factors” that they consider appropriate.²⁹⁹

As previously noted, nonbank financial companies are defined as those whose gross revenues or total assets from financial activities equal or exceed 85% of their total gross revenues or total assets from all sources.³⁰⁰ The Act recognizes that such a bright line rule could lead to some firms attempting to avoid being classified as a nonbank financial company by keeping either their total gross revenues or total assets from financial activities under the 85% threshold. The Act includes an antievasion provision which allows two-thirds of the voting members of the FSOC to agree to place a financial company under the supervision of the Federal Reserve even though that company has organized itself in such a way as to fall outside the definition of a nonbank financial company, provided that the “material financial distress” of the company poses a threat to the financial stability of the United States.³⁰¹

Berkshire Hathaway illustrates how a firm could change the mix of the businesses in which its subsidiaries operate in order to fall outside the definition of a nonbank financial company. Berkshire Hathaway is not a BHC, a FHC, or a THC and so is not supervised by the Federal Reserve.³⁰² In 2008 and 2009, more than 85% of its total revenues came from financial activities, predominately its insurance subsidiaries.³⁰³ In 2009, just under 85% of its total assets were associated with financial activities.³⁰⁴ Thus, if the Dodd-Frank Act had been in existence in 2008 and 2009, Berkshire Hathaway would have been classified as a nonbank financial company.³⁰⁵

In 2010, Berkshire Hathaway acquired Burlington Northern Santa Fe Corporation, a railroad company.³⁰⁶ In the wake of that acquisition, only about 80% of Berkshire Hathaway’s total revenues came from financial activities and only roughly 69% of its total assets

299. *Id.* § 113(a)(2), at 1398 (to be codified at 12 U.S.C. §5323).

300. *See supra* note 281 and accompanying text.

301. Dodd-Frank Act § 113(c), 124 Stat. 1399 (to be codified at 12 U.S.C. §5323).

302. Berkshire Hathaway does not own any banks or thrifts and thus, is not required by law to be regulated by the Federal Reserve as a FHC, BHC, or THC. *See* Berkshire Hathaway Inc. 2010 10-K Report, *supra* note 20, at Ex. 21 (listing all of Berkshire Hathaway’s subsidiaries, which do not include any banks, thrifts, or industrial loan companies).

303. *Id.* at 28.

304. *Id.* at 61.

305. *See* Dodd-Frank Act § 102(a)(4), 124 Stat. 1392 (to be codified at 12 U.S.C. § 5311) (defining nonbank financial companies as companies whose gross revenues or total assets from financial activities equal or exceed 85% of their total gross revenues or total assets from all sources).

306. Berkshire Hathaway Inc. 2010 10-K Report, *supra* note 20, at 36.

were associated with financial activities in 2010.³⁰⁷ Going forward, it is unlikely that Berkshire Hathaway's total revenues from financial activities or total assets from financial activities will exceed the 85% threshold set forth in the Dodd-Frank Act. If the anti-avoidance provision did not exist, any firm that did not want to be classified as a nonbank financial company would simply acquire enough nonfinancial subsidiaries so that its total revenues from financial activities or total assets from financial activities fell below the thresholds set forth in the Act.³⁰⁸

If the FSOC does place a firm under the supervision of the Federal Reserve, the Federal Reserve may only impose regulations on the firm's financial activities and not on its nonfinancial activities.³⁰⁹ For example, if the FSOC decided that Berkshire Hathaway should be subject to Federal Reserve supervision, the Federal Reserve could only regulate the financial activities of Berkshire Hathaway and not its railroad subsidiaries.

5. *Weaknesses of the reforms aimed at reducing regulatory arbitrage*

a. *Some current THCs might evade Federal Reserve supervision in the future*

The Hotel California provision only applies to companies that were classified as BHCs and FHCs on January 1, 2010.³¹⁰ It would not apply to large THCs like AIG and Prudential Financial, two of the largest financial conglomerates in the United States.³¹¹ If any THC decided it no longer wanted to be supervised by the Federal Reserve, it could convert any thrift it owned to an industrial loan company and thereby cease to be a THC while still offering the same range of products and services.³¹² Depending upon which state the industrial loan company was chartered in, a THC that did this type of reorganization might still be subject to supervision by a state regulator as an industrial loan

307. *Id.* at 28.

308. *See, e.g., supra* notes 302–307 and accompanying text (describing how Berkshire Hathaway has lowered its financial activities so as to fall outside the definition of a nonbank financial company).

309. Dodd-Frank Act, § 113(c)(6), 124 Stat. 1400–01 (to be codified at 12 U.S.C. § 5323).

310. *Id.* § 117, at 1406–07 (to be codified at 12 U.S.C. § 5327).

311. *Id.* (Hotel California provision only applies to BHCs, not THCs).

312. While the Hotel California provision only applies to BHCs and not THCs, the Federal Reserve still will regulate THCs under the Dodd-Frank Act. *See id.* §§ 117, 301–19. As a result, a THC would have to get rid of its thrift or convert it into an industrial loan company in order to escape being supervised by the Federal Reserve.

holding company, but it would no longer be subject to supervision by any federal holding company regulator.³¹³

Alternatively, a THC could sell its thrifts, which would also result in it ceasing to be a THC, but it probably would no longer be able to offer the full range of services that it had previously provided unless it either owned or acquired a foreign bank, as holding companies for foreign banks are not classified as BHCs or FHCs subject to supervision by the Federal Reserve.³¹⁴ If it acquired a foreign bank, it would no longer be subject to supervision by any state or federal holding company regulator. It might, however, become subject to similar supervision by the relevant foreign financial services regulator in the country that chartered the foreign bank that it acquired.³¹⁵ For example, if the company acquired a French bank, the EU Financial Conglomerate Directive would require it to be supervised on a consolidated basis by the French financial supervisor because it has no U.S. financial supervisor fulfilling that function.³¹⁶

The Federal Reserve would have to convince the FSOC to classify any THC that undertook such reorganizations as a nonbank financial company subject to supervision by the Federal Reserve. In cases like AIG, getting two-thirds of the FSOC voting members to agree to do this probably would not be difficult because the federal government had to provide \$125 billion to AIG in order to bail it out during the financial crisis.³¹⁷ The Federal Reserve probably would find it significantly more difficult to persuade two-thirds of the FSOC voting members that companies like Prudential Financial, which did not receive any TARP funds, constitute a threat to the financial stability of the United States.³¹⁸

b. The FSOC might find it difficult to agree on which firms pose a threat to financial stability

Getting two-thirds of the voting members of the FSOC to agree to require a firm to submit to Federal Reserve supervision may prove

313. See *supra* Part I.E (describing how state banking and financial institution regulators also regulate holding companies).

314. Foreign banks are excluded from the definition of bank under the Bank Holding Company Act. See 12 U.S.C. § 1841(c)(2)(A) (2006).

315. Financial Conglomerates Directive, *supra* note 72, at Ch. II, Art. 18.

316. *Id.*

317. Jim Puzzanghera, *AIG Makes \$6.9-billion Repayment of TARP Bailout Funds*, L.A. TIMES, Mar. 9, 2011, <http://articles.latimes.com/2011/mar/09/business/la-fi-aig-tarp-20110309>.

318. *Prudential, Ameriprise Turn Down TARP*, UPI.COM, May 16, 2009, http://www.upi.com/Business_News/2009/05/16/Prudential-Ameriprise-turn-down-TARP/UPI-80481242481550/.

problematic. The FSOC is chaired by the Treasury Secretary and is comprised of nine other voting members who are the Chairman of the Federal Reserve Board of Governors, the Comptroller of the Currency, the Director of the FDIC, the SEC Chairman, the CFTC Chairman, the Director of the Consumer Financial Protection Bureau (CFPB), the Director of the FHFA, the Chairman of the NCUA, and an insurance expert appointed by the president.³¹⁹ The FSOC also has five nonvoting members, including the Director of the Federal Insurance Office (“FIO”), the Director of Office of Financial Research, and three representatives from the state financial regulators with one of these representing each of the major sectors—banking, securities, and insurance.³²⁰

The members of the FSOC do not have a strong history of working together. This is due in part to the fact that each of these agencies has different regulatory objectives and constituencies.³²¹ Some of these agencies have engaged in bitter turf wars in the past over who had the right to regulate a particular product or firm.³²² It is doubtful that they will work smoothly together on the FSOC.

The experience of FFIEC illustrates this. FFIEC only has five members, but how well those members cooperated with one another has been highly dependent on the individuals representing each agency at any given time.³²³ As a result, it suffered from cooperation and coordination problems at various times in its history.

These types of problems are likely to be worse with the FSOC, which has twice as many voting members as FFIEC.³²⁴ Various studies on boards of directors have found that as the number of board

319. Dodd-Frank Act, § 111(b), 124 Stat. 1392 (to be codified at 12 U.S.C. § 5321).

320. *Id.* § 111(b)(2), at 1393 (to be codified at 12 U.S.C. § 5321).

321. *See supra* Part I (describing the varying objectives of the different organizations before the enactment of the Dodd-Frank Act).

322. FCIC REPORT, *supra* note 116, at 46–48, 152 (describing disputes between the CFTC and the SEC and between the SEC and the OTS); Brown, *supra* note 6, at 52–57, 64–65 (discussing agency turf wars between federal and state bank regulators and between the SEC and CFTC).

323. OIG FFIEC REPORT, *supra* note 154, at 14–15 (discussing problems among the banking regulators with creating uniform examination procedures and reports); *id.* at 16–18 (discussing problems with expanding the number of agencies on FFIEC and problems concerning coordination efforts between the banking agencies and the SEC); GAO FINANCIAL REGULATION, *supra* note 147, at 97–101.

324. *Compare* Dodd-Frank Act § 111(b), *supra* notes 319–320 and accompanying text (listing the ten voting members of the FSOC and the five nonvoting members of the FSOC), *with* OIG FFIEC REPORT, *supra* note 323 and accompanying text (noting there were five members of the FFIEC).

members increase, the coordination and cooperation problems worsen.³²⁵

c. The Federal Reserve may prove to be a poor supervisor

While all of these actions eliminate regulatory arbitrage, that alone is not sufficient to prevent a future financial crisis. Much will depend on how well the Federal Reserve fulfills its roles as the primary regulator of financial conglomerates. The jury is still out on whether the Federal Reserve proved to be a substantially better supervisor of financial institutions than the other regulators.

Before the crisis, the Federal Reserve was responsible for regulating both very large financial conglomerates and very small state chartered banks that were members of the Federal Reserve.³²⁶ In 2006, before the financial crisis began, the Federal Reserve supervised 901 state-chartered member banks with average assets of \$1.5 billion, 4,654 small BHCs with average assets of \$203 million, and 448 large BHCs with average assets of \$27 billion, as well as 643 FHCs.³²⁷ These 6,646 institutions in 2006 represented a 5% decline from the 7,046 institutions, including 1,042 state-chartered member banks and 6,004 BHCs, supervised by the Federal Reserve a decade earlier in 1995.³²⁸ The number of full-time employees of the Federal Reserve, however,

325. Theodore Eisenberg, Stefan Sundgren & Martin T. Wells, *Larger Board Size and Decreasing Firm Value in Small Firms*, 48 J. FIN. ECON. 35, 53 (1998) (finding that larger boards in small firms led to lower firm performance due in part to problems with communication and coordination); David Yermack, *Higher Market Valuations of Companies With a Small Board of Directors*, 40 J. FIN. ECON. 185, 185–86 (1996) (finding that the stock markets reward companies with small boards of directors with higher stock valuation); Martin A. Lipton & Jay W. Losch, *A Modest Proposal for Improved Corporate Governance*, 48 BUS. LAWYER 59, 70–72 (1992) (noting that boards with more than ten members are slower to make decisions, and have less candid discussions). *But see* Mohamed Belkhin, *Board of Directors' Size and Performance in the Banking Industry*, 5 INT'L J. MANAGERIAL FIN. 201 (2009) (finding no negative relationship associated with size of board and the firm's performance); Kenneth M. Lehn, Sukesh Patro & Mengxin Zhao, *Determinates of the Size and Composition of US Corporate Boards: 1935–2000*, 38 FIN. MANAGEMENT 747, 748 (Winter 2009) (finding “no robust relationship” between board size and firm performance); Jeffrey L. Coles, Naveen D. Daniel & Lalitha Naveen, *Boards: Does One Size Fit All*, 87 J. FIN. ECON. 329, 351 (2008) (concluding that certain types of firms benefit from larger boards).

326. U.S. BD. OF GOVERNORS OF THE FED. RESERVE SYS., 93D ANNUAL REPORT 65 (2006) [hereinafter FEDERAL RESERVE ANNUAL REPORT 2006], *available at* <http://www.federalreserve.gov/boarddocs/rptcongress/annual06/pdf/ar06.pdf>; U.S. BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 60 (9th ed. 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf (shares regulatory authority with the FDIC for state chartered member banks).

327. FEDERAL RESERVE ANNUAL REPORT 2006, *supra* note 326, at 65.

328. U.S. BD. OF GOVERNORS OF THE FED. RESERVE SYS., 82D ANNUAL REPORT 231 (1995) [hereinafter FEDERAL RESERVE ANNUAL REPORT 1995], *available at* <http://www.federalreserve.gov/boarddocs/rptcongress/ann95.pdf>.

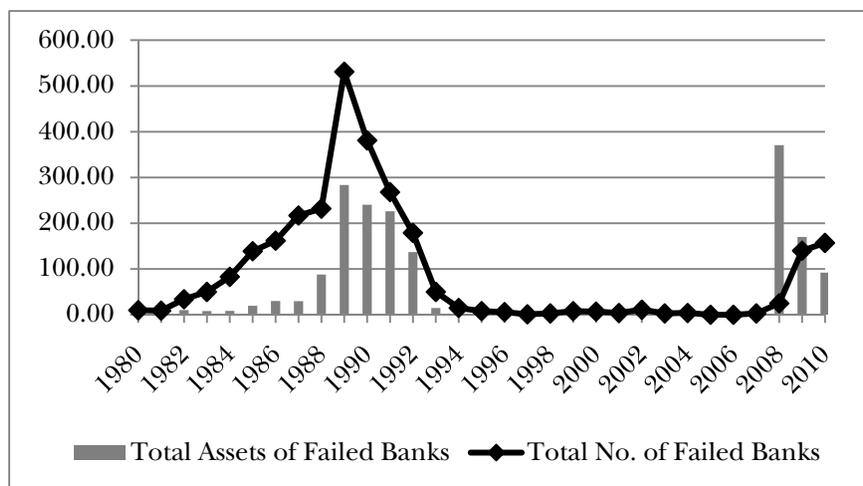
declined 17% from a total of 22,457 full-time employees in 1995 to 18,681 full-time employees in 2006.³²⁹ Thus, the Federal Reserve's resources to supervise financial firms shrank substantially more than the number of firms it oversaw during the ten year period prior to the financial crisis.

TARP and other actions have to some extent masked how many financial conglomerates regulated by the Federal Reserve might have failed because of poor supervision. The same is not true at the other end of the scale. Smaller firms were not so lucky and hundreds of them were allowed to fail.³³⁰ The number of U.S. banks and thrifts that have failed in this recent crisis is considerably smaller than the number that failed during the savings and loan crisis in the 1980s and 1990s, as illustrated in Figure 4. Nevertheless, the amount of assets controlled by the U.S. banks and thrifts that failed in 2008 was greater than the amount of assets controlled by the U.S. banks and thrifts that failed in any single year during the savings and loan crisis, as also shown in Figure 4.

329. *Id.* at 293; FEDERAL RESERVE ANNUAL REPORT 2006, *supra* note 326, at 297.

330. FED. DEPOSIT INS. CORP., FAILURES AND ASSISTANCE TRANSACTIONS INTERACTIVE DATABASE, SUMMARY REPORT OF YEARS 1970 TO 2010, *available at* <http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30> (select "Effective Date" range from "1970 to 2010" and "Report" type as "Summary").

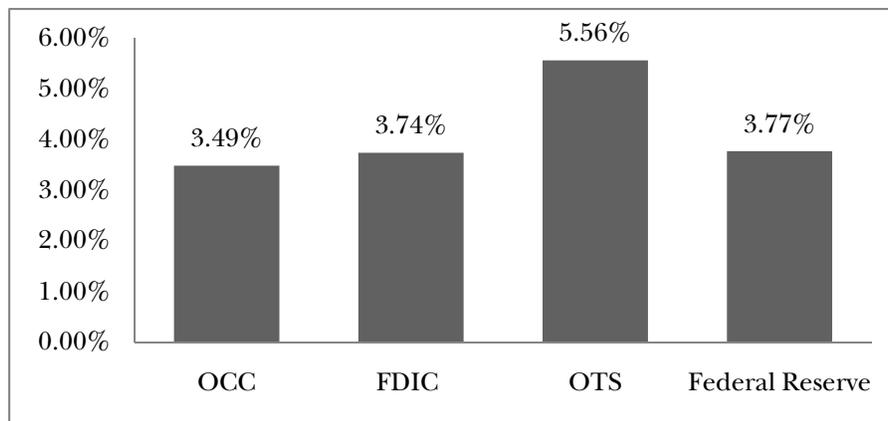
Figure 4: Total Number of Failed U.S. Banks and Thrifts and Their Total Assets: 1980–2010 (total assets in billions of constant 2009 U.S. dollars)³³¹



With regard to these smaller institutions, the Federal Reserve performed no better than the FDIC or the OCC when comparing the number of banks under its supervision that failed or required assistance from the FDIC with the total number of institutions under its supervision, as illustrated in Figure 5. Only the OTS had a worse track record.

331. *Id.*; FED. DEPOSIT INS. CORP., STATISTICS AT A GLANCE, FDIC HISTORICAL TRENDS—AS OF DEC. 31, 2010, *available at* <http://www.fdic.gov/bank/statistical/stats/index.html> (under December 2010 Statistics, select “FDIC Historical Trends”); U.S. BUREAU OF LABOR STATISTICS, CPI INFLATION CALCULATOR, *available at* <http://data.bls.gov/cgi-bin/cpicalc.pl> (to convert asset values into constant 2009 U.S. dollars).

*Figure 5: Number of Failed and Assisted Institutions by Regulator as a Percentage of the Total Number of Institutions Supervised by That Regulator in 2006*³³²



B. Improved Supervision of Holding Companies

The Dodd-Frank Act did not just attempt to reduce regulatory arbitrage by FHCs. It also took two actions to enhance supervision of such companies.

1. The Act established uniform minimum capital adequacy standards

The Dodd-Frank Act established one set of minimum capital requirements for insured depository institutions, BHCs, and nonbank financial companies subject to supervision by the Federal Reserve.³³³

³³². Assisted institutions does not refer to troubled financial institutions that received TARP funds, but instead to institutions that were either acquired by another institution with the assistance of the FDIC or were involved in open bank assistance transactions in which the FDIC provided the troubled institution with funds to keep it from failing. For a definition of “open bank assistance,” see FED. DEPOSIT INS. CORP., RESOLUTIONS HANDBOOK 47 (2003), *available at* <http://www.fdic.gov/bank/historical/reshandbook/index.html> (select Chapter 5). For data in Figure 5, see FED. DEPOSIT INS. CORP., FAILURES AND ASSISTANCE TRANSACTIONS INTERACTIVE DATABASE, DETAILED SEARCH OF YEARS 2006 TO 2010, *available at* <http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30> (select “Effective Date” range from “2006 to 2010”, select “Report” type as “Detailed”, selected Charter Type as “All Commercial & Savings”, and select Transaction Type as “All Transaction Types”); FEDERAL RESERVE ANNUAL REPORT 2006, *supra* note 326, at 65, 127; OFFICE OF THRIFT SUPERVISION, U.S. DEP’T OF THE TREASURY, 2006 FACT BOOK 5 (2006), *available at* http://www.ots.treas.gov/_files/2006FactBook.pdf. For purposes of this chart, the FDIC-supervised institutions includes both failed and assisted banks and savings banks as a percentage of all of the financial institutions supervised by the FDIC in 2006.

³³³. Dodd-Frank Act, Pub. L. No. 111-203, § 171(b), 124 Stat. 1376, 1436 (2010) (to be codified at 12 U.S.C. § 5371).

The minimum capital requirements include both generally applicable minimum leverage capital requirements³³⁴ and the generally applicable risk-based capital requirements.³³⁵ The Dodd-Frank Act states that the levels for these two requirements on July 21, 2010 serve as a floor and prohibits the Federal Reserve from reducing these requirements below their levels on July 21, 2010.³³⁶ The Act allows the Federal Reserve to set higher amounts for both generally applicable minimum leverage capital requirements and the generally applicable risk-based capital requirements than the levels that they were at on July 21, 2010.

The advantage of this requirement is that all holding companies for financial services that are systemically important will be required to meet the same, minimum capital adequacy requirements. As a result, these holding companies will be on a level playing field in terms of competition. As noted above, under the prior regulatory regime, CSEs had a competitive advantage over FHCs and BHCs because of the weaker capital requirements imposed on them by the SEC than the requirements imposed on FHCs and BHCs by the Federal Reserve.³³⁷ In addition, if the Federal Reserve becomes captured by the financial conglomerates that it supervises, this measure will prevent those conglomerates from using their influence over the Federal Reserve to undermine capital adequacy standards completely because the Federal Reserve does not have complete discretion on the required levels due to this provision in the Act.³³⁸

Another effect of this provision is that the largest banks in the United States will probably not be allowed to use their own internal risk models that would allow them to operate with lower minimum risk-based capital requirements than smaller banks.³³⁹ The Federal

334. These are defined as “the minimum ratios of tier 1 capital to average total assets” set by the federal banking regulators. *Id.* § 171(a)(1), at 1435 (to be codified at 12 U.S.C. § 5371).

335. These are defined as the ratios based on “the regulatory capital components in the numerator” and “the risk-weighted assets in the denominator.” *Id.* § 171(a)(2)(B), at 1436 (to be codified at 12 U.S.C. § 5371).

336. *Id.* § 171(b), at 1436 (to be codified at 12 U.S.C. § 5371). The Dodd-Frank Act also contains some phase-in periods for certain debt and equity instruments and for depository institution holding companies that were not regulated by the Federal Reserve on May 19, 2010. *Id.* § 171(b)(4), at 1437 (to be codified at 12 U.S.C. § 5371).

337. SEC IG’s CSE REPORT, *supra* note 70, at 4, 19–20.

338. § 171(b), 124 Stat. 1436 (to be codified at 12 U.S.C. § 5371).

339. The FDIC, OCC, and the Federal Reserve issued on Dec. 16, 2010 a joint notice of proposed rulemaking to amend the advanced risk-based capital adequacy standards under Basle II that they had approved in 2007 to eliminate the transitional floors that would have allowed certain banks to use internal risk models to lower their capital adequacy requirements. FED. DEPOSIT INS. CORP., FIL-88-2010, PROPOSED

Reserve, the OCC, and the FDIC currently are considering adopting a rule to that effect.³⁴⁰ If such a rule is ultimately adopted, it will also allow small banks to compete with larger banks on a more level playing field in the future. As a result, banks and other financial institutions may not feel pressured as much to merge as they would have if the advanced risk-based capital adequacy standards that the federal banking regulators originally adopted under Basel II were left in place. Without this pressure, fewer financial institutions may join the ranks of the “too big to fail” firms because they no longer think that they must in order to remain competitive.

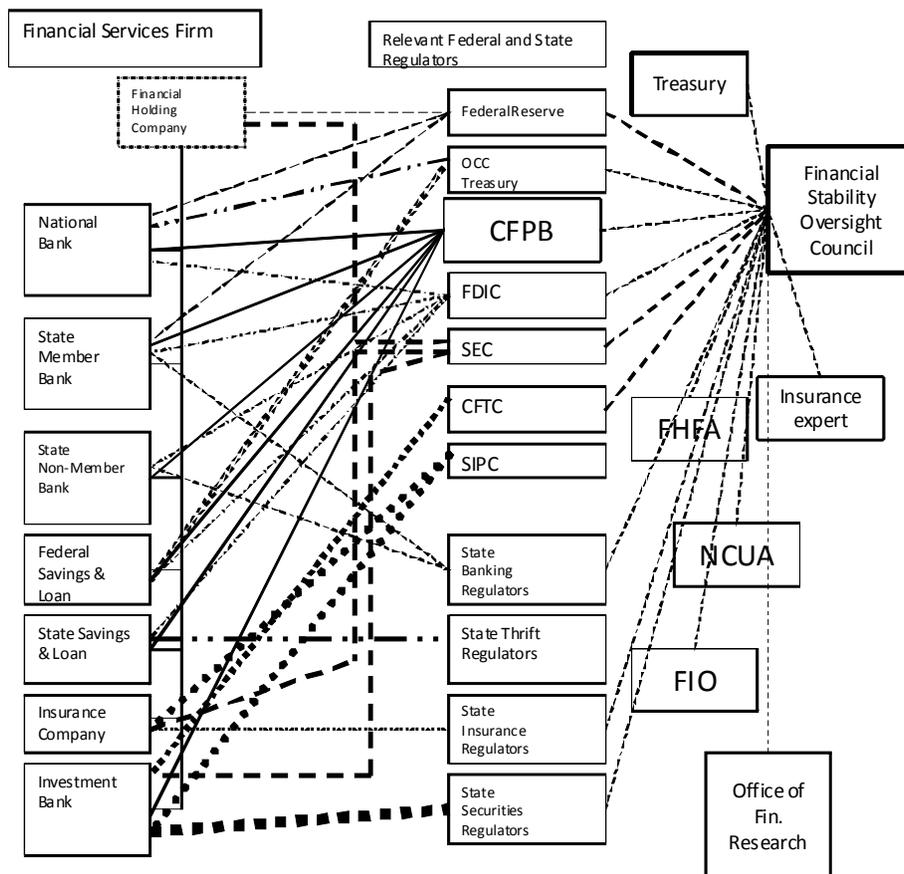
2. *The Act gives the Federal Reserve greater powers to examine a holding company's subsidiaries*

The ability of a holding company regulator to examine the subsidiaries of a financial conglomerate remains a pressing concern because the Dodd-Frank Act did not simplify the regulatory structure within the United States. The U.S. regulatory structure continues to rely heavily on functional and institutional regulation as illustrated in Figure 6.

RULE ON ADVANCED CAPITAL ADEQUACY FRAMEWORK—BASEL II; *ESTABLISHMENT OF A RISK-BASED CAPITAL FLOOR* (2010). The notice and comment period has expired. *See id.* (noting that comments were due sixty days after its publication on December 16, 2010).

340. *Id.*

Figure 6: How the Dodd-Frank Act Changed the Regulation of Financial Conglomerates³⁴¹



341. Dodd-Frank Act § 111(b)(2), 124 Stat. 1393 (to be codified at 12 U.S.C. § 5321); *id.* § 1011, at 1964–65 (to be codified at 12 U.S.C. § 5491).

The number of regulators operating with the United States remains largely unchanged in the wake of the enactment of the Dodd-Frank Act. While the OTS will be gone by 2012 at the latest, the Act created a new federal regulator in the form of the CFPB.³⁴² The CFPB has the authority to regulate any consumer financial product or service, except for products and services that fall within the business of insurance or are considered electronic conduit services, which the Act broadly defines to cover any type of electronic data transmission, telecommunication system, or electronic network.³⁴³ As a result, all of the subsidiaries of the financial conglomerate depicted in Figure 6, with the possible exception of the insurance company, may be required to comply with regulations issued by the CFPB.³⁴⁴

The Dodd-Frank Act did improve the ability of the Federal Reserve to examine at least some of the subsidiaries of the holding companies under its supervision by requiring it to investigate nonbank subsidiaries that are engaged in activities that the subsidiary bank can perform.³⁴⁵ An example of this would be a mortgage broker that is a subsidiary of a BHC. It is engaged in mortgage lending but does not take deposits. Thus, the mortgage broker qualifies as a nonbank subsidiary. It is, however, competing with banks that also issue mortgages. Thus, the Federal Reserve would be required to examine the mortgage brokerage subsidiary of the BHC under the Dodd-Frank Act.

3. The FSOC provides an inter-agency forum for making additional improvements to supervision

The Dodd-Frank Act envisions that the FSOC will not only provide a forum for inter-agency information sharing and coordination of regulatory activities, but that it would fulfill several new supervisory and regulatory functions as well.³⁴⁶ These duties include, among others, directing the work of the Office of Financial Research, monitoring the financial system to identify threats to its stability, advising Congress on domestic and international financial services

342. *See id.* § 1011, at 1964 (to be codified at 12 U.S.C. § 5491) (establishing the CFPB).

343. *Id.* §§ 1002, 1011, at 1956, 1964 (to be codified at 12 U.S.C. § 5481 and 12 U.S.C. § 5491, respectively).

344. *See id.* § 1011, at 1964 (to be codified at 12 U.S.C. § 5491) (explaining that the CFPB will regulate consumer financial products and services under the federal consumer financial laws).

345. *Id.* § 605(b), at 1604 (to be codified at 12 U.S.C. § 1831c).

346. *Id.* § 112(a)(2), at 1395–96 (to be codified at 15 U.S.C. § 5322).

regulatory proposals, making recommendations to its member agencies regarding supervisory priorities, reviewing and commenting to the SEC on accounting principles and practices, and making recommendations to the Federal Reserve regarding prudential standards and risk management.³⁴⁷ The FSOC can also compel its member agencies, the Office of Financial Research and the FIO, to provide it with any information or data that it deems necessary to fulfill its duties under the Act.³⁴⁸ It can also compel certain financial firms to provide it with information that it deems necessary to safeguard the stability of the financial system.³⁴⁹

4. *Weaknesses of the reforms to improve supervision*

a. *The FSOC's powers to examine other types of nonbank subsidiaries continue to be limited*

The Dodd-Frank Act does not require the Federal Reserve to examine nonbank subsidiaries that are not engaged in activities that a subsidiary bank can perform.³⁵⁰ The Federal Reserve still retains its limited power to do so as the Dodd-Frank Act did not eliminate the authority granted to the Federal Reserve to examine a subsidiary if it determined that the subsidiary posed a material risk to an affiliated depository institution, if it determined such an examination is necessary to obtain information on any financial and operational risks that pose a material risk to any depository subsidiary, or if it has reasonable cause to believe that a subsidiary is not in compliance with any law that it has the jurisdiction to enforce.³⁵¹ In addition, the Dodd-Frank Act makes clear that, in the case of functionally regulated subsidiaries, the Federal Reserve should not ask for new reports, but it should rely on the reports already prepared by the subsidiary for its functional regulator “to the fullest extent possible.”³⁵² As a result, it is still unlikely that under the Dodd-Frank Act examination procedures the Federal Reserve will uncover the risks posed by any holding company nonbank subsidiary like those of AIG Financial Products Corporation, which was a nonbank subsidiary that was not engaged in banking activities.

347. *Id.*

348. *Id.* § 112(a)(2)(A), (D), at 1395, 1396–97 (to be codified at 12 U.S.C. § 5322).

349. *Id.*

350. *See supra* note 345 and accompanying text.

351. 12 U.S.C. § 1844(c)(2)(B) (2006).

352. Dodd-Frank Act § 604, 124 Stat. 1600 (to be codified at 12 U.S.C. § 1844(c)(1)).

b. The FSOC generally cannot compel the Federal Reserve or the FSOC members to adopt any of the new regulations that it recommends

With the exception of requiring the Federal Reserve to supervise particular nonbank financial companies, directing the work of the Office of Financial Research, and compelling certain institutions to provide it with information, the FSOC has no authority to compel either its member agencies or any financial firm to take any particular regulatory action. As a result, its direct regulatory powers are rather weak.

C. Attempts to Address the “Too Big To Fail” Problem

The Dodd-Frank Act makes a few attempts to provide mechanisms for regulators to use to deal with the “too big to fail” problem. Unfortunately, these actions are inadequate to the task.³⁵³

1. Limits placed on growth of financial conglomerates

The Act attempts to strengthen the restrictions on financial conglomerates from becoming too big to fail by imposing some limits on their growth. It does this in two ways. One way is by eliminating the loophole in the Riegle-Neal Act that permitted mergers between banks and thrifts or industrial loan companies that would create an entity that controlled more than 10% of the deposits in the United States.³⁵⁴ It does this by prohibiting interstate mergers that create any depository institution, not just a bank, that controls more than 10% of the deposits in the United States.³⁵⁵

Another way that the Act places restrictions on financial companies’ growth is by not permitting “financial companies,” which include more than just depository institutions, from merging if the resulting company would control more than 10% of the total consolidated liabilities of all financial companies at the end of the prior year.³⁵⁶

353. For a more detailed analysis of this particular issue, see Arthur E. Wilmarth Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OREGON L. R. (forthcoming 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719126.

354. Dodd-Frank Act § 623(a), 124 Stat. 1634 (to be codified at 12 U.S.C. 1828(c)).

355. *Id.*

356. *Id.* § 622, at 1632 (to be codified at 12 U.S.C. § 1852).

2. *Allows the FSOC to make recommendations to address problems caused by the size and complexity of financial conglomerates*

The Dodd-Frank Act allows the FSOC to make recommendations to the Federal Reserve regarding what standards to use to address the problems posed by the growth in size and complexity of firms.³⁵⁷ This potentially provides another force on the Federal Reserve, encouraging it to adopt stronger prudential regulations to balance the pressure from the financial services industry for weaker regulations.

3. *Attempts to establish an orderly liquidation process for financial conglomerates*

The Dodd-Frank Act creates what it calls an “orderly liquidation authority” to force a troubled firm into liquidation to avoid a bailout.³⁵⁸ Under this authority, the Treasury, the FDIC, and the Federal Reserve have the power to force a firm into liquidation, but only if they unanimously agree to do so.³⁵⁹ In addition, it requires that at least two-thirds of the directors on the Board of Governors of the Federal Reserve and at least two-thirds of the directors on the Board of Directors for the FDIC have to approve the liquidation.³⁶⁰

4. *Bans the use of taxpayer funds to bail out troubled financial firms*

Finally, as part of this orderly liquidation authority, the Dodd-Frank Act attempts to create a mechanism to liquidate financial firms while having the costs of liquidation borne by the liquidating firm, its shareholders and creditors, and paid for by an assessment on large financial companies like an insurance guarantee fund.³⁶¹ The Act goes so far as to expressly ban taxpayer funds from being used to bailout or prevent the liquidation of any firm.³⁶²

357. *Id.* § 112(a)(2)(I), at 1395 (to be codified at 12 U.S.C. § 5322).

358. *Id.* §§ 201–17, at 1377–524 (to be codified at 12 U.S.C. §§ 5381–401).

359. *Id.* § 206, at 1459 (to be codified at 12 U.S.C. § 5386).

360. *Id.* § 203(a)(1)(A), at 1450 (to be codified at 12 U.S.C. § 5383).

361. *Id.* § 214, at 1518 (to be codified at 12 U.S.C. § 5394).

362. *Id.* § 214(c), at 1518 (to be codified at 12 U.S.C. § 5394).

5. *Weaknesses of the reforms aimed at addressing the “too big to fail” problem*

a. *Loopholes continue to exist that will allow firms to evade the caps on their growth*

Unfortunately, the Dodd-Frank Act leaves open two loopholes, which could result in other financial conglomerates controlling more than 10% of the total deposits in the United States. The Act expressly allows mergers that would create an entity that controls more than 10% of the total deposits in the United States when the merger involves at least one financially distressed firm.³⁶³ The merger between Bank of America and Merrill Lynch was just such a merger and resulted in a firm that now controls more than 11% of the deposits in the United States.³⁶⁴ In addition, the Act’s limits only apply to interstate mergers.³⁶⁵ Thus, the Act would allow intrastate mergers that would create a firm with more than 10% of the deposits in the United States.

With regard to the prohibition on a merger that would result in a firm possessing 10% of the total consolidated liabilities of all financial companies at the end of the prior year, the Dodd-Frank Act provides three ways that this limit can be circumvented. The first way is if the merger involves at least one firm that is in default or on the verge of default.³⁶⁶ The second way is if it is part of one of FDIC’s assistance programs.³⁶⁷ The third way is if the amount of the increase in total liabilities above the limit is a “de minimis” amount above the limit.³⁶⁸ The Act, however, does not define what would be a “de minimis” amount.³⁶⁹ These exceptions would allow two already too big to fail firms, like Bank of America and Merrill Lynch or JP Morgan Chase and Bear Stearns, to merge and control more than 10% of the total liabilities of all financial companies. In other words, the exceptions undermine the very purpose of the new rule.

363. *Id.* § 622(b), (c)(1), at 1633 (to be codified at 12 U.S.C. § 1852).

364. Federal Reserve System, Bank of America Corporation, Charlotte, NC, Order Approving the Acquisition of a Savings Association and an Industrial Loan Company 2 (Nov. 26, 2008). Bank of America controlled 10.8% of the deposits in the United States and Merrill Lynch controlled 1.1% of the deposits in the United States at the time that the Federal Reserve approved their merger. *Id.* The combined firm controlled 11.9% of the deposits in the United States. *Id.*

365. Dodd-Frank Act § 622(b), 124 Stat. 1633 (to be codified at 12 U.S.C. § 1852).

366. *Id.* § 622(c)(1), at 1633 (to be codified at 12 U.S.C. § 1852).

367. *Id.* § 622(c)(2), at 1633 (to be codified at 12 U.S.C. § 1852).

368. *Id.* § 622(c)(3), at 1633 (to be codified at 12 U.S.C. § 1852).

369. *Id.*

b. The FSOC has no authority to force the Federal Reserve to actually adopt new regulations or standards

As discussed above, FSOC can only make recommendations to the Federal Reserve. The Federal Reserve is not required to implement these recommendations.³⁷⁰ Given how much the Federal Reserve craves its independence, it is unclear whether it would be receptive to the recommendations by the FSOC.

c. The agreement among the relevant agencies that a firm needs to be liquidated may be difficult to achieve

The decision to force a firm into liquidation must be a unanimous decision by the Treasury, the Federal Reserve, and the FDIC.³⁷¹ Just getting all three agencies to agree probably will be difficult, particularly if the personalities heading those agencies do not get along.³⁷² The Dodd-Frank Act makes reaching such an agreement even more difficult by requiring that two-thirds of the Board of Directors of the Federal Reserve and the FDIC must approve the liquidation.³⁷³

The United Kingdom's experience during the Northern Rock crisis illustrates this point. A memorandum of understanding had established a Tripartite Arrangement under which the Bank of England, the Treasury, and the Financial Services Authority could intervene to provide emergency assistance to a financial institution, but only if all three agreed that such intervention was necessary.³⁷⁴ In the case of Northern Rock, the Bank of England was reluctant to provide assistance because of concerns about creating a moral hazard problem.³⁷⁵ The delays caused by the Bank of England's

370. See *supra* Part III.B.4.b.

371. See *supra* note 359 and accompanying text.

372. During the financial crisis, it was well known that Treasury Secretary Timothy Geithner and FDIC Chairman Sheila Bair did not get along well with each other and as a result, found it difficult to work together on issues that required their cooperation.

373. Dodd-Frank Act § 203(a)(1)(A), 124 Stat. 1450 (to be codified at 12 U.S.C. § 5383).

374. HM TREASURY ET AL., MEMORANDUM OF UNDERSTANDING BETWEEN HM TREASURY, THE BANK OF ENGLAND AND THE FINANCIAL SERVICES AUTHORITY 1, available at <http://www.bankofengland.co.uk/financialstability/mou.pdf>.

375. Ian McConnell, *About-turn from Bank Causes Stock Market Rocketing*, HERALD SCOTLAND, Sept. 20, 2007, <http://www.heraldscotland.com/about-turn-from-bank-of-england-sends-stock-market-rocketing-1.865568>.

unwillingness to authorize an intervention led to the first run on a British bank in over 100 years.³⁷⁶

d. Troubled financial firms can still receive other forms of government assistance, even if they cannot directly receive taxpayer funds

Unfortunately, the prohibition on using taxpayer funds is not air tight. The reality is that the Act allows the FDIC to provide assistance to the liquidating firm's receiver in order to facilitate an orderly liquidation.³⁷⁷ The FDIC can do this by providing loans, purchasing or guaranteeing against loss of the firm's assets, assuming or guaranteeing obligations of the firm, taking a lien on the firm's assets, or providing the funding for a bridge financial company.³⁷⁸ In addition, the Dodd-Frank Act only expressly prohibits the use of taxpayer funds, but it does not prohibit the use of other funds to bail out troubled firms.³⁷⁹ For example, troubled firms could continue to use the Federal Reserve's discount window and other programs prior to entering receivership.

CONCLUSIONS: WHERE DO WE GO FROM HERE?

We are better off than we were before, but the Dodd-Frank Act still falls short in a number of areas. It is doubtful that Congress will have the political will to revisit any of the provisions of the Dodd-Frank Act in the near future. Hopefully, Congress will not wait for another major financial crisis before doing so. The areas where improvements could be made the next time these issues are addressed include, among others, completely eliminating the possibility of regulatory arbitrage for financial conglomerates, closing or narrowing the loopholes that allow financial conglomerates to grow beyond the caps set forth in the statutes, and simplifying the regulatory structure to move it towards a twin peaks model.

With regard to the first issue, the Dodd-Frank Act sets up a rather elaborate scheme to preserve some of the authority of existing state agencies to regulate financial conglomerates, while moving towards having the Federal Reserve supervise all of the largest, most systemically important financial conglomerates. This arrangement is

376. Rosa M. Lastra, *Northern Rock and Banking Law Reform in the UK*, in *THE FAILURE OF NORTHERN ROCK: A MULTIDIMENSIONAL CASE STUDY* 133–34 (Tim Congdon et. al. eds., 2009), available at <http://www.suerf.org/download/studies/study20091.pdf>.

377. Dodd-Frank Act § 204(d), 124 Stat. 1455 (to be codified at 12 U.S.C. § 5384).

378. *Id.*

379. Wilmarth, *supra* note 353, at 50–54.

complex and cumbersome, and these characteristics may undermine its effectiveness. If two-thirds of the voting members of the FSOC cannot agree that a nonbank financial company should be supervised by the Federal Reserve, then it will escape such supervision. Thus, nonbank financial companies that want to escape such regulation would only have to convince four members on the FSOC to block any move to make them subject to supervision by the Federal Reserve. Since agency capture is a documented problem, the ability of industry groups to prevent the Federal Reserve from regulation of systemically important holding companies is very real. An easier method of eliminating the problems of regulatory arbitrage would have been to make the Federal Reserve responsible for supervising all holding companies for financial services firms, regardless of whether they are BHCs, FHCs, or nonbank holding companies.

In terms of making additional progress on the too big to fail problem, the easiest fix would be to close or narrow the loopholes that allow firms to grow beyond the caps set forth in the statutes. Certainly, the intrastate loophole should be eliminated. In addition, Congress may also want to reconsider whether firms that have already exceeded these caps should be broken up or at least forced to spin off sufficient assets to bring them under the caps.

Finally, the U.S. regulatory system needs to be simplified and moved away from a functional regulatory structure towards one that regulates based on the risks posed by the products, services, or firms. The complexity and costs of the current structure encouraged firms to seek ways to avoid it. These incentives have only been heightened with the new, more complex structure created by the Dodd-Frank Act.

In addition, the structure's very complexity was part of the reason that firms were able to engage in regulatory arbitrage in the first place. The structure is based on rigid definitions for banking, securities, and insurance products that allowed them to create hybrid products, services, or firms that failed to fit within those definitions. By minding the gaps in the U.S. regulatory structure, financial firms were able to take on excessive risks and create and sell questionable products and services.

Other countries, like Australia, that have moved to a twin peaks model avoid most of the problems that the United States experienced in the recent financial crisis. For example, unlike the United States, Australia did not have to bail out a single one of its financial

institutions nor did it have dozens of financial firms fail.³⁸⁰ In a twin peaks model, there is one national regulator for prudential risks and one national regulator for market conduct and consumer protection risks.³⁸¹ The Dodd-Frank Act moved the United States slightly in that direction by creating the CFPB and by giving the Federal Reserve most of the authority to prudentially regulate systemically important financial conglomerates. President Obama and his team did not feel that the political will existed to move to a twin peaks model, despite the fact that the Treasury Secretary for his Republican predecessor had proposed doing just that in his blueprint for financial regulatory reform. At some point in the future, the United States is going to have to address this issue because the fragmentary nature of our regulatory structure was the underlying cause for the problems with the way the United States supervised financial conglomerates. The fragmentary structure allowed regulatory arbitrage, created the need for and the absence of regulatory coordination among agencies, encouraged the lack of uniform supervisory and regulatory standards, contributed to the lack of understanding by holding company regulators of the risks posed by the subsidiaries within those companies, and ultimately fostered our inability to adequately address the too big to fail problem. Reforming the U.S. regulatory structure is the one of the most important projects left undone by the Dodd-Frank Act.

380. Elizabeth F. Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom, and Australia*, 55 VILL. L. REV. 509, 525 (2010).

381. *Id.* at 514–15.