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2009

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### Recommended Citation

Lawrence A. Cunningham & David T. Zaring, The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response, 78 *Geo. Wash. L. Rev.* 39 (2009).

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# THE THREE OR FOUR APPROACHES TO FINANCIAL REGULATION: A CAUTIONARY ANALYSIS AGAINST EXUBERANCE IN CRISIS RESPONSE

Lawrence A. Cunningham\* & David Zaring\*\*

## INTRODUCTION

First the financial markets collapsed, and second came massive government intervention designed to address the collapse. The third part of any financial crisis is reform. Judging by the exuberant production of scores of ambitious alternative visions for financial regulation reform, one may expect unprecedented reform in the aftermath of the 2008 crisis.<sup>1</sup> In considering what reform should look like, we caution that the headlong rush to do something should not neglect the surprisingly good things about the old system or ignore the considerable reform that has already been achieved by the federal government's massive and unorthodox response to crisis.

Among the bewildering proliferation of alternatives, one, offered by Treasury Secretary Henry Paulson shortly after the failure of the first of many institutions in March 2008, boldly imagined a revolution in financial regulation.<sup>2</sup> After it, other recommendations poured in, each with their own revolutionary visions of financial regulation reform, including two by an organization of financial industry notables led by Paul Volcker, the Group of Thirty.<sup>3</sup> Other grand visions come from the Government Accountability Office,<sup>4</sup> the Consumer Federation,<sup>5</sup> the

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We thank participants in presentations at the following law schools: George Washington University, University of Pennsylvania, University of Miami and University of Vancouver. For specific comments, we thank Steve Charnovitz, Steve Davidoff, Amanda Frost, [ ]. For research assistance, we thank Nikki Cho.

<sup>1</sup> Some say that if this crisis “fails to do the trick, then there is little hope Washington will ever summon the will to reorganize its creaking, disjointed system of financial regulation.” *Now or Never for Financial Watchdogs Shake-Up*, REUTERS (Oct. 29, 2008), available at <http://www.reuters.com/article/reutersEdge/idUSTRE49S6PD20081029>. Others say “we don’t have to start from scratch on regulatory reform of the financial services industry: There’s already a sensible blueprint for change.” Editorial, *A Starting Point for Regulatory Reform*, MINN. STAR TRIB. (Sept. 20, 2008), available at <http://www.startribune.com/opinion/editorials/28668184.html?page=2&c=y>.

<sup>2</sup> U.S. DEPARTMENT OF THE TREASURY, A BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (March 2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf> [hereinafter, TREASURY BLUEPRINT].

<sup>3</sup> THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (Oct. 2008), available at [http://www.deloitte.com/dtt/cda/doc/content/us\\_fsi\\_banking\\_G30%20Final%20Report%2010-3-08.pdf](http://www.deloitte.com/dtt/cda/doc/content/us_fsi_banking_G30%20Final%20Report%2010-3-08.pdf) [hereinafter VOLCKER I]; FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (Jan. 2009), available at [http://www.group30.org/pubs/pub\\_1460.htm](http://www.group30.org/pubs/pub_1460.htm) [hereinafter VOLCKER II].

<sup>4</sup> GOV’T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM, GAO-09-216 (JAN. 2009), available at <http://www.gao.gov/new.items/d09216.pdf> [hereinafter GAO FRAMEWORK].

Congressional Oversight Panel created to oversee government interventions,<sup>6</sup> plus a flurry of reports by Washington think tanks, dis- or semi-interested observers, and blue ribbon panels.<sup>7</sup>

Not to be overlooked is the functional reform that government's extensive intervention created on the fly: reform, in essence, by deal, rather than by report. There also continue to be good suggestions for reform of an incremental character, following the traditional US approach to financial reform in response to crisis.<sup>8</sup>

These various visions of regulatory reform, including those that follow traditional approaches, all stand a chance of enactment in the near term. The Treasury Secretary and Federal Reserve Chair indicate desire for legislation and outline their own reform preferences, informed by the proliferation of reports.<sup>9</sup> Congress debates proposals, poised to enact reform. And President Obama repeatedly calls for a new approach to financial regulation.<sup>10</sup>

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<sup>5</sup> MARK COOPER & BARBARA ROPER, REFORM OF FINANCIAL MARKETS: THE COLLAPSE OF MARKET FUNDAMENTALISM AND THE FIRST STEPS TO REVITALIZE THE ECONOMY (2009), <http://consumerfed.org/pdfs/FinancialMarketReformReport.pdf>.

<sup>6</sup> CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM: MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM (2009), <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf>.

<sup>7</sup> Noel Sacasa, *Preventing Future Crises: Priorities for Regulatory Reform after the Meltdown*, FINANCE AND DEVELOPMENT, Dec. 2008, 11; Luigi Zingales, *A New Regulatory Framework*, CITY JOURNAL (March 31, 2009), <http://www.city-journal.org/2009/eon0331lz.html>; CHARLES CALOMIRIS, THE SUBPRIME TURMOIL: WHAT'S OLD, WHAT'S NEW, AND WHAT'S NEXT (2008), [http://www.williams.edu/Economics/seminars/Calomiris\\_10\\_02\\_08.pdf](http://www.williams.edu/Economics/seminars/Calomiris_10_02_08.pdf); STEPHANY GRIFFITH-JONES, PROPOSALS FOR REGULATORY REFORM (Investment Property Databank (IPD) Policy Brief, 2008), <http://www.nsi-ins.ca/english/pdf/Proposals%20for%20Regulatory%20Principles.pdf>; COMM. ON CAP. MARKETS, RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL REGULATORY STRUCTURE (Jan. 14, 2009) <http://www.capmktreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf>; U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS, REGULATORY REFORM PRINCIPLES (Nov. 2008), [http://www.uschamber.com/assets/ccmc/081114ccmc\\_principles.pdf](http://www.uschamber.com/assets/ccmc/081114ccmc_principles.pdf); INTERNATIONAL SECURITIES EXCHANGE, INTERNATIONAL SECURITIES EXCHANGE PROPOSAL FOR REGULATORY REFORM FOR THE U.S. MARKETS (2009), [http://www.ise.com/assets/files/about\\_ise/ISE\\_Proposal\\_for\\_US\\_Financial\\_Market\\_Regulatory\\_Reform.pdf](http://www.ise.com/assets/files/about_ise/ISE_Proposal_for_US_Financial_Market_Regulatory_Reform.pdf); INVESTMENT COMPANY INSTITUTE, FINANCIAL SERVICES REGULATORY REFORM: DISCUSSION AND RECOMMENDATIONS (2009), [http://www.ici.org/pdf/ppr\\_09\\_reg\\_reform.pdf](http://www.ici.org/pdf/ppr_09_reg_reform.pdf); NEW DEMOCRAT COALITION, NEW DEMOCRAT COALITION PRINCIPLES FOR FINANCIAL REGULATORY REFORM (2009), <http://www.financialreformwatch.com/uploads/file/New%20Democrat%20Principles%20for%20Financial%20Regulatory%20Reform.pdf>.

<sup>8</sup> E.g., Elizabeth Warren & Oren Bar-Gill, *Making Credit Safe*, 157 U. PA. L. REV. 1 (2008) (proposing a federal Financial Product Safety Commission as a consolidated federal regulator akin to the Consumer Products Safety Commission); John C. Coffee Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. \_\_\_\_ (2009) (concentrating on the Securities and Exchange Commission).

<sup>9</sup> TREASURY OUTLINES FRAMEWORK FOR REGULATORY REFORM: PROVIDES NEW RULES OF THE ROAD, FOCUSES FIRST ON CONTAINING SYSTEMIC RISK (2009), <http://www.financialstability.gov/latest/tg72.html>

<sup>10</sup> Damian Paletta, *U.S. to Toughen Finance Rules*, WALL ST. J. (March 16, 2009), A1; BARAK OBAMA, REMARKS BY THE PRESIDENT AFTER REGULATORY REFORM MEETING (Feb. 25, 2009), [http://www.whitehouse.gov/the\\_press\\_office/Remarks-by-the-President-after-Regulatory-Reform-Meeting/](http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-after-Regulatory-Reform-Meeting/).

Amid the hurly-burly, how shall rational choices among this avalanche of ideas be evaluated and made? In this Article, we try to organize the choices for the perplexed. Although in details the reform proposals can vary enormously, at bottom, they reflect, we think, a few stark choices. There is, in short, a vital difference between the large number of regulatory reform proposals in circulation and the small number of functional regulatory reform choices actually available. We think there are three or four options in approaching financial regulation. They may be broken down into Democratic, Republican, old, and new—or, at least, events-driven—alternatives, and each of these proposals has an exemplar.

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

First, for example, the pre-existing system, although often castigated, has its merits and has long had its defenders. It is a highly fragmented set of regulators, distributing authority between federal and state governments and across various agencies within both levels. The system was disorganized but battle-tested and built out of repeated reforms, in a patchwork effort not to repeat the mistakes of the last business cycle. It brought, at its best, creative, competitive, and disaggregated oversight to the financial system. The advantages of such a system have been praised by scholars for decades, including by Ralph Winter, Roberta Romano, Frank Easterbrook and others.<sup>11</sup>

It is not, however, the system we currently have. A second approach to financial regulation and reform is the developed-on-the-fly approach adopted by Secretary Paulson and Federal Reserve Chair Ben Bernanke during the crisis of 2008. This system developed from the old, disaggregated approach, yet looks like its own model of a reformed, and centralized, financial regulatory system. It puts the Federal Reserve, with its matchless ability to intervene in the economy, at the fore of a financial regulatory system without many of the checks and balances that administrative law usually provides.

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<sup>11</sup> *E.g.*, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); *see also* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961 (2001); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

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

A third approach appears in several widely-circulating reports addressing financial regulation reform, including Secretary Paulson's blueprint released in March 2008. These reports offer variations on a broad theme contemplating considerable consolidation of regulatory oversight in the US federal government. The Treasury blueprint champions a version of the "two-peaked" model, centralizing in the federal government two broad categories of overseers, one focused on systemic stability and one on consumer and investor protection; in practice, Treasury has pursued this centralization during the financial crisis.<sup>12</sup> These proposals rationalize and centralize authority to regulate markets—but then adopt a model of delegation to self-regulation within the industry. Because the Paulson blueprint was the first, most prominent, and most detailed variant of these approaches, we highlight it to analyze this approach to financial regulation.

Surprisingly close variations on the consolidation theme appear in reports offered by others, including the Group of Thirty, headed by Paul Volcker, Chair of the Obama Administration's Economic Recovery Advisory Board. If Paulson's blueprint represents the view of the Republican financial establishment, the Volcker reports give the view of its Democratic counterpart—Treasury Secretary Timothy Geithner, appointed by President Obama to succeed Paulson, is a member of Volcker's group. These visions are not entirely different, and in practice, both Republicans and Democrats have embraced the on-the-fly model of centralizing financial regulation in the Treasury and the Fed during the crisis. Indeed, Secretary Geithner has done so explicitly, although he has adopted a consciously more transparent, restrictive and control-oriented approach than his predecessor, Secretary Paulson.<sup>13</sup>

On the other hand, the Volcker group urges not only consolidation but prescribes more stringent, substantive, reform, establishing size limitations on financial institutions and other controls, such as limitations on proprietary securities trading by commercial banking

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<sup>12</sup> Notably, much of what is articulated in architectural detail in the blueprint, and especially the centralization, was enacted on the fly by Secretary Paulson and the Federal Reserve Chairman during the 2008 crisis.

<sup>13</sup> See, e.g., U.S. Treasury, Fact Sheet, Financial Stability Plan (Feb. 11, 2009), available at <http://www.financialstability.gov/docs/fact-sheet.pdf> (announcing continuation of government investment in financial institutions' preferred stock but boasting of new transparency of approach and stating firm limits on any investee's right to declare cash dividends on common stock, to use cash for acquisitions or to pay annual cash compensation to executive officers in excess of \$500,000).

institutions.<sup>14</sup> This sort of federalization follows a line of scholarship reaching from William Cary to Lucian Bebchuk.<sup>15</sup>

Although the Paulson blueprint and Volcker reports both endorse consolidation of financial regulation in the federal government, ending the traditional American fragmentary system, they appear to do so for different reasons and with different visions for the consequences. The blueprint promotes consolidation to enable U.S. capital markets and financial firms to compete globally, where other nations offer their own regulatory systems and all compete, in what is ultimately a competitive global stage. In contrast, the Volcker proposals seek consolidation to stabilize and control American markets and firms and concurrently to join other national regulators in similar regulatory control to maintain an ordered global financial system. The Volcker approach is internationally *collaborative*, while Paulson's is internationally *competitive*. Even so, the consolidated approach endorsed by both Paulson and Volcker has gained traction and an emerging consensus appears to extend regulation to new parts of the financial services industry, including hedge funds, possibly private equity, and over-the-counter derivatives.<sup>16</sup>

As we have suggested, we think that within these various approaches to financial regulation, three or four models can be discerned. There is the decentralized old approach, the on-the-fly reforms in 2008 that have transformed it—not trivially—and the more considered centralized alternatives exemplified by Paulson's Treasury Department and Volcker's Group of Thirty. They may stand in for other proposals that, we think, look like a reimagining of the architecture of financial regulation from institutionally similar, but distinctively Democratic and Republican, viewpoints. More than two and less than five, these alternative visions of financial regulation are the approaches from which we will select our future system of finance.<sup>17</sup>

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

This Article delineates these alternative approaches to financial regulation and provides a framework to assess them. Some issues turn on questions well beyond law, including economic

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<sup>14</sup> Steve Vogel, *Report Faults Financial Overnight*, WASH. POST (Jan. 23, 2009), available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/22/AR2009012201681.html>. The GAO likewise encourages greater consolidation of regulatory authority in particular branches of the federal government and opine on characteristics that any refashioned US financial regulatory system should have. See GAO FRAMEWORK, *supra* note \_\_\_, at \_\_\_.

<sup>15</sup> *E.g.*, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

<sup>16</sup> The Treasury Secretary has testified before Congress on the need for “A Single Independent Regulator with responsibility over Systemically Important Firms and Critical Payment and Settlement Systems.” *Supra* note 9.

<sup>17</sup> Compare JOHN KENNETH GALBRAITH, *THE GREAT CRASH: 1929 (1938)* (cautiously reflecting upon the several alternative approaches to financial regulation to diminish the frequency or magnitude of economic crises).

theory, political science and international relations. Moreover, the alternatives confront a vast swath of the US regulatory bureaucracy, essentially all aspects of its financial markets and dozens of large regulatory organizations; the approaches bear considerable effects on the real economy and present literally hundreds of discrete, and important, issues for decision. These complexities, and the prospect of both many proposals and potential revolutionary change, suggest the usefulness of having a framework for evaluation, which this Article provides.

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

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

Third, although the approaches exemplified by the Paulson and Volcker proposals both prescribe centralization to abandon fragmentation, they do so using different models, for different reasons and with different objectives—both federalize and centralize, but then one delegates to promote US global competitiveness whereas the other proposes to regulate, as apolitically as possible, and collaborate with international counterparts.

Fourth, we think the fact that the principle regulatory reforms depend on a vision of globalization is prudent. But we also believe that an approach that embraces the fact that both finance and regulators can cross borders is more sustainable than one that does not. From both domestic and global perspectives, therefore, the grand visions may simply be impracticable and reliance on the traditions of ad hoc regulatory response all one should reasonably prescribe.

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

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

competition with other systems. Volcker seeks centralization within the US, and coordination among other nations, to promote order in global financial markets.

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

Ultimately, neither grand vision may be sustainable. We may yet be left with remnants of the traditional US fragmented system, as concentrated by the on-the-fly reforms made during the 2008 crisis, with perhaps new regulations addressing certain financial instruments and institutions previously outside federal regulatory purview. We evaluate the merits of this approach as well, leading to our conclusion that incremental regulatory adjustments rather than sweeping regulatory revolution are both superior and more practicable.

## I. PREVAILING APPROACHES: DYNAMIC EVOLUTION

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

Section C continues the historical inquiry by connecting the traditional fragmentation and crisis response to the unusual nature of Treasury Secretary Paulson's blueprint for regulatory reform which, given its timing and scope, may be seen as both anticipatory and preemptive. It exemplifies a species of financial regulation which rationalizes in an effort to ensure domestic political control and international market competitiveness. It was issued ahead of the crisis both to outline strategic and tactical responses to it and to lead and influence national reform discussions that its authors may have anticipated as they foresaw the coming crisis.<sup>18</sup>

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<sup>18</sup> A thumbnail sketch of the 2008 crisis may begin with the increased personal savings rate in Asian countries, in the late 1990s, following stringent economic controls to correct the bursting of speculative asset bubbles there. Resulting cash found its way into the US mortgage finance system, which was already expanding. Expansion arose in part from low interest rates the Fed maintained to combat a recession threatened by the collapse of the US technology bubble in 2000 and terrorist attacks of late 2001. Existing mortgage finance institutions, including Fannie Mae and Freddie Mac, supported expansion by continuing to buy or guarantee mortgage loans. Expansion was propelled by growing use of highly-rated mortgage-backed securities, pools of mortgages that pay interest and principal to investors, sold through investment banks.

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

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

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

In the old model, for example, insurance law is primarily state law; banking law is a combination of state and federal law, depending on whether a bank is chartered by a state or at federal level; securities regulation is primarily, but not exclusively, federal; and futures regulation is entirely federal. Various other intermediaries, including government-sponsored mortgage finance entities like Freddie Mac and Fannie Mae, fit awkwardly into the picture, and were subject to special federal regulatory oversight, while mortgage origination itself was left to state oversight. . The same is true of credit unions.

This fragmented system entailed roles for numerous actors, including state and federal law makers, regulators, supervisors and administrators. In some fields, especially futures and to a lesser extent securities, important regulatory determinations were delegated to self-regulatory organizations, essentially industry groups charged with self-regulation. It was difficult for any single authority to command knowledge of the entire financial system. But if regulators found it difficult to evaluate systemic risk, the system, at least, knew what the regulators were up to. Most regulatory production and supervision was conducted in accordance with open government principles, meaning administrative law and procedure, such as notice and comment periods, subject to accountability tools such as those appearing in the Administrative Procedure Act (or state equivalents) and judicial review of legislative, executive and administrative action.<sup>19</sup>

The traditional system, conceived as a model of financial regulation, looked almost irrational, but offered its share of advantages, such as a close fit between regulatory expertise and targeted industries, a degree of devolution that enables exercise of state authority and experimentation rather than monopolistic regulatory consolidation in Washington, and some competition among regulators themselves.<sup>20</sup> Overall, the system's characteristic open government promoted valued notions of democratic accountability and legitimacy. Moreover,

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The result was rising home prices that became a speculative bubble. The bubble began to deflate in 2004. Interest rates rose, sales slowed, lenders tightened standards and rating agencies identified greater risk in financial instruments supporting the expansion. Large numbers of people defaulted on mortgage loans when their outstanding balances exceeded a home's market value. Cascade effects ensued: prices fell, mortgage defaults rose, mortgage-backed securities were impaired, capital contracted, and the effects rippled through all financial markets, eventually infecting the real economy, triggering a steep recession. All these effects pulsed through the global financial system, sparing no national economy.

<sup>19</sup> See 5 U.S.C. 551, et seq.

<sup>20</sup> Indeed, some observers have characterized the system as a law market. See LARRY RIBSTEIN & ERIN O'HARA, *THE LAW MARKET* (2008).

the various overlaps meant that regulators competed against one another for business. To be sure, such a fragmented system resulted, at times, in both redundant and incomplete regulation. Under it, some institutions were subject to more than one layer of regulation while some transactions and institutions evaded regulation or oversight altogether.<sup>21</sup>

Moreover, the structure posed challenges concerning addressing periodic financial crises that erupt. Financial regulators certainly perform vital quotidian tasks, such as ensuring the safety and soundness of financial institutions, in addition to promoting fair treatment of customers and investors. But they also must deal with occasional financial shocks. A fragmented structure may enable authorities to respond to discrete institutional failures using tailored tools; but it may also blind senior regulators to important systemic risks that lead to widespread crisis. The question becomes the net value of disaggregation, an industry-by-industry focus, and redundancy with gaps, or whether consolidation is likely to result in better regulatory performance in crises, as by reducing their magnitude or duration.

Other scholars, along with many white papers and books, have described precisely how this chaotic system works, and repeating their organizational charts and diagrams here would be unproductive.<sup>22</sup> Instead, it may be useful to offer four examples of how this structure has been used to respond to, and at the same time how the structure has been changed by, past crises.<sup>23</sup>

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

Consider first the widespread failure of savings and loan institutions during the 1980s.<sup>24</sup> In brief, these institutions heavily financed the purchase of individual properties, including many farms, at relatively high prices using relatively low interest rates. After a real estate boom turned to bust, and property values fell while interest rates rose, borrowers defaulted in droves. A downward spiral ensued. All savings and loans were affected and several thousand became insolvent.

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<sup>21</sup> We provide more elaborate assessment and implications in Part III.

<sup>22</sup> Readers wishing may consult GAO FRAMEWORK, *supra* note \_\_\_\_ or TREASURY BLUEPRINT, *supra* note \_\_\_\_.

<sup>23</sup> For a partial list, see [http://www.nytimes.com/2008/09/07/business/07bailout.html?\\_r=2&oref=slogin&oref=slogin](http://www.nytimes.com/2008/09/07/business/07bailout.html?_r=2&oref=slogin&oref=slogin).

<sup>24</sup> For an account of the RTC process, see Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 247 (2000). For a more general overview of the S&L crisis, see Edward L. Rubin, *Communing with Disaster: What We Can Learn from the Jusen and the Savings and Loan Crises*, 29 LAW & POL'Y INT'L BUS. 79, 79 (1997).

The government responded with a serial federal takeover of all those institutions, at a cost of more than \$100 billion, under the supervision of the Treasury in a Congressionally-created special purpose authority called the Resolution Trust Corporation.<sup>25</sup> It administered those institutions by selling off their assets over a period of years. The response suggests a standard outline of using federal apparatus to resolve national problems that plagued thousands of state-based or regional institutions that were largely not subject to federal oversight.

Similarly, the crisis led to reorganization of the S&L industry as well as abolishment of existing regulatory bodies and replacement with new ones.<sup>26</sup> The government's reform could be characterized as an industry reorganization: it turned thrifts into something that looked more like banks and gave a parallel makeover to the thrift regulator, which was renamed the Office of Thrift Supervision and placed within Treasury (it was formerly called the Federal Home Loan Bank Board).<sup>27</sup>

Consider second the stock market break of October 1987, when the Dow Jones Industrial Average dropped 22.6% on a single day and nearly 35% in the course of a month. Capital markets shut down. Panic was prevalent as the volume of corporate transactions, ranging from financings to mergers, fell. Financial innovations, such as computer-triggered block sales of stock, and, again, regulatory gaps, were the story of the crisis. President Reagan formed a working group to assess and advise on these matters.<sup>28</sup> Here government's reform was more measured and technical; it took reflective, post-crisis advice, and then adopted a number of "small ball" reform proposals.

President Reagan's task force diagnosed causes, which it said were proliferation of new financial instruments, such as financial derivative contracts, program trading and portfolio insurance.<sup>29</sup> Adopted reforms were pegged to specific stock market operations, like establishing circuit breakers to halt market trading if stated declines occurred. Suggested reforms that were not adopted include some appearing in 2008's Treasury blueprint and the 2009 Volcker report, such as reposing greater supervisory power over financial firms within the Fed and combining aspects of securities and futures regulation.<sup>30</sup>

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<sup>25</sup> Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989).

<sup>26</sup> FIRREA abolished the Federal Savings and Loan Insurance Corporation and Bank Board and replaced them with the Resolution Trust Corporation and Office of Thrift Supervision. *Id.* §§ 401, 501, 103 Stat. at 354, 364-94.

<sup>27</sup> *See id.*

<sup>28</sup> This President's Working Group (PWG) is discussed more fully *infra* text accompanying notes \_\_\_\_ - \_\_\_\_.

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

<sup>30</sup> *See* BRADY REPORT, *supra* note \_\_\_\_, at 59 (Chapter Seven on Regulatory Implications: "One Market Mandates One Agency for Inter-market Issues") & 61 (recommending possible merger of SEC and CFTC to promote joint responsibility); *see also* Michael D. Guttentag, *Regulatory Rule #2: Insurance Products Need to be Regulated*,

Third, consider the collapse of the large hedge fund, Long Term Capital Management, in 1997. Again financial innovation played a role in causing the crisis, although this one featured the growth of an alternative asset class, rather than a liberalization of lending practices, or new computerized trading techniques. Hedge funds were just beginning to reach the massive size they achieved by 2008. And regulatory gaps appeared. Neither the SEC nor CFTC oversaw the trades made by these funds.<sup>31</sup>

LTCM essentially placed side bets on the direction of various financial benchmarks, such as currency exchanges and interest rates. The firm used fairly sophisticated risk management tools and appears to have invested heavily in careful scrutiny of its positions.<sup>32</sup> But due to a financial crisis that swept across Asia, both currency rates and interest rates moved sharply in directions LTCM had deemed highly improbable. As a result, the firm was exposed to losses on hundreds of billions of dollars of trades.

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

No systemic regulatory innovations were taken in the failure's wake, however, despite increasing spread of financial derivatives and calls by some for enhanced oversight and regulation of them.<sup>33</sup> However, the President's Working Group, descendant of President Reagan's post-1987 market crash task force, studied the crisis and resolved to strengthen cooperation among regulators in the future.<sup>34</sup>

Although not a financial crisis, as such, the corporate accounting scandals of the early 2000s and regulatory responses contribute perspective on the traditional fragmented system and pattern of crisis-response reform. Four large enterprises, mostly in the technology sector, although one in the energy sector, used fiendish accounting shenanigans to create the illusion of

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<http://www.theconglomerate.org/2008/10/regulatory-ru-1.html> (describing the role of portfolio insurance in the 1987 stock market crash).

<sup>31</sup> For an account of the various proposals to regulate hedge funds by a current SEC commissioner, see Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975 (2006).

<sup>32</sup> See generally ROGER LOWENSTEIN, *WHEN GENIUS FAILED* (2002).

<sup>33</sup> E.g., Thomas A. Russo, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431 (1991). Noted investor Warren Buffett famously quipped that derivatives had become "financial weapons of mass destruction." See LAWRENCE A. CUNNINGHAM & WARREN E. BUFFETT, *THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA* 145 (2d ed. 2008).

<sup>34</sup> See *supra* note \_\_\_ and accompanying text.

billions of dollars of value.<sup>35</sup> These and dozens of other corporations were discovered as all but (and in some cases total) frauds amid the collapse of the technology sector.

Here too, financial innovations increasingly popular elsewhere. Off-balance sheet special purpose investment vehicles and various forms of aggressive accounting for financial instruments appeared. Gaps in the division between state and federal oversight, and relatively laissez-faire federal accounting oversight, were exploited.

The swift federal response was the Sarbanes-Oxley Act of 2002, reform targeted mostly at diagnosed causes of the frauds, plus a dozen remotely related provisions favored by various political interests. The controversial legislation provoked criticism as an over-reaction to the perceived crisis of investor confidence.<sup>36</sup> Although most of its provisions remain in effect, some implementing policies, especially concerning mandatory audits of corporate internal controls, were scaled back considerably. Many observers cite Sarbanes-Oxley as illustrating the kind of dangerous over-reaction that crisis-driven legislative and regulatory reform can pose.

These selected examples show some familiar traditional patterns of financial crisis and response in the fragmented model. The crisis can bubble up in a particular sector—real estate bank lending in the S&L crisis, equity market pricing in 1987's stock market break, derivative financial products in LTCM's 1997 failure and technology in the early 2000's accounting scandals.<sup>37</sup> They also show a substantially coordinated national response, led at the federal level, usually based on ex post diagnostics of causes. Finally, they show that regulatory responses are often tailored to the particulars of the problem, although many un-adopted proposals with greater systemic scope often are made. In short, comprehensive reform of financial regulation has usually required a crisis to develop, but a crisis does not always lead to comprehensive regulatory reform.

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

The 2008 crisis bears kinship to predecessors, in several ways, but its scale and scope were unprecedented. One of us has elsewhere provided a detailed account of how the government responded to the crisis;<sup>38</sup> here we consider its response as a *model of regulatory reform*.

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<sup>35</sup> See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 Conn. L. Rev. 915 (2003).

<sup>36</sup> E.g., Roberta Romano, *Sarbanes-Oxley and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005).

<sup>37</sup> Federal intervention to address problems of one or a few firms that could pose systemic ripple effects recurs. Famous examples include addressing Penn Square bank, which threatened to topple Continental Illinois Bank, then 7<sup>th</sup> largest in the US, see Phillip L. Zweig, *Learning Old Lessons from a New Scandal*, N.Y. TIMES, Feb. 2, 2002, at A19 (reviewing case in light of pending crisis at Enron Corporation), and Bank of Credit and Commerce International (BCCI), an illicit international web of financial operations whose collapse threatened the financial system's stability, see *United States v. BCCI Holdings*, 69 F. Supp. 2d 36 (D.D.C. 1999).

<sup>38</sup> See Steven M. Davidoff & David Zaring, *Big Deal: The Government's Response to the Financial Crisis* (draft Jan. 2009), available at [http://papers.ssrn.com/abstract\\_id=1306342](http://papers.ssrn.com/abstract_id=1306342).

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

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

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

As with past crises, the 2008 crisis spread quickly. The S&L crisis and the 1987 stock market collapse exemplified the speed with which financial markets can turn from relatively safe to extraordinarily risky. The 2008 crisis took on a momentum that accelerated rapidly, especially in the final quarter of that year. As former Treasury Secretary Paulson wondered of the serial collapse of financial institutions during that period: "[w]ho are these guys that just keep coming?"<sup>39</sup>

The 2008 crisis also followed the financial crisis rulebook in response, at least in the beginning. The response began with firm-by-firm intervention in the spring, summer, and early fall of 2008,<sup>40</sup> but ensuing efforts broadened to prevent asset prices from plunging.<sup>41</sup> As with the S&L and LTCM crises, federal authorities used deals (M&A and corporate finance) to respond.<sup>42</sup> But, again given the scale, ultimate responses reached unprecedented levels, amounting to regulatory intervention involving what is best described as *regulation by deal*.

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<sup>39</sup> See Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. TIMES, Oct. 23, 2008, at A1.

<sup>40</sup> As discussed, *infra*, Bear Stearns in investment banking; Indy Mac, Washington Mutual and Wachovia in commercial banking, AIG in insurance; and Fannie Mae and Freddie Mac in mortgage finance.

<sup>41</sup> Emergency Economic Stabilization Act of 2008. This Act envisioned Treasury buying up to \$750 billion in troubled assets using techniques such as reverse auctions to generate prices otherwise unformed amid distressed market conditions. It was subsequently used as the basis for Treasury's investment of \$250 billion in preferred stock and warrants of banks. See Steve Lohr, *Bold Action With Basis in History*, N.Y. TIMES (Oct. 14, 2008).

<sup>42</sup> See Davidoff & Zaring, *Big Deal*, *supra* note \_\_\_\_.

On balance, then, the government did something entirely new in responding to the 2008 crisis, to the point of altering regulation of financial markets more generally. It provided financial guarantees, bought preferred stock and warrants in private companies, extended commercial loans to others, acted as broker of numerous mergers and takeovers of yet others, took over some companies, in whole or in part, and made what amounted to business decisions to participate in some corporate finance and M&A activity with certain companies while allowing others simply to fail.<sup>43</sup> The response paradigm was accordingly not unknown to the financial system, but is distinguished by ad hoc deal-making out of the crisis, rather than post hoc reform to calm troubled waters, as in previous crises.

The Fed and Treasury's deal-making and injection of liquidity into capital markets forced both to resort to the novel use of legal authority to justify their actions. And, given the scale of responses, it was never clear that either had that authority.<sup>44</sup> They did seek and obtain legislation authorizing using up to \$750 billion in Treasury funds to buy distressed assets and/or make investments in banks on behalf of the US government.<sup>45</sup> But they also relied extensively on flexible Depression-era statutes to get involved in sectors of the economy in which they had previously never had purchase, dramatized by how the Fed bought an insurer—AIG—and Treasury *became* an insurer of money market funds.<sup>46</sup>

As with other financial crises, this one and the response to it prompted proposals for large-scale, planned reform, including contributions made by groups and commentators ranging from the Group of Thirty to the GAO.<sup>47</sup> Ironically, however, in this case, some of the reforms achieved by the Fed and Treasury were contemplated before the scale of crisis became clear, in March 2008's Treasury blueprint. For example, as we will detail, the blueprint counseled the centralized model which the Fed adopted, with assistance from Treasury, during 2008. It advised consolidating safety and soundness supervision in a single entity, and during the crisis, the Fed took over supervision of investment banks from the Securities and Exchange Commission. The blueprint urged a federalization of insurance, and the Fed responded with a takeover of AIG.

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

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<sup>43</sup> See Charles Duhigg *et al.*, *As Crisis Grew, A Few Options Shrank to One*, N.Y. TIMES (Sept. 8, 2008).

<sup>44</sup> See Davidoff & Zaring, *Big Deal*, *supra* note \_\_\_\_.

<sup>45</sup> Emergency Economic Stabilization Act of 2008.

<sup>46</sup> See *infra* text accompanying notes \_\_\_\_-\_\_\_\_. On money market funds amid the crisis, see Mercer Bullard, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance* (March 2, 2009) (ssrn id. no. 1351987); on AIG, see William K. Sjostrom, Jr., *The AIG Bailout* (March 10, 2009) (ssrn id no. 1346552).

<sup>47</sup> See *supra* text accompanying notes 2-5 (citing sources).

financial regulation. It centralized regulatory authority in the Fed and Treasury, significantly reducing regulatory authority of other federal agencies and state regulators.

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

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

Bear tripped first, in March 2008, after counterparties refused to offer short-term credit it needed to run its business. In moves reminiscent of those applied to address the LTCM crisis in 1997, the Fed and Treasury orchestrated a merger of Bear with JP Morgan Chase, a commercial bank, at an initial price per share of about \$2—a price that holders promptly protested, getting it raised within two weeks to \$10 per share.<sup>48</sup>

In September 2008, an even worse fate befell Lehman Brothers, an investment bank, like Bear Stearns, heavily exposed to the subprime mortgage market.<sup>49</sup> The Fed and Treasury elected not to sustain Lehman, though they helped to arrange for other financial institutions, like Barclay's, a British commercial bank, to assume many of its operations.<sup>50</sup>

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<sup>48</sup> See Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity* (Aug. 11, 2008), available at [http://papers.ssrn.com/abstract\\_id=1254648](http://papers.ssrn.com/abstract_id=1254648).

<sup>49</sup> Evidence of its dire straits appeared in how Lehman was the only major defendant that refused to settle lawsuits challenging the suitability for individuals of auction rate securities. These were portrayed as liquid cash equivalents but their liquidity depended on investment banks willing to trade them, willingness that terminated amid the crisis and left individuals holding securities they could not sell. See Gretchen Morgenson, *As Good as Cash, Until It Is Not*, N.Y. TIMES (March 9, 2008).

<sup>50</sup> The effort to enlist Barclay's was important to protect investors under securities laws designed to secure customer funds held in brokerage accounts. See SEC Press Release, *Statement on Proposed Lehman Brothers, Inc. Acquisition by Barclays* (Sept. 17, 2008), available at <http://www.sec.gov/news/press/2008/2008-206.htm>.

During the same September week the Fed and Treasury signaled unwillingness to support Lehman, they sent the same signal to Merrill Lynch.<sup>51</sup> As a result, Merrill quickly merged with Bank of America on the weekend that Lehman Brothers fell, in a deal likewise supported by the Fed and Treasury. Within that week, moreover, also with the blessing of the Fed and Treasury, Goldman and Morgan Stanley opted to turn themselves into bank holding companies under Fed supervision and with expanded access to its liquidity facilities.<sup>52</sup>

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

Under the Glass-Steagall Act—itsself an ad hoc response to that period’s financial crisis—commercial banks would take deposits and make loans; investment banks would buy and sell securities and engage in other transactional corporate finance. Enterprises engaged in commercial banking could not engage in investment banking. Most of that Act was repealed by the Gramm-Leach-Bliley Act of 1999, having gradually been chipped away with exemptions for commercial banks to underwrite securities and investment banks to own commercial bank subsidiaries. The partial repeal ended the legal limitations on combining these activities within one firm.

Despite that repeal, there remained a large and recognizable group of firms that epitomized traditional investment banking—Bear, Goldman, Lehman, Merrill, and Morgan Stanley. After repeal, and until the cataclysmic events of 2008, the SEC had jurisdiction over the safety and soundness of these firms, though its role in determining their fate would ultimately be minimal. The SEC exercised its oversight through a voluntary program.<sup>53</sup> The SEC Chairman who created and oversaw that program admitted in September 2008 that it was a total failure.<sup>54</sup> With Lehman bankrupt, Bear and Merrill subsumed by commercial banking institutions and Goldman and Morgan Stanley officially commercial bank holding companies,

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<sup>51</sup> See Merrill Lynch & Co., Inc., Definitive Proxy Statement on Schedule Form 14A, at 49-50, Oct. 31, 2008, available at <http://www.sec.gov/Archives/edgar/data/65100/000095012308014246/g15211mldefm14a.htm>. See also Jonathan Keehner & Bradley Keoun, *Bank of America Said to Reach \$44 Billion Deal to Buy Merrill*, BLOOMBERG, Sep. 14, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601110&sid=alGoI3fTq1Us> (quoting an analyst stating that “If Lehman fails, the next bank to be attacked would be Merrill. They are attempting to forestall that attack by linking with Bank of America.”).

<sup>52</sup> See Federal Reserve Board Press Release (Sept. 21, 2008), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm>

<sup>53</sup> The SEC’s inspector general analyzed the program amid the crisis, available at <http://www.sec.gov/about/oig/audit/2008/446-a.pdf>

<sup>54</sup> See SEC Press Release, *Chairman Cox Announces End of Consolidated Supervised Entities Program* (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

the regulatory landscape was radically, although haphazardly, reformed, on the fly, by the Fed and Treasury.

2. Commercial Banking. Fed and Treasury activities during the 2008 crisis concerning commercial banking followed a more traditional model, although also on an unprecedented scale, and with the functional reform of concentrating regulatory authority in the Fed and Treasury. US commercial banking was traditionally a dual system, created at state and federal levels, although both subject to federal oversight. Three institutional categories prevailed: national banks within the Federal Reserve system; national banks under supervision of the Comptroller of Currency within Treasury; and state-chartered banks, either within the Federal Reserve system or under the jurisdiction of the Federal Deposit Insurance Corporation.

During the 2008 crisis, numerous commercial banks from within all three institutional categories faced extraordinary liquidity challenges. Some became insolvent, failed and were taken over by federal authorities or sold to larger banks in deals orchestrated by federal authorities, especially the Fed and Treasury. Principal examples are Indy Mac (put under FDIC supervision in July 2008),<sup>55</sup> Washington Mutual (arranged sale to JP Morgan Chase in September 2008)<sup>56</sup> and Wachovia (arranged sale to Wells Fargo in October 2008).<sup>57</sup> The Fed and Treasury enlisted larger banks, including Bank of America, Barclays, Citicorp, JP Morgan Chase and Wells Fargo, to provide safer homes for these and other failing institutions.

The Fed and Treasury also directly invested federal government funds in smaller and larger banks alike, not only relying upon traditional lending, but buying equity positions, and not only extending credit to commercial banks within their traditional purview, but to banks and non-banks outside their traditional jurisdiction.<sup>58</sup> All of this was done quickly, on an emergency basis, and without the usual notice and comment that accompanies government rulemaking. Indeed, during Secretary Paulson's tenure, this was often done without any pre-action notice at all and, despite a commitment to greater transparency, advance notice was not a feature of Secretary Geithner's program either.<sup>59</sup>

The Fed intervened in these events and transactions in two different ways: it provided financial support to some firms seeking liquidity and provided advice and support for others for whom merging operations was deemed superior. Section 13 of the Federal Reserve Act creates the liquidity mechanism, called the discount window, which had been used in the past to support

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<sup>55</sup> See <http://www.fdic.gov/bank/individual/failed/IndyMac.html>.

<sup>56</sup> See Christopher Palmeri, *JP Morgan to Buy Washington Mutual*, BUS. WK. (Sept. 26, 2008).

<sup>57</sup> See Andrew Frye & Alison Veshkin, *Wachovia Regulators Push Citicorp, Wells to Settle* (Oct. 7, 2008), available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aZ2gXzQV2ndI&refer=home> (noting that Wachovia initially agreed to merge with Citicorp but terminated that agreement in favor of superior deal with Wells Fargo, with federal regulators intervening to encourage a tripartite settlement of resulting dispute).

<sup>58</sup> See Jon Hilsenrath & Prabha Natarajan, *Federal Reserve to Buy Commercial Paper*, DOW JONES NEWSWIRES, (Oct. 7, 2008), available at <http://www.smartmoney.com/breaking-news/smw/?story=20081007094827>.

<sup>59</sup> See *supra* note \_\_\_\_.

troubled financial institutions, although not to the extent that it was used in 2008 to backstop credit in commercial banking more generally. The relevant part of Section 13 provides:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank, . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when . . . indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: *Provided*, That before discounting . . . the Federal Reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. . . .<sup>60</sup>

The Fed interpreted that Act to allow it to open its discount window not just to banks but other institutions in emergencies.<sup>61</sup> These on-the-fly regulatory exertions did not overrule the system of dual banking in the United States, nor clearly reallocate authority within federal agencies, but they did put the Fed in a far stronger regulatory position than it had identified with historically. As a rule of thumb in administrative law, if an agency has never done something in the past, it usually cannot do it, no matter how broad the grant of Depression era authority.<sup>62</sup> But the dynamic paradigm of ad hoc centralization during 2008 allowed little time for quarrels over such legal niceties.

3. Mortgage Finance. Treasury's secondary mortgage market forays also seemed to recalibrate the government approach to home ownership support through the process of a government takeover. By June 2008, it became clear that financial weakness plagued two of the most central participants in the US mortgage finance system,<sup>63</sup> Freddie Mac and Fannie Mae. These government-sponsored entities (GSEs), created by Act of Congress but run as private firms, were widely but incorrectly perceived as enjoying government guarantees.<sup>64</sup>

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

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<sup>60</sup> 12 U.S.C. § 343.

<sup>61</sup> The Fed also had invoked this authority when opening its discount window to investment banking institutions early in the 2008 crisis.

<sup>62</sup> See Andrew Ross Sorkin, *A Bailout Above the Law*, N.Y. TIMES (Sept. 22, 2008) available at <http://www.nytimes.com/2008/09/23/business/23sorkin.html?scp=1&sq=bailout%20administrative%20law&st=cse>.

<sup>63</sup> See Charles Duhigg *et al.*, *As Crisis Grew, A Few Options Shrank to One*, N.Y. TIMES, Sep. 8, 2008, at A1.

<sup>64</sup> The same was true for Ginnie Mae and the Federal Home Loan Banks; the same had been true for Sallie Mae until it transitioned fully into a private enterprise in the early 2000s. See PAUL WEISS, A REFERENCE GUIDE TO THE U.S. RESCUE EFFORTS (Feb. 24, 2009) at p. 49. For a prescient prescription that could have reduced the role that Fannie Mae and Freddie Mac played in the 2008 crisis, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 ILL. L. REV. 543.

The steadily worsening weaknesses at Freddie and Fannie, however, induced Treasury to intervene. It directed that they be put into a conservatorship.<sup>65</sup> The intervention “stemmed from a growing realization by Fed and Treasury officials that the two companies could not survive in their existing forms, and that any collapse would be devastating to the economy.”<sup>66</sup> The intervention depended on hastily passed supervisory authority that the Treasury, and Fannie and Freddie’s regulators, had promised Congress not to use.<sup>67</sup> The Congressional authority, given on July 30, 2008, provided the following:

The Director is authorized, . . . to make such determinations, take such actions, and perform such functions as the Director determines necessary regarding . . . decisions to appoint conservators for [Freddie Mac and Fannie Mae].<sup>68</sup>

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

Fannie and Freddie had their own regulators who had little to do with the final disposition of the institutions.<sup>69</sup> Treasury’s intervention in mortgage finance thus represents another part of the considerable financial regulation reform that occurred during the crisis of 2008.

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

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<sup>65</sup> See Federal Housing Finance Agency, *Fact Sheet: Questions and Answers on Conservatorship*, available at [http://www.ustreas.gov/press/releases/reports/fhfa\\_consrv\\_faq\\_090708hp1128.pdf](http://www.ustreas.gov/press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf)

<sup>66</sup> See Deborah Solomon, Sudeep Reddy & Susanne Craig, *Mounting Woes Left Officials with Little Room to Maneuver*, WALL ST. J., available at [http://online.wsj.com/article/SB122083060663308415.html?mod=hpp\\_us\\_pageone](http://online.wsj.com/article/SB122083060663308415.html?mod=hpp_us_pageone).

<sup>67</sup> Treasury’s promise not to use its sought authority to rescue the Frannies was based on an assumption that market knowledge of the existence of Treasury’s power would increase market confidence in the viability of the two firms, thus obviating need to exercise the authority. This hypothesis proved incorrect. Notably, the same theory of market confidence appears in parts of the Treasury blueprint. See *infra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>68</sup> Pub. L. 110-289.

<sup>69</sup> The institutions also had plenty of skeptics, particularly of its forays into secondary mortgage finance, at the Federal Reserve (Alan Greenspan was particularly critical), in the Republican Party, and at Treasury itself. Bethany McLean, *Fannie Mae’s Last Stand*, VANITY FAIR (Feb. 2009), available at [www.vanityfair.com/politics/features/2009/02/fannie-and-freddie200902](http://www.vanityfair.com/politics/features/2009/02/fannie-and-freddie200902).

underwrote a large volume of credit default swaps, essentially insurance against borrower default on debt.<sup>70</sup>

Amid the 2008 crisis of borrower defaults that spread through the financial system, AIG's exposure on these reached staggering proportions that appeared to impair other parts of the company.<sup>71</sup> AIG's New York State insurance overseer proved unable to come up with the financing to backstop the company's disastrous moves into credit default swaps and the mortgage market.<sup>72</sup> But, in the Fed's judgment, an AIG failure would threaten the financial system. As a result, the Fed opened its discount window for AIG, initially to lend it \$85 billion, with Treasury subsequently investing additional amounts in exchange for preferred stock that represented a controlling interest in the company.<sup>73</sup>

The move was particularly notable because insurance law is primarily state law. It is, in fact, quintessentially state law (and controversially so), as it is strongly insulated from federal oversight and influence.<sup>74</sup> The 2008 crisis gave federal authorities reason and opportunity to revisit this arrangement. And, again, the imposition of the central bank into insurance supervision was not only novel, such a trade of credit for equity was unprecedented in the Fed's use of Section 13 of the Federal Reserve Act.<sup>75</sup> Furthermore, numerous insurance companies sought to convert themselves into savings and loan associations precisely to become subject to the Fed's jurisdiction (in terms of both supervision and access to funds).<sup>76</sup>

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

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<sup>70</sup> Robert O'Harrow Jr. & Brady Dennis, *Downgrades and Downfall*, WASH. POST (Dec. 31, 2008), available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/30/AR2008123003431.html>.

<sup>71</sup> In a scathing depiction of these operations, however, Delaware Vice Chancellor Leo Strine refused motions to dismiss certain AIG directors in a shareholder derivative action in part on the grounds that the complaint's allegation supported characterizing AIG as a "criminal organization." *In re AIG Consol. Deriv. Litig.*, at 54 (Feb. 10, 2009), available at <http://www.delawarelitigation.com/uploads/file/int8B.PDF>

<sup>72</sup> WALL ST. J. (Feb. 5, 2009); Robert O'Harrow Jr. and Brady Dennis, *Downgrades and Downfall*, WASH. POST, December 31, 2008, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/30/AR2008123003431.html>.

<sup>73</sup> See Monica Langley, *et. al.*, *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J. (Sept. 18, 2008); Sjoström, *supra* note \_\_\_\_, at 19-30; PAUL WEISS, A REFERENCE GUIDE, *supra* note \_\_\_\_, at 27.

<sup>74</sup> McCarran-Ferguson Act, 15 U.S.C. 1011-1015; see *Barnett-Bank v. Nelson*, 517 U.S. 25 (1996); Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 NYU L. REV. 13 (1993).

<sup>75</sup> See Press Release, Federal Reserve Board of New York, Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008) available at <http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html>; see also Greg Ip, *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis: Central Bank Offers Loans To Brokers, Cuts Key Rate; Historic Steps*, WALL ST. J. (Mar. 17, 2008).

<sup>76</sup> See PAUL WEISS, A REFERENCE GUIDE, *supra* note \_\_\_\_, at 2 & 12.

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

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

Credit default swaps, and many other modern financial products, evade tidy characterization within traditional classifications of financial devices. They could be classified as insurance or securities or futures and therefore subject to state, SEC or CFTC regulation. In fact, however, many of these devices were simply put beyond regulatory reach in the Commodities Futures Modernization Act of 2000.<sup>77</sup> Whether due to this statutory exemption or general problems of classification and jurisdiction, it became clear that trillions of dollars in notional amount of these products had been created without the kind of transparency, for markets or regulatory authorities, that usually accompany financial instrument creation, trading and settlement.<sup>78</sup>

Many diagnoses of the 2008 crisis identified as a culprit the regulatory gap that allowed credit default swaps to evade supervision under insurance, securities and futures regulations. But authorities in those fields abjured oversight. Little that the Fed or Treasury did addressed these issues either, although the Fed's intervention did guarantee a portion of AIG's debt, providing at least some supervision. In addition, by mid-February 2009, a bill was circulating in Congress to provide federal regulation of credit default swaps.<sup>79</sup> This is in keeping with more traditional crisis-response practice. Still, although complex derivatives appear to have been mis-valued by financial institutions, to their peril, none of the government regulators did anything about them in 2008.

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<sup>77</sup> CFMA largely put an array of financial derivative products outside the jurisdiction of either the SEC or CFTC. The blueprint provides a review of this legislation that seems generally favorable to it. TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 46-48.

<sup>78</sup> The difficulty of classifying credit default swaps continued amid the crisis, with New York State considering treating them as insurance, the SEC expressing concern that they were not covered by its regulations and futures entrepreneurs floating proposals to develop organized futures trading markets for the instruments. *See* WALL ST. J. (Oct. 9, 2008) (reporting discussions of participants seeking to create a new organized trading platform for credit default swaps).

<sup>79</sup> Derivatives Markets Transparency and Accountability Act of 2009 (sponsored by Representative Colin Peterson, Chair, House Agriculture Committee). Other steps taken included efforts to establish an organized exchange market on which to trade credit default swaps. *See* PAUL WEISS, A REFERENCE GUIDE, *supra* note \_\_\_\_ at 4 (noting SEC approval of LCH.Clearnet Ltd. to operate temporarily as a central clearing agency for credit default swaps).

6. Corporate Governance. All this on-the-fly deal making even reached into areas of corporate governance traditionally governed by state corporation law. For example, the AIG investments were accompanied by the AIG board's contractual commitment that it would "work in good faith" with the investors "to ensure corporate governance arrangements satisfactory to the Trustees."<sup>80</sup> More generally, an eruption of public interest in executive compensation arose, leading regulators and Congress to impose limits on the compensation that investee companies were allowed to pay their senior executives.<sup>81</sup>

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

Justifications for US intervention in many cases, especially as to Bear and AIG, included threats to the global financial system, also an argument that supported the federal orchestration of the rescue of LTCM in 1997. The ad hoc response to the crisis even had an official global component, as the principals from the G20 group of countries met to discuss the crisis in November, 2008.<sup>82</sup> They released a statement of relatively low specificity, but one that nonetheless underscored the global character of the crisis:

We pledge to strengthen our regulatory regimes, prudential oversight, and risk management, and ensure that all financial markets, products and participants are regulated or subject to oversight, as appropriate to their circumstances. We will exercise strong oversight over credit rating agencies, consistent with the agreed and strengthened international code of conduct. We will also make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanded trade in financial products and services. We commit to transparent assessments of our national regulatory systems.<sup>83</sup>

Given this statement's relatively vague quality, perhaps it is notable for the signal it sent about the global nature of the crisis, rather than for specific regulatory reforms agreed to at the

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<sup>80</sup> <http://www.sec.gov/Archives/edgar/data/5272/000095012309004659/y75292exv10w1.htm>.

<sup>81</sup> See PAUL WEISS, A REFERENCE GUIDE, *supra* note \_\_\_ at 19 ff.

<sup>82</sup> Indeed, one way to think about international regulatory harmonization is as a three-stage process. First, domestic regulators agree to share information with their foreign counterparts. This doesn't harmonize regulation, but solves some globalization problems (at least from the regulator's perspective). Second, the mechanism used for international information exchanges becomes the forum to generate principles of regulation commanding assent. These tend to be gauzy, short, and vague, and it isn't clear that they amount to much. Third, some of these institutions actually develop their own set of hard rules, as the Basle Committee on Banking Supervision did with its capital adequacy accord. See David Zaring, *Three Challenges for Regulatory Networks*, \_\_ INT'L LAWY. \_\_ (forthcoming 2009).

<sup>83</sup> <http://www.nytimes.com/2008/11/16/washington/summit-text.html?pagewanted=3>.

international level.<sup>84</sup> Moreover, the ad hoc response to the 2008 crisis took on its most substantive global tint with various Fed efforts to coordinate monetary policy with its counterpart banks abroad. And as future financial crisis will also draw on global trends, regulatory reform will likely be judged in part based on its global efficacy.<sup>85</sup>

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Back on the domestic stage, in summary, the Fed and Treasury seized upon sweeping powers in response to the 2008 crisis. A couple of these were explicitly created by Congress during the crisis, including legislation authorizing TARP and granting Treasury authority to seize GSE assets. But, by and large, the agencies exercised authority in reliance on other, older statutes, in surprising novel ways, in exercises that amounted to the achievement of financial regulation reform.

Indeed, in addition to the powers referenced previously, the Fed and Treasury also extended their authority when expanding support into commercial paper market markets, money markets, asset-backed securities markets and even to bolster the financial stability of US automobile manufacturers.<sup>86</sup> The Fed even let the financing arm of General Motors, GMAC, become a bank holding company, just as Goldman Sachs and Morgan Stanley had done, subject to Fed supervision and gaining access to the Fed's liquidity facilities.

The extent of all of this transactional activity, ranging across the financial spectrum, was certainly novel and, as an administrative law matter, quite creative. There is some precedent, at least internationally, and to some degree in the LTCM case, for the Fed and Treasury's active engagement in coordinating transactions between failed and sustainable institutions.<sup>87</sup> But the 2008 crisis—and the merger and investment scheme used to confront it—injects the Fed into industries it neither licensed nor in any other way regulated.

The 2008 crisis, in short, led to a “new model Fed,” one turned into something of a financial roving commission in search of safety and soundness, no matter what the industry. It

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<sup>84</sup> To be fair, the action plan that follows the agreement on principles in some cases is a bit more substantive; the IMF gets a to-do list, and perhaps this looks like agreement on credit default swap regulation: “Supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps (CDS) in some countries, should: speed efforts to reduce the systemic risks of CDS and over-the-counter (OTC) derivatives transactions; insist that market participants support exchange traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.” *Id.*

<sup>85</sup> Our evaluation in Part II and especially Part III includes considerable attention to globalization.

<sup>86</sup> See Paul Weiss, A Reference Guide, *supra* note \_\_\_ at 44, 46,50; Robert Schmidt & Scott Lanman, *Treasury, Fed Said to Unveil Plan to Bolster Consumer Financing*, Bloomberg News (Nov. 25, 2008 ) available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aIXCu2ptpeCQ>. The FDIC also created a novel liquidity guarantee program. See Paul Weiss, A Reference Guide, *supra* note \_\_\_ at 38.

<sup>87</sup> In other countries, cajoling one bank to buy another one would be clearly within the purview of a central bank. David Zaring, *How Does the Fed Have the Legal Authority to Bail out Bear?*, <http://www.theconglomerate.org/2008/03/how-does-the-fe.html>.

also placed the Treasury Department in an energetic and central role in crisis response. The result is regulatory reform producing a vastly more centralized financial regulatory system than the United States has had, despite no formal dismantling of the infrastructure of the traditional fragmented model.

### C. *Anticipatory Preemptive Reform*

We think that history helps to explain the old model and the way it has been changed, *sub silentio*, during the 2008 crisis. Accordingly, we conclude our overview of the recent history of our system of financial regulation with a historical anomaly in the timing of one of the leading proposals for systemic reform. In past financial crises, the tendency was for regulatory and policy analysts to study events after-the-fact, diagnose them and prescribe reform. The studies ranged in scope and formality, from detailed exhumations to rough guesses, depending on exigencies. But they were made in light of past events.

However, unlike in prior crises, Treasury had produced its blueprint for reform in March 2008, before it became clear to the public that a crisis was at hand, and certainly before its severity was broadly understood. Indeed, much of the blueprint was prepared, including predecessor study papers,<sup>88</sup> amid comparatively calm market conditions, and released at the beginning of a crisis, rather than at the end of it. Certainly, numerous post-crisis diagnoses and proposals have been made,<sup>89</sup> in keeping with traditional US responses to crises, yet the blueprint's early arrival remains a strikingly unusual feature of the 2008 crisis.

The blueprint preceded the 2008 crisis, is not exactly proportional or even always related to it, and is more organized than is typical of responsive regulatory reform. As we have noted, scholars have found a common pattern of financial crises followed by financial reform and that pattern partly generated the fragmented model that prevailed up until the crisis of 2008.<sup>90</sup> But with the blueprint, Secretary Paulson appeared to want to act ahead of the crisis, to prescribe radical change but relatively light regulation. To that extent, the blueprint can be seen as seeking to preempt what its authors anticipated, rightly, would be calls for heavier regulation.<sup>91</sup>

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

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<sup>88</sup> *E.g.*, COMM. ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET (Dec. 5, 2006 & Dec. 4, 2007), available at <http://www.capmksreg.org/research.html>.

<sup>89</sup> *See supra* notes 2-5.

<sup>90</sup> *See* Larry Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003); STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION* (2003).

<sup>91</sup> *See* Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. TIMES (Oct. 14, 2008).

diagnosed weaknesses. The blueprint, in contrast, imagined wholesale renovation of regulatory structures along lines that, when written, would have seemed disproportionate to any manifest urgency.

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

Yet on other subjects, the blueprint may be less than proportional. For example, some obvious culprits in the 2008 crisis are not expressly addressed, including the proliferation of unregulated credit default swaps. Should they be regulated? Many called for it during the burgeoning crisis, and Congress proposed applicable legislation. But the blueprint has nothing to say about it.<sup>92</sup> Other blueprint proposals address matters that had no diagnostic role in the crisis, such as merging the SEC and CFTC.

Implicit in these observations about the blueprint's timing and content is a story about when regulatory reform is possible. As Professors Ribstein and Banner have separately shown, comprehensive reform is not something for prosperous financial times. It usually takes a crisis to generate the will for government innovation.<sup>93</sup> Crises contribute heavily to a felt need for reform, which often means that crises are opportunities to enact a mixture of reform proposals that had accumulated for years, resulting in a kitchen sink model of reform (such as that appearing in parts of Sarbanes-Oxley).

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

## II. ENVISIONED APPROACHES AND PLANNED STRUCTURES

The 2008 crisis certainly looks like a testimonial for the proposition that the fragmented, industry-by-industry, regulatory model is outdated and leaves regulatory gaps that must be closed. Moreover, the haphazard character and uncertain success of the on-the-fly response to that crisis makes its own case for more planned out regulatory structures. The Treasury blueprint, along with a variety of other approaches, embraces these viewpoints and radically re-

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<sup>92</sup> The blueprint does seem to endorse aspects of the Commodity Futures Modernization Act that limited federal regulation of certain financial derivative instruments, *supra* note \_\_\_\_\_. See BLUEPRINT, *supra* note \_\_\_\_, at 46-48.

<sup>93</sup> BANNER, *supra* note \_\_\_\_; Ribstein, *supra* note \_\_\_\_\_.

imagines unification across all financial sectors, to eliminate industry specificity and potentially to close gaps.<sup>94</sup>

Unification the blueprint way means, ultimately, just a few senior regulators overseeing all financial markets and institutions—and those regulators would be politically accountable. Similar calls for concentration appear in proposals made by the Group of Thirty, though the senior regulators would have a rather different relationship with the political branches in those cases. The centralization prescribed by both has been echoed by a number of the testimonials of high-ranking political officials about regulatory reform, including the Treasury Secretary.<sup>95</sup> Because the blueprint and the Group of Thirty solutions represent the considered views of the Republican and Democratic establishments on financial regulation, the most important aspects of both warrant review, which this Part provides.

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

The blueprint's motivations were not the 2008 crisis that widened after its release—the blueprint was released, basically, before everything that happened in the crisis except for the collapse of Bear Stearns. It is accordingly difficult to read the document as reflecting complete anticipation of them. On the contrary, the blueprint says: “while functioning well, the U.S. regulatory system is not optimal for promoting a competitive financial services sector leading the world and supporting continued economic innovation at home and abroad.”<sup>96</sup>

The blueprint's stated justifications for its proposals are the increasingly global capital markets, financial innovations such as through securitizations, and convergence among different kinds of financial institutions into large multi-line providers.<sup>97</sup> In the widening crisis that followed, all these forces played a role, as Part I explored, but not exactly ones the blueprint suggests. Globalization showed interlocking systemic dependencies, not threats to US competitiveness; securitization emerged as at least a partial cause of the problems, not a positive development that regulation should accommodate; and convergence of financial institutions was hastened during government orchestrated bailouts and mergers, along with substantial regulatory concentration in the Fed and Treasury.

On the other hand, the blueprint rightly noted that the existing environment prevented any single governmental authority to command all necessary information concerning systemic financial risk. It attributed this limitation to regulatory fragmentation, separating functions according to industry (banking, insurance, securities and futures). It also presciently noted that market and/or regulatory failure in the financial sector could adversely affect the real economy.<sup>98</sup>

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<sup>94</sup> For examples of other reform proposals that endorse the blueprint, see *supra* notes \_\_\_\_-\_\_\_\_ and accompanying text.

<sup>95</sup> See *supra* note \_\_\_\_ (citing <http://www.financialstability.gov/latest/tg71.html>).

<sup>96</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 1.

<sup>97</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 3-4.

<sup>98</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 4.

As discussed below, the blueprint imagines a radical, formal overhaul of US financial regulation, consisting of substantial federalization and unification, along with considerable delegation of regulatory authority to self-regulatory organizations in various financial services industries. An important motivation is to promote US capital market competitiveness globally.

1. Federalization. The blueprint's most significant suggestion for general regulatory authority over financial matters is formal expansion of Fed powers—pretty much those that the Fed exercised to address the 2008 crisis. While the Fed used an ad hoc approach during the crisis, the blueprint welcomes the centralization that the new model Fed represents. For example, during the crisis and for the first time since the Great Depression, in the interest of stabilizing markets, the Fed made loans to non-depository institutions through its discount window, the lending facility of last resort in the US. Endorsing exactly these steps, the blueprint says this properly reflects the “fundamentally different nature of the [Fed’s] market stability function in today’s financial markets compared to those of the past.”<sup>99</sup>

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

As noted, a presidential task force made similar recommendations in its report evaluating the stock market break of October 1987.<sup>100</sup> The blueprint's difference turns on the way this centralization is to be done. The blueprint specifies the availability of the discount window—the loan-making power that the Fed relied upon to act in addressing failures at Bear Stearns and AIG—more clearly. The blueprint provides for broad powers to open the discount window to any who need it, but suggests that the power to lend ought to be used both judiciously, and more generally than it has been used in the most recent emergency. The idea is that a systemic regulator ought to act more systemically.<sup>101</sup>

The blueprint would also vest considerable new and expansive authority in the President's Working Group (PWG), the group created after the 1987 market break we discussed earlier.<sup>102</sup> The group is, if it works, an indirect form of centralization of financial regulation, and

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<sup>99</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 7, 83.

<sup>100</sup> See BRADY REPORT, *supra* note \_\_\_\_, at \_\_\_\_; *supra* \_\_\_\_.

<sup>101</sup> Early in the widening 2008 crisis, Secretary Paulson called for aid to industry sectors, rather than struggling individual institutions, and for clearer up front rules on availability. Generally, the blueprint approaches bailouts with skepticism, but the skepticism is related to individual businesses. TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 156.

<sup>102</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_. President Reagan created the PWG in Executive Order 12631 (Mar. 18, 1988) 3 C.F.R. 559 (1989), Working Group on Financial Markets.

one without Congressional approval or oversight. It brings the diverse federal regulatory agencies into a room heavily peopled with White House officials. We view the blueprint's intermediate recommendation of expanded PWG authority as an interim effort to begin its prescribed process of centralization in the executive in an administratively easy way.

The official PWG members are: (1) the Treasury Secretary (as Chair); (2) the Fed Chair; (3) the SEC Chair; (4) the CFTC Chair; and their respective staffs. The executive order creating the group directed it to analyze the “major issues raised” by the 1987 market break, to determine “the actions, including governmental actions under existing laws and regulations (such as policy coordination and contingency planning),” that could forestall future such crises, provided that the group would pursue “private sector solutions wherever possible.”<sup>103</sup>

Since receiving that charge, the PWG grew in size and scope, although it has never coordinated financial regulation in the way the blueprint would have it. Its growth in size bespeaks both its importance as a matter of regulatory coordination and in setting financial policy. Thus, since the 1990s, in addition to the permanent members, who are conventionally thought to be the premier financial regulators, policymakers such as the head of the President's National Economic Council and the Chair of the President's Council of Economic Advisers, began to attend the PWG's meetings. Similarly, other banking regulators joined the Fed at those meetings: the Comptroller of the Currency and the President of the New York Federal Reserve Bank “frequently attend” Working Group sessions.<sup>104</sup>

The group also evolved from undertaking ex post diagnoses of previous failures to a more proactive role in coordinating future regulation. The group has considered how financial regulators can together promote investor confidence, track credit system issues (such as pursuing on-line clearing and same-day trade comparison for all equity and derivative products), develop effective market controls such as trading halts in emergencies and how to deal with large and rapid unwinding of positions.<sup>105</sup>

The PWG has also considered how to more formally coordinate work—a chief goal tasked to the PWG under the blueprint. This is not clearly a question of presidential aggrandizement. Congress suggested in the early 1990s that the group could be used for “coordinating the activities of the agencies amidst increasingly integrated global financial markets.”<sup>106</sup> The group has even been the source of some regulations.<sup>107</sup> During the 2008 crisis,

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<sup>103</sup> *Id.*

<sup>104</sup> Brett D. Fromson, *Plunge Protection Team*, WASH. POST (Feb. 23 1997).

<sup>105</sup> GOV'T ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY COORDINATION: THE ROLE AND FUNCTIONING OF THE PRESIDENT'S WORKING GROUP (2000) 18-19.

<sup>106</sup> *Id.* at 5.

<sup>107</sup> For example, in 1997, it suggested that the New York Stock Exchange change its circuit breaker rules from a point decline in the Dow Jones Industrial Average to a percentage decline in that index. Those changes were made effective in 1998, when the group also proposed that Congress amend federal bankruptcy laws for financial institutions, and analyzed the LTCM hedge fund debacle in a report that discussed ways to limit excessive leverage

according to Paul Volcker’s Group of Thirty Report, the WPG “provided the backdrop for U.S. financial supervisors to respond quickly and decisively” by fostering “ongoing and fluid communication among regulators.”<sup>108</sup>

The blueprint proposes expanding the PWG’s powers by turning it into the short-run locus of a consolidated financial regulatory approach through four steps:<sup>109</sup> (1) broadening its focus “to include the entire financial sector, rather than solely financial markets,” (2) promoting consumer and investor protection, (3) expanding membership to formally include heads of the Office Comptroller of the Currency, FDIC and Office of Thrift Supervision and (4) authorizing the group to issue reports to the “President and others, as appropriate, through its role as the coordinator of financial regulatory policy.”<sup>110</sup>

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

Apart from this short-term expansion of Fed authority and PWG power, the blueprint introduces numerous new federal regulatory authorities. The following highlights several of the more consequential new authorities that the blueprint envisions creating. First, the blueprint proposes a Mortgage Origination Commission. This would have a President-appointed Director of a 7-person board composed of designated agency heads.<sup>111</sup> Federal legislation would create a uniform minimum licensing scheme for state mortgage market participants and the Mortgage Origination Commission would publish evaluative data on each state’s system implementing that legislation. The blueprint says that this will create incentives among states to provide strong oversight and set floors for mortgage originators.<sup>112</sup>

Under the blueprint, insurance would no longer be exclusively a state matter but a federal matter because state regulation “makes the process of developing national products cumbersome and more costly, directly impacting the competitiveness of U.S. insurers.”<sup>113</sup> Accordingly, the

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and cultivate better risk management policies. President’s Working Group, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>.

<sup>108</sup> VOLCKER I, *supra* note \_\_\_\_, at 49.

<sup>109</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 5.

<sup>110</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 6.

<sup>111</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 6 & 80. These are: the Federal Reserve, Office Comptroller of the Currency, FDIC, Office of Thrift Supervision, Credit Union Administration and Conference of State Bank Supervisors.

<sup>112</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 7 & 80.

<sup>113</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 9.

blueprint proposes to establish an optional federal charter (OFC) for insurers within the existing insurance regulation structure.<sup>114</sup>

In addition, the blueprint proposes an Office of National Insurance within Treasury to regulate insurers using the new, optional federal charter for insurance.<sup>115</sup> It is not obvious how Congressional oversight would work for this arrangement, although the blueprint notes that there was pending debate in Congress on the subject.<sup>116</sup> Still, it also recommends creating an Office of Insurance Oversight within the Treasury Department.<sup>117</sup> It would have authority to address international regulatory issues, including “authority to recognize international regulatory bodies for specific insurance purposes.”<sup>118</sup> Similarly, the blueprint proposes a Federal Insurance Guarantee Fund.<sup>119</sup> This would be run, in turn, by a Federal Insurance Guarantee Corporation, which would be a reconstituted version of the FDIC, handling not only deposit insurance but also insuring insurance products.<sup>120</sup>

The blueprint also recommends that the “The direct federal supervision of state-chartered banks . . . be rationalized,” putting all such examination duties in the Fed or the FDIC.<sup>121</sup> It would abolish the existing separate thrift charter in favor of a single national bank charter.<sup>122</sup> This would entail closing the Office of Thrift Supervision and transferring its power to the Office of the Comptroller of the Currency.<sup>123</sup> Finally, under the blueprint, payment and settlement systems that are systematically important would be federally chartered and subject to Fed oversight, with associated federal preemption.<sup>124</sup>

In some ways, this grab bag of proposals offers some of the most striking the federal government has ever made. They are a particular rebuke to proponents of state regulation of business, and mark both a centralization of power and an expansion of federal regulation. States would lose a lot of their insurance regulatory authority. The state bank counterparts to federal

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<sup>114</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 10.

<sup>115</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 10.

<sup>116</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 11.

<sup>117</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 11.

<sup>118</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 11.

<sup>119</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 19.

<sup>120</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 21.

<sup>121</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 8-9.

<sup>122</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 8.

<sup>123</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 8.

<sup>124</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 9.

banks would also be eliminated—although it is by no means clear that state banks played any precipitating roles in the 2008 crisis. And the mortgage and insurance regulatory powers that the federal government would take on are entirely new.

Nonetheless, this rationalization and centralization of regulatory authority would not happen without a role for states. The availability of state regulations and state traditions are hard to break, as the way the blueprint’s proposed mortgage origination commission would be set up demonstrates. That commission, after all, would cajole states and permit state regulation over and above federal minimum standards. It is a curious exception to the general federalization of power represented by the blueprint, but perhaps the oversight of home mortgages is something that regulators outside of Fannie and Freddie simply cannot bring themselves to get involved with.

Having proposed to expand executive branch power, and grow and consolidate federal power, the blueprint also proposes extensive delegation of much of this power to self-regulatory organizations (called SROs) in the various financial sectors being supervised. It draws inspiration from extensive SRO use in futures regulation by the CFTC, urges expansion of SRO delegation by the SEC, and encourages other sectors either to create or expand such institutions too. As one example, the blueprint proposes that Congress and the SEC converge broker-dealers with investment advisers to harmonize regulation of participants who are “offering similar services to retail investors.”<sup>125</sup> It then proposes creating an SRO for investment advisers, pretty much along lines as presently exists for broker-dealers.<sup>126</sup>

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

The blueprint sets three regulatory objectives and envisions three senior regulators to achieve them: overall market stability by the Fed;<sup>127</sup> financial supervision of firms with

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<sup>125</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 14.

<sup>126</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 13.

<sup>127</sup> The blueprint envisions the Fed continuing as at present except with broader jurisdiction. The Fed would continue as the central bank, setting monetary policy and serving as lender of last resort, among other traditional macroeconomic functions. Its supervision would extend to all financial institutions, not just depository institutions. This expansion is said to reflect changes in financial markets, in which non-depository institutions play at least as vital a role as depository institutions once did. In this vision, the blueprint emphasizes repeatedly that authority would be “broad, important and difficult to undertake.” TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 148 & 152. The Fed’s intervention powers would be “limited to instances threatening overall financial stability.” *Id.* at 151. The blueprint envisions two aspects of the Fed’s traditional lender of last resort function. One would be regular discount window operations, along traditional lines. A new one would be called a “market stability discount window.” This

government guarantees by a prudential financial regulator using prevailing regulatory philosophies;<sup>128</sup> and protective regulation for consumers of all financial firms by a new business conduct regulator.<sup>129</sup> These are supplemented by two junior federal agencies charged with (a) administering the system of explicit government guarantees and (b) supervising public securities markets, presumably including futures markets, to encompass corporate disclosure, governance, accounting and auditing.<sup>130</sup>

The blueprint arrives at its proposed optimal structure by eliminating alternatives:<sup>131</sup> (1) *institutionally-based functional regulation* pretty much describes the pre-crisis fragmentary system, the chief weakness of which is that no single regulator has all information or coordination power; (2) *pure functional regulation* is based on activities, the chief weakness of which is trouble delineating activities that often overlap and assigning multiple regulators to individual firms; and (3) a *single consolidated regulator* for financial and consumer protection regulation, the chief drawback of which is it can limit synergies and reduce market innovation. The blueprint's proposed optimal structure overcomes these weaknesses and its chief drawback, assuring communications between regulators, can be met, the theory goes.

The blueprint acknowledges that numerous issues are presented that it does not address, saying it only begins to identify main ones.<sup>132</sup> Despite this reticence, the blueprint is clear in offering a summary of guidelines that would govern regulation throughout these agencies. First, agencies would coordinate closely, perhaps with a coordinating body led by the Treasury

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would be available on more flexible terms, as to types of loans and borrowers. The idea is that the flexibility could be more effective to address short-term liquidity needs than the traditional discount window alone.

<sup>128</sup> Prudential financial regulation refers to things like capital adequacy, activity limits and related supervision. It is akin to regulation now applicable to depository institutions. TREASURY BLUEPRINT, at 157. This regulation is necessary to address moral hazard that arises from explicit government guarantees. The blueprint imagines a new federal charter for all financial institutions enjoying explicit government guarantees. Contending that the traditional US model of federal plus state banking regulation and experimentation is no longer useful, *id.* at 160, it recommends a new federal charter for all depository institutions to replace the fragmentary chartering system. It draws the same conclusion for insurers, suggesting all become federally chartered. All related guarantees, including for insurers, would be administered by a reconstituted Federal Deposit Insurance Corporation (FDIC). The prudential financial regulator would oversee all such chartered firms.

<sup>129</sup> The business conduct regulator would have authority over all types of financial firms, not only those overseen by the prudential financial regulator, but also broker-dealers, hedge funds, private equity funds, venture capital funds, mutual funds, securities and futures firms and others. *Id.* at 19. All would be subject to identical national standards overseen by this single agency. This regulator also would eventually oversee all financial markets, including securities and futures markets. Its primary function would address interactions between financial institutions and consumers and investors. *Id.* at 170. Regulatory focus would be on information, disclosures and business practice standards. It would include prohibitions against unfairness, deception and discrimination. It would also include regulation of financial capacity and expertise. It would not include power to prohibit products, limit entry, control prices or impose rigid licensing. *Id.*

<sup>130</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 137-138.

<sup>131</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 140-142.

<sup>132</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 146.

Secretary. Second, funding would be generated by fees imposed on regulated firms, not from general tax revenue. Third, all regulation would be governed by stated general principles: “guidelines for regulatory process (e.g., public comment), analysis (e.g., cost-benefit analysis and alternative analysis), and review (e.g., monitoring compliance with the principles and reports to Congress).”<sup>133</sup>

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

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

The blueprint’s optimal structure envisions three senior regulators of the financial system, although it is essentially a two-peaked model, in which the Fed and a prudential regulator probably rooted in Treasury are jointly responsible for systemic stability and a third senior agency is responsible for investor and consumer protection (this agency might also be situated within the Treasury Department). The effort to remodel financial regulation into a “twin peaks” structure has some currency among financial policy experts, and is the remodeling achieved by Australia in the past decade. Variations on it abound, including an even more concentrated model that features essentially one regulatory authority, as the United Kingdom’s Financial Services Authority.

But the blueprint’s vision is not the only way to rationalize the system. A similar sort of regulatory analysis might be called the Volcker approach. Paul Volcker, a former Fed chair, and the inaugural Chair of the Economic Recovery Advisory Board in the Obama Administration, led a 2008 task force of public and private notables to opine on “The Structure of Financial Supervision”<sup>134</sup> Shortly thereafter, in early 2009, the group issued its more prescriptive report called “Financial Reform: A Framework for Financial Stability.”<sup>135</sup>

Although not nearly as detailed as Paulson’s blueprint, the Volcker proposals state relatively clear principles and offer many specific proposals. The proposals show considerable affinity with the Treasury blueprint, along with some subtle yet important differences in philosophy, purpose and implementation methods. It is a potential arch-rival to the Treasury blueprint for these reasons. Indeed, the Volcker vision might be thought of as the insider alternative to the Paulson (himself an insider) approach. The Volcker proposals also assume that status both because of Volcker’s role in the Obama Administration and because the drafting

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<sup>133</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 146.

<sup>134</sup> VOLCKER I, *supra* note \_\_\_\_.

<sup>135</sup> VOLCKER II, *supra* note \_\_\_\_. Both reports were prepared under the auspices of the so-called “Group of Thirty,” an exclusive group of former and current regulators, including Andrew Crockett, formerly of the Basel Committee, Jacob Frenkel, a former board member of AIG, and former Fed Board members Roger Ferguson and E. Gerald Corrigan. *See id.* at 10.

committee included Secretary Geithner, also an insider, having worked closely with Secretary Paulson as the President of the New York Federal Reserve Bank during the 2008 crisis.

It appears that in some ways insiders think alike, as both Volcker and Paulson in their reports express worry about globalization (albeit Volcker a bit more vigorously), exhibit an inclination to centralize and rationalize regulatory authority, and display a substantial amount of regard for central banks. This overlap between the Volcker and Paulson approaches is either an indication of a reform consensus or a testament to the process by which Washington insiders quickly learn to see things in similar ways. As we will explain, however, despite some important points of consonance, including promoting centralization, the two differ in vital, though perhaps subtle, ways.<sup>136</sup>

The 2008 Volcker report's chief insight is to present a four-box menu of approaches to financial supervision that closely resembles the similar formulation appearing in Treasury's blueprint.<sup>137</sup> In the Volcker group's view, the approaches include: *institutional* (where banks are supervised by one regulator and broker-dealers by another), *functional* (where the regulator is determined by the type of business being transacted—meaning that a bank like Bank of America would be responsible to banking regulators and, regarding its newly acquired broker dealer arm Merrill Lynch, to securities regulators); *consolidated* (where one regulator has responsibility over all financial institutions), and *twin-peaks* (where one regulator focuses on safety-and-soundness, and the other on conduct of business).<sup>138</sup> This menu list is a descriptive, rather than prescriptive, accomplishment.

The 2008 Volcker report is like the Paulson blueprint in that it urges a rationalization of the US regulatory system, which it characterizes as “somewhat dated and complex”<sup>139</sup> and the “exception” to the ordinary models for financial regulation prevalent elsewhere in the world.<sup>140</sup> It essentially embraces consolidation on either a single-peaked model or twin-peaked model, as both “more rationally reflect the changes that have taken place in the financial services business over the past several years, and thus are widely viewed as more efficient and cost-effective by both regulators and regulated entities.”<sup>141</sup>

The 2008 Volcker report all but fetishizes this sort of concentration, including coordination “with the central bank,” securing the central bank's “involvement in crisis management.”<sup>142</sup> It particularly urges coordination by regulators with their international

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<sup>136</sup> See *infra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>137</sup> We, of course, have our own views of the range of possibilities.

<sup>138</sup> *Id.* at 13.

<sup>139</sup> VOLCKER I, *supra* note \_\_\_\_, at 49.

<sup>140</sup> *Id.* at 10.

<sup>141</sup> *Id.* at 50.

<sup>142</sup> *Id.* at 49-50.

counterparts over “systemically important global financial institutions.”<sup>143</sup> It argues that financial reform in the US is not impossible, observing that “a majority” of jurisdictions “are in the process of further restructuring or are actively debating the need for significant changes to modernize their systems” in the past 15 years.<sup>144</sup> The authors encourage the “trend toward the adoption of integrated regulators and towards regulation by objective.”<sup>145</sup>

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

As for institutions themselves, the theme of the Volcker reports is promoting an important public-sector role in safeguarding financial stability, given the “inherent volatility of free financial markets, and the danger that volatility may occasionally reach crisis proportions threatening economic stability.”<sup>146</sup> Accordingly, the future of financial regulation, in Volcker’s view, is in extending supervision over more of the financial system to governmental authorities. The 2009 report accordingly recommends extending federal supervision over non-bank financial institutions like insurance companies and investment banks (to the extent any may exist).

The federal agency to be created under the 2009 Volcker proposal would also oversee money market mutual funds, reasoning that there are “dangers of institutions with no capital, no supervision, and no safety net operating as large pools of maturity transformation and liquidity risk.”<sup>147</sup> The Volcker report would extend financial supervision over hedge funds, albeit somewhat modestly. The report cites “need for greater transparency, a need for formal authority to register and track . . . funds, in terms of size, use of leverage, risk styles, and other important variables.”<sup>148</sup> Certainly, this would require hedge funds to increase their disclosures about their positions to financial regulators.<sup>149</sup> Nonetheless, the report also recommends subjecting hedge

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<sup>143</sup> *Id.* at 49-50.

<sup>144</sup> *Id.* at 49.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 17.

<sup>147</sup> *Id.* at 29.

<sup>148</sup> *Id.* at 30.

<sup>149</sup> *Id.*

funds to the possible discipline of formal regulatory authority to “reduce counterparty risk” (and so holds open the possibility of more elaborate command-and-control regulation).

The only potentially deregulatory of the Volcker proposals involves getting the government out of the secondary mortgage market. Institutions like Fannie and Freddie, which are both “profit-seeking private companies and agents of government policy, ha[ve] been shown to be unworkable over time and particularly in the midst of crises.”<sup>150</sup> Despite that slight ratcheting down of government’s role in finance, enterprises engaged in mortgage lending activities would be subject to oversight of the new federal government regulatory apparatus.

As for new financial products, the Volcker 2009 report concludes that it is “imperative that securitized and other structured product and derivative markets be held to regulatory disclosure and transparency standards at least comparable to those that have historically been applied to the public securities markets.”<sup>151</sup> Concerning credit default swaps and other over-the-counter derivatives, the report urges the establishment of a “central counterparty clearing arrangement for the credit derivatives market and coordinated efforts to greatly reduce the growth and size of outstanding contracts through bilateral compression agreements.”<sup>152</sup> The goal is to reduce the size of these new markets, and to impose a “consistent regulatory framework on an international scale over the novel financial products,” in which “national regulators . . . share information and enter into appropriate cooperative arrangements with authorities of other countries responsible for overseeing activities.”<sup>153</sup>

As for the form of regulation, the Volcker report embraces an important role for the central bank in an extensively centralized regulatory edifice, which should “simplify and consolidate overly complex structures.”<sup>154</sup> As for regulatory content, the report evinces a preference for principles over rules.<sup>155</sup>

Volcker’s 2009 report also urges particular substantive changes, on subjects not only of concern to traditional central banks and banking supervisors. Certainly, the proposals call for enhancing capital requirements and ratios, and liquidity risk requirements, and assuring that a mechanism to resolve failing institutions exists. The report also says that credit rating agencies should be compensated for risk analyses on a different payment model than they have used in the past.<sup>156</sup> They urge improving fair value accounting and promoting the flexibility of accounting

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<sup>150</sup> *Id.* at 30.

<sup>151</sup> *Id.* at 49.

<sup>152</sup> VOLCKER II, *supra* note \_\_\_\_, at 52-53.

<sup>153</sup> *Id.* at 53.

<sup>154</sup> *Id.* at 35.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 51; see Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. \_\_\_\_ (2009).

standards generally.<sup>157</sup> This includes a specific endorsement of mark to market accounting for “trading activities and most elements of market risk.”<sup>158</sup> The Volcker 2009 report also ventures beyond any manifest elements of the 2008 crisis by recommending strengthening corporate board governance to improve risk management, executive compensation oversight, and auditing functions.<sup>159</sup>

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

Above all, as with Volcker’s 2008 report, its 2009 recommendations strongly emphasize the need for international approaches—and, in particular, international coordination. The Volcker reports embrace international cooperation as a solution to prudent oversight amid increasingly global financial markets. For example, the reports suggest that “Prudential regulators in central banks should collaborate with international agencies in an effort to define leverage,” and ultimately limit it. It admits concerns about capital adequacy, naturally enough, given that the largest institutions during the crisis appeared to be—much to their surprise—substantially undercapitalized.

These views provide an interesting contrast between the Volcker report and Paulson’s Treasury blueprint. While the Paulson blueprint pushed globalization as a reason for regulatory reform, the Volcker report characterizes it as part of the solution. Volcker’s 2008 report pins high hopes for “colleges of supervisors”—that is, regulatory authorities from different jurisdictions who oversee the same multinational enterprise, and do so in a coordinated way.<sup>160</sup> Indeed, “international groupings [such as the informal networks represented by the Basle Committee and IOSCO] . . . need to be supplemented by colleges that facilitate communication between home and host supervisors in normal times so as to prepare the lines of communication for times of systemic crises.”<sup>161</sup>

This focus on international coordination and control differs from the blueprint’s engagement with globalization, which seems more intended to promote US competitiveness in global capital markets than a way to impose order on them. Indeed, while both the Paulson and Volcker visions imagine substantial federalization and consolidation of regulatory power over wide ranging financial institutions, markets and products, they appear to do so for different

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<sup>157</sup> VOLCKER II, *supra* note \_\_\_\_, at 36.

<sup>158</sup> *Id.* at 45.

<sup>159</sup> VOLCKER II, *supra* note \_\_\_\_, at \_\_\_\_.

<sup>160</sup> VOLCKER I, *supra* note \_\_\_\_, at 48.

<sup>161</sup> *Id.*

reasons. These differences, and further contrasts with how both differ from the pre-existing structure and the developed-on-the-fly system forged by the 2008 crisis, entice the following framework for choosing among these three or four approaches to financial regulation.

### III. CHOOSING AMONG APPROACHES

Our three or four models of financial regulation take different views on centralized versus decentralized government, the place of the executive branch in administrative law, and even the place of states and self-regulators in financial law. In this Part, we evaluate the implications of each of these approaches on these areas. In the end, while we understand the impetus for reform, we register a note of caution. Centralization and rationalization along the Paulson and Volcker models seems sensible, and certainly has been practiced, to some degree, in 2008 and 2009. But we think the unlabeled older system had its advantages that should not be overlooked—redundancy has its uses, and so does regulatory competition.

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

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

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

These paired proposals, then, although in very different ways, both would radically alter the indisputably creaky current approach. The current system relies on an incongruous blend of state supervision in some cases, while in others it depends on federal supervision divided by specific industry, and sometimes by various issue areas within an industry—say, local banks regulated by states, national banks regulated by the Fed and Treasury, and all federally insured banks, whether state or federally chartered, subject to the discipline imposed by the Federal Deposit Insurance Corporation.<sup>162</sup>

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<sup>162</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

The Volcker I report found the old American approach to be so idiosyncratic as to mark the United States as the “exception” to the world’s financial regulatory approaches.<sup>163</sup> As we explained in Part I, there is no question that the pre-crisis system evolved through path dependency and a reactive, crisis-driven, rather than systematic, approach to financial regulation.<sup>164</sup> But that does not mean that it is without its attractions. The system kept regulators on their toes through regulatory competition, and yet permitted regulators to act substantively, through litigation, formal rules-based regulation, and informal principles oversight. Small patchwork fixes to this system, such as assuring some regulatory authority over credit default swaps, may be both politically feasible and appropriately cautious.<sup>165</sup>

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

First, procedurally, the blueprint embodies a new vision of the bureaucracy as a creature to be tamed and supervised by the President—and no one else.<sup>166</sup> This means a consolidation of power in the federal government rather than states. It involves reposing that power in the executive branch rather than in Congress. The vision then concentrates that power in the office of the President and the cabinet secretaries removable by him or her at will, rather than distributing it through independent agencies like the SEC and the Fed. After this amassing of power, the executive would delegate it, to the extent feasible, to self-regulatory organizations in the various industries.

The Volcker proposals, in contrast, while also contemplating a radical reorganization, seem to follow the more traditional approach of using independent federal agencies, which are in turn more responsive to Congress, rather than reposing extensive power in the President and executive branch. The 2008 Volcker report calls for a “system in which those responsible for prudential regulation and supervision have a high degree of political and market independence,” and emphasize a “need to ensure the political and market independence of national regulatory authorities.”<sup>167</sup> That would rule out giving plenary power to the President and his cabinet

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<sup>163</sup> VOLCKER I, *supra* note \_\_\_\_, at 20.

<sup>164</sup> *See supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>165</sup> As noted, House Agricultural Committee Chairman, Collin Peterson, in February 2009 introduced legislation to require the CFTC to regulate credit default swaps and other derivative financial instruments. *Supra* note \_\_\_\_.

<sup>166</sup> *See infra* notes \_\_\_\_-\_\_\_\_ and accompanying text.

<sup>167</sup> *Id.* at 16, 35.

appointees, as the blueprint contemplates (and, indeed, as the on-the-fly approach to the crisis of 2008 reflected).

The reason for the different approaches seems to lie, in part, in competing understandings of political pressures that can be brought to bear against regulators during financial crises. While the Paulson blueprint centralizes the response to crises in politically accountable officials in the Treasury Department, the Volcker approach, consistent with a long line of scholarship suggesting that central banking is best done independently from the political process, prefers insulating decision makers as remotely as possible from such political accountability and pressure.<sup>168</sup> Furthermore, the Volcker reports evince no or little enthusiasm for expanded use of self-regulatory organizations so exuberantly championed in the blueprint.

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

The blueprint's philosophy entails heavier focus on minimums of safety and soundness for financial institutions, than on traditional investor or consumer protection that U.S. financial regulators are best known for. This reflects a particular view of the purposes of financial regulation, concentrating on systemic stability—and American competitiveness—rather than constituent protection, with minimal standards of prudential oversight and business conduct or corporate disclosure.

The Volcker proposals also evince a preference for principles to rules and offer at least some gestures of a deregulatory nature, such as withdrawing the federal government from the mortgage finance business. But the Volcker proposals recommend a more substantive regulatory philosophy than the Treasury blueprint. They imagine specific substantive limits on institutional size and trading activities. They imagine specific regulation of financial products. They imagine specific ways to regulate rating agency compensation and even weigh in on accounting debates and matters of corporate governance like board performance and executive compensation. The role of independence for domestic regulators and global coordination for the Volcker group are hard to overstate. Volcker emphasizes: markets have “become international in scope,” but this is not a reason to compete—instead “efforts to reregulate them” are best approached “on a coordinated basis.”<sup>169</sup>

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<sup>168</sup> The Volcker [2008] report explains: “as risks are materializing and extreme pressures mounting, it is even more challenging for supervisors not to overreact to the use of capital, reserve, and liquidity buffers that should have been built up for use in just such circumstances. All this further underscores the importance of these agencies having . . . independence.” VOLCKER I, *supra* note \_\_\_, 42.

<sup>169</sup> VOLCKER I, *supra* note \_\_\_, at 49.

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

Framed this way, two themes warrant the special attention supplied in the following framework and evaluation. The first theme, which Section A explores, concerns a longstanding debate among administrative lawyers about what to make of the independent agencies that the blueprint would eliminate, in favor of executive branch control, followed by delegation to industry groups. In this view, the independence of regulators is a problem that the financial crisis presents an opportunity to solve. The Volcker approach, on the other hand, appears more likely to welcome regulatory independence, and appears less sure about the value of delegation to private industry. The 2008 Volcker report contends that “the time has also come to move beyond moral suasion and enlightened market self interest” to create a comprehensive regulatory scheme.<sup>170</sup>

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

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

#### *A. Administrative Law*

As a matter of administrative law, Paulson and Volcker’s formal centralizing proposals for regulation roundly reject the old, disaggregated model; Paulson’s blueprint may vindicate those theorists who support presidential control over decision-making; and both raise some questions about the future of preemption in this vigorous and federalized area. We consider the administrative law implications of the approaches to financial regulation by focusing on the blueprint. The blueprint’s proposed reorganization both federalizes and centralizes financial

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<sup>170</sup> *Id.* at 53.

regulation is unusual in the degree of power concentrated within the executive branch of the federal government, to the point where the structure of financial regulation would change. Before, that regulation has been conducted by agencies that have always existed outside the executive branch—the SEC, CFTC, and, to some degree, the Fed.<sup>171</sup> The President cannot fire the heads of these agencies absent cause (which in practice has meant that they are not fired at all), and the agencies are run by a balanced set of Republican and Democratic appointees.<sup>172</sup>

But under the blueprint, these agencies would be replaced by new regulators with less obvious independence. In the interim, financial policy would be set by an inter-agency working group chaired by the Secretary of the Treasury, and not subject to many of the usual constraints on bureaucratic power, such as open government, and even judicial review.<sup>173</sup> Ultimately, moreover, the powers of the Treasury Department would grow under the new regime, as the PWG were folded into the new, Treasury-controlled regulators that would supersede the SEC and much of the Fed. The President’s control over financial regulation would also grow. Treasury, of course, is in the heart of the executive branch, and led by secretaries who serve at the will of the president. These officials can be, and often are, fired by the President.<sup>174</sup>

The blueprint thus marks a move away from independence and towards executive branch control. Executive control over agency decision-making is something that administrative lawyers have been thinking carefully about since Elena Kagan made the case for such control after serving in the Clinton White House for seven years.<sup>175</sup> To Kagan, executive authority over administration in general is all for the best. She approvingly concluded, in a well-known article, that a contemporary president should “treat[] the sphere of regulation as his own.”<sup>176</sup>

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<sup>171</sup> John Schwartz, *Some Ask if Bailout Is Unconstitutional*, N.Y. TIMES (Jan. 15, 2009), available at [www.nytimes.com/2009/01/16/us/politics/16challenge.html](http://www.nytimes.com/2009/01/16/us/politics/16challenge.html).

<sup>172</sup> For an interesting view of the potential for the President to be reconstituted as an independent agency, see R. Berry & Jacob E. Gersen, *The Unbundled Executive*, 75 U. CHI. L. REV. 1385 (2008).

<sup>173</sup> These sorts of interagency commissions are usually not subject to the Freedom of Information Act, 5 U.S.C. 552(b)(5) (exempting many inter-agency communications from FOIA), and the Administrative Procedure Act, which reviews final rules and adjudications of agencies would not be applicable to the putatively coordinative work of the of the PWG. See 5. U.S.C. 706 (setting forth the availability of judicial review).

<sup>174</sup> Recent examples include the case of President George W. Bush’s Secretary of the Treasury, Paul O’Neill. David E. Sanger, *Upheaval at the Treasury: The Treasury Secretary; Departure from Cabinet and Niceties*, N.Y. TIMES, (Dec. 10, 2002), available at <http://query.nytimes.com/gst/fullpage.html?res=9801E4DF173AF933A25751C1A9649C8B63&scp=8&sq=president%20can%20fire%20secretary%20paul%20o%20neill&st=cse>.

<sup>175</sup> Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245 (2001).

<sup>176</sup> See *id.* at 2281.

This means that he should “convert[] administrative activity into an extension of his own policy and political agenda.”<sup>177</sup> In Kagan’s view, this can lead to “enhanced government” through “executive[] vigor.”<sup>178</sup> She is not alone in her enthusiasm. Steven Croley has concluded that the White House is and, it is argued, should be, a principle source of bureaucratic initiative.<sup>179</sup> Other scholars believe that Presidential power “inevitably expands,” and that this is no bad thing.<sup>180</sup> Skeptics exist, of course. For example, Thomas Sargentich characterized the most awe-inspired and enthusiastic of the “presidentialists” as proponents of a “Presidential mystique.”<sup>181</sup>

The Bush administration did much to prove the descriptive part of Kagan’s hypothesis accurate. It did so in the war on terror in particular, under which essentially every government

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<sup>177</sup> *Id.* at 2282; see also David J. Barron & Elena Kagan, *Chevron’s Nondelegation Doctrine*, 2001 SUP. CT. REV. 201, 201-02 (emphasizing the benefits of decision-making by high-level government officials, rather than low-level bureaucrats).

<sup>178</sup> Kagan, *Presidential Administration*, *supra* note \_\_\_\_, at 2281.

<sup>179</sup> Steven Croley, *White House Review of Agency Rulemaking: An Empirical Investigation*, 70 U. CHI. L. REV. 821, 883 (2003) (“the White House clearly has used rulemaking review to put its own mark on particular agency rules increasingly often over the course of the past two decades, and at an accelerated pace during the Clinton administration”). As a descriptive matter, Presidents tend to locate the (to their minds) worthy enhancements of the President’s role in the domestic administrative state in a series of executive orders. President Reagan’s 1981 Executive Order on regulatory review, No. 12,291, which required agencies within the executive branch to run their draft regulations by the White House’s Office of Management and the Budget in the White House before promulgating them, as a sea-change in the structure of the federal bureaucracy that marked the beginning of ever greater amounts of Presidential control over it. The Clinton administration’s cognate Executive Order, No. 12,866, underscored the need for OMB to review particularly significant regulatory action on a cost-benefit plan, and adopted an annual regulatory planning process. George Bush passed a subsequent executive order that largely retained these elements of Presidential supervision, and brought even more agencies into the planning process.

<sup>180</sup> William P. Marshall, *Eleven Reasons Why Presidential Power Inevitably Expands and Why It Matters*, 88 B.U. L. REV. 505, 517 (2008) (“The President’s power is also enhanced by the vast military and intelligence capabilities under his command. In his roles as Commander-in-Chief and head of the Executive Branch, the President directly controls the most powerful military in the world and directs clandestine agencies such as the Central Intelligence Agency and National Security Agency. That control provides the President with immensely effective, non-transparent capabilities to further his political agenda...”); *but see* Lisa Schultz Bressman & Michael P. Vanderbergh, *Inside the Administrative State: A Critical Look at the Practice of Presidential Control*, 105 MICH. L. REV. 47, 70-76 (2006) (offering an empirical perspective qualifying and specifying the influence the White House has over EPA policymaking).

<sup>181</sup> Thomas O. Sargentich, *The Emphasis on the Presidency in U.S. Public Law: An Essay Critiquing Presidential Administration*, 59 ADMIN. L. REV. 1, 2 (2007); see also Peter M. Shane, *Political Accountability in a System of Checks and Balances: The Case of Presidential Review of Rulemaking*, 48 ARK. L. REV. 161, 200 (1995) (“If bureaucratic accountability to elected politicians is to be used as a structural mechanism aimed at achieving direct responsiveness to public opinion, it would probably make more sense to intensify the influence that Congress—especially the House—has over the agencies. Members of Congress are eligible for reelection indefinitely; a common observation of the House is that its members are in a constant election campaign.”); Cynthia R. Farina, *The “Chief Executive” and the Quiet Constitutional Revolution*, 49 ADMIN. L. REV. 179, 179 (1997) (decrying “cult of the Chief Executive”); Nicholas Bagley & Richard L. Revesz, *Centralized Oversight of the Regulatory State*, 106 COLUM. L. REV. 1260, 1263 (2006) (arguing that Presidential administration has led to an “unwarranted embrace of an unjustified antiregulatory mission”).

agency, and many state and local ones too, were pressed into a quintessentially executive sort of service—and concomitantly within the ambit of executive supervision.<sup>182</sup> Eric Posner and Adrian Vermuele have concluded that the presidentialism of the war on terror has also characterized the prominence of the executive in responding to the financial crisis.<sup>183</sup>

But until Treasury's blueprint, no executive had proposed turning large, famous, and old independent agencies into executive branch subordinates before. Nor has the coordination of the actions of financial regulators proceeded along quite so novel administrative processes.<sup>184</sup> Moreover, the blueprint does more than just centralize power. It also would extend regulatory supervision over any remaining investment banks, and perhaps even hedge funds. It would move the federal government into the regulation of insurance carriers and extensively curtail enduring state roles in banking law.

In this, the Volcker approach is quite duplicative, and the urge to rationalize and nationalize is strong in both the Democratic and Republican versions of financial reform. The difference in the centralization between the two approaches lies in the independence of the regulators to whom centralization would be entrusted; with Volcker, the independence of the regulator is particularly important, whereas with the Paulson blueprint, the idea is to consolidate regulatory power in the executive branch under Presidential control, which is pretty much where it resided after the on-the-fly responses to the crisis in both 2008 and 2009.

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

The idea that federal law might preempt state law is unsurprising to anyone with a passing familiarity with the Supremacy Clause of the Constitution. But when, exactly, the federal government *has* preempted state law is lately an increasing preoccupation of the Supreme Court. Congress does not always explicitly express its desire to preempt all state law in a sphere of federal regulation with clarity. This reticence puts courts in the difficult position of deciding whether the legislature silently intended to displace state rules, usually by enabling a federal

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<sup>182</sup> See Zaring & Baylis, *supra* note \_\_\_\_, at \_\_\_\_.

<sup>183</sup> Eric A. Posner & Adrian Vermuele, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1301164](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301164).

<sup>184</sup> Ironically, these far reaching proposals were made through a process that is both administratively regular—the Department requested comment on its proposal the same day it issued the work—and seemingly legally modest, in that it was not accompanied by draft legislation or even an executive order.

agency to regulate in the area.<sup>185</sup> Because the objectives of this sort of federal statutory scheme might be frustrated by enforcement of state law, a court may also find the state law preempted.<sup>186</sup>

Agency-driven preemption cases arise in a variety of contexts, but often arise when federal consumer protection or safety standards conflict with state tort law.<sup>187</sup> The Supreme Court has recently shown increasing willingness to conclude that federal law does preempt state tort law in these cases, particularly if a federal regulatory agency supports that stance. There are, of course, exceptions, such as the recent decision in *Wyeth Pharmaceuticals v. Levine*, where the Court decided against state tort law preemption.<sup>188</sup>

Still, as Catherine Sharkey has noted, the Supreme Court almost always sides with the federal agency when the preemption of state law by federal regulation comes before it.<sup>189</sup> Accordingly, there is a prospect that the new, central, and powerful institutions envisioned by the blueprint, and perhaps those required to implement the Volcker proposals, could see their ambit to require regulations that they would conclude should preempt state law—and that federal courts could agree with them.

## B. *Regulatory Theory*

Administrative law differences aside, it may be difficult to imagine consolidating into just a few federal agencies the traditional and varying functions performed by the Fed, other federal and state banking authorities, the various state insurance regulators and the SEC and CFTC. Admittedly, federal government agencies are both created and terminated from time to time and no agency's permanent survival can be taken for granted.<sup>190</sup> Yet such large-scale

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<sup>185</sup> This is known as implied preemption, and Congress is sometimes unclear about how much state law is to be preempted intentionally, in the view of some scholars. See, e.g., Roderick M. Hills, Jr., *Against Preemption: How Federalism Can Improve the National Legislative Process*, 82 N.Y.U. L. REV. 1, 16 (2007); Caleb Nelson, *Preemption*, 86 VA. L. REV. 225, 302 n.235 (2000) (“When members of Congress focus on a particular issue but fail to reach a collective decision about how to resolve it, they sometimes compromise by enacting intentionally ambiguous language that transfers the issue to the courts.”).

<sup>186</sup> As it did in *Nash v. Fla. Indus. Comm’n*, 389 U.S. 235, 240 (1967) (holding that state law preventing anyone who filed a complaint with the National Labor Relations Board to be preempted by the National Labor Relations Act).

<sup>187</sup> See, e.g., *Reigel v. Medtronic*, 128 S.Ct. 999 (2008). These sorts of preemption cases have been going on for some time. See Marin R. Scordaro, *Federal Preemption of State Tort Claims*, 35 U.C. DAVIS L. REV. 1, 13 (“in a 1913 Supreme Court case, a Wisconsin statute required that certain containers of syrup be labeled in such a way that the producer, in order to comply, would have to remove the product labels that were required by Congress under the Pure Food and Drug Act.”).

<sup>188</sup> *Wyeth Pharmaceuticals v. Levine*, No. 06-1247.(S.Ct. 2009) [placeholder oral argument review article: <http://online.wsj.com/article/SB122572239149293091.html>].

<sup>189</sup> Catherine Sharkey, *Products Liability Preemption: An Institutional Approach*, 76 GEO. WASH. L. REV. 449, 471 (2008) (“from *Cipollone* in 1992 to *Riegel* in 2008, the Supreme Court's position in every products liability preemption case (save one—*Bates*) aligned with the relevant underlying federal agency's take on preemption.”).

<sup>190</sup> E.g., David E. Lewis, *The Politics of Agency Termination: Confronting the Myth of Agency Immortality*, 64 J. POL. 89, 92–93 (2002) (noting 62% of agencies created after 1946 were terminated by 1997); DAVID E. LEWIS,

reorganizations of numerous agencies simply have not happened in the administrative state, at least not since the Great Depression.<sup>191</sup>

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

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

Believers in a Madisonian vision of divided government may be inclined to keep the financial regulatory system in the form closely resembling the current one (whether or not treated as modified by the 2008 crisis-response centralization). Divided government slows down the ability of new visionaries (which may include Messrs. Paulson and Volcker) with a comprehensive approach to regulation to implement that vision. And there are those who believe that this would be no bad thing, such as, for example, those persuaded by the Burkean advantages of making change difficult.<sup>192</sup>

Proponents of decentralized experimentalism, such as Charles Sabel and Michael Dorf, might have additional reasons to prefer the relative disunity of the current system, or something that looks like it.<sup>193</sup> On this view, it is desirable that the CFTC and SEC oversee markets that do similar things, because it creates something of a market for law. Dispersion of regulatory authority creates incentives for competing authorities to engage in experimentation.

Consolidation of regulatory authority would alter those incentives. It is not clear that experimentation could occur under a centralized financial regulator, even if that regulator delegated considerable standard-setting authority to private self-regulatory organizations, as

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PRESIDENTS AND THE POLITICS OF AGENCY DESIGN: POLITICAL INSULATION IN THE UNITED STATES GOVERNMENT BUREAUCRACY, 1946–1997 at 154 (2003).

<sup>191</sup> With the possible exception of the Department of Homeland Security after 9/11. On the larger issue, see Darrell Delamaide, *Washington Witch Hunt*, Market Watch (Apr. 3, 2008) available at <http://www.marketwatch.com/news/story/story.aspx?guid={23077fbb-a4c3-414c-9a89-6dd8e0ac45ac}>. Practical political problems also warrant skepticism about the likelihood of an SEC-CFTC merger. The two agencies are overseen by different committees in Congress, each with vested stakes in maintaining their respective oversight.

<sup>193</sup> See, e.g., Charles Sabel & Michael Dorf, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998).

visions like the blueprint contemplate, and certainly seems unlikely under the centralization that the Volcker reports contemplate.

The optimal balance between state and federal regulation, and corresponding fragmentation or consolidation, is an issue in substantially all fields of financial regulation implicated in the blueprint and Volcker reports. In banking, consider capital adequacy regulations, a fundamental tool intended to promote the safety and soundness of banks. A global standard for this tool appears in the Basel II Capital Accord.<sup>194</sup> In the United States, different regulators embraced the global standard in various measures. The Federal Reserve, the FDIC, Treasury, and even the SEC each took tailored approaches to capital adequacy of the institutions they supervised. Some adopted the tool slowly or in tranches or even made adoption of it by certain institutions voluntary.

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

These costs may increase amid globalization. Consider insurance. The fact that insurance supervision in the United States is managed by the 50 states has been one reason why efforts to harmonize insurance regulation internationally have gone much less far than parallel efforts to harmonize banking supervision standards and even securities regulation, especially in the area of accounting.<sup>195</sup> Although insurance companies have not hesitated to expand operations widely and deeply around the globe, oversight of them has not followed. Even if the regulatory disensus and gaps in insurance were deemed desirable, it results not from any conscious national decision but is a haphazard result of the fragmented National Association of Insurance Commissioners' inability to coordinate internationally.

Scholarly debate on federalism and regulatory theory has been particularly vibrant in the context of securities regulation and its cognate field of corporation law. Since the days of Ralph Winter, scholars have found some value in the fragmented approach to regulation, especially in corporation law.<sup>196</sup> To some, like Roberta Romano, fragmentation makes it possible for small, fee dependent regulators to be responsive—indeed more responsive—to the interests of the

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<sup>195</sup> See David T. Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281 (1998); Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1 (2008).

<sup>196</sup> Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-62 (1977).

regulated industry than would the federal government (and this is seen as desirable).<sup>197</sup> To many, fragmentation can lead to a race to the regulatory top, where the best regulatory policies are forced to prove themselves in a 50 state market for law.

Opponents object that through regulatory rent-seeking<sup>198</sup> or managerial power, the result becomes a race to the bottom.<sup>199</sup> More agnostic are those scholars who doubt the efficacy of any such competition leading to any particular or predictable results.<sup>200</sup> Despite longstanding debate over state competition in corporate law, including whether it is to the top or to the bottom, in recent years, that competition abated considerably.<sup>201</sup> Delaware won, with some newfound competition for it from Washington replacing erstwhile state competitors. This occurs primarily when Congress uses or threatens to use federal securities regulation to enact laws that intrude into subjects traditionally seen to be within state corporation law, as with Sarbanes-Oxley.<sup>202</sup>

Federal corporate regulation preempts state law, however, meaning the potential for federal monopoly that can result in inefficient laws. To address that concern, proponents of state competition in corporate law adapted its insights to the federal securities regulation context.<sup>203</sup> They propose devices to overcome that monopoly by creating avenues for regulatory competition among jurisdictions worldwide. Leading examples are to give securities issuers the choice of applicable laws;<sup>204</sup> give stock exchanges where issuers list that choice;<sup>205</sup> or offer “substituted

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<sup>197</sup> See Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987); see also FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

<sup>198</sup> Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

<sup>199</sup> See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947 (1990); RALPH NADER, *ET AL.*, *TAMING THE GIANT CORPORATION* (1976)..

<sup>200</sup> See, e.g., William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L. REV. 401 (1994); Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002); Robert B. Ahdieh, *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*, 77 GEO. WASH. L. REV. \_\_\_\_ (2009).

<sup>201</sup> Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002) .

<sup>202</sup> See Renee M. Jones, *Rethinking Corporate Federalism in the Era of Reform*, 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 605 (2003); but see Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 2005 OXFORD REV. ECON. POL'Y 31 at n. 19 (March 2005).

<sup>203</sup> Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

<sup>204</sup> Stephen J. Choi & Andrew T. Gozman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

<sup>205</sup> Romano, *Empowering Investors*, *supra* note \_\_\_\_, at 2399-2401.

compliance” (also called mutual recognition), which lets foreign entities regulated comparably at home access securities markets abroad without regulation there.<sup>206</sup> Although the desirability of such proposals can be questioned,<sup>207</sup> there is less doubt about their feasibility given global stock market competition.<sup>208</sup>

In fact, when United States capital markets were among the only places to raise large amounts of capital, US federal securities regulation may have been a functional monopoly. But of late, stock exchange competition, and accompanying regulatory oversight, intensified amid globalization and technology changes.<sup>209</sup> There are now dozens of vibrant capital markets in the world, all vying with each other to attract capital. These markets and regulators compete with one another, breaking the erstwhile US federal monopoly.<sup>210</sup> Choice of law devices may not even be necessary to enable national markets and related regulatory oversight to compete on a global basis.<sup>211</sup>

The blueprint and Volcker reports respond to such global developments in different ways. True, both would take large strides towards ending the state role in financial regulation and substantially consolidate it in the federal government. The blueprint explicitly contemplates doing so for traditional state insurance and banking, and maintaining and unifying federal regulatory authority over securities and futures. Although not explicit, the blueprint’s logic even allows for consolidation of federal authority over state corporation law,<sup>212</sup> and the Volcker reports refer to the need to increase corporate board governance generally, and especially in the areas of executive compensation and financial reporting.<sup>213</sup> Both also raise the prospect of the preemption of state law in all these fields, something that federal regulators and courts, as we noted, have increasingly interpreted their statutory responsibilities to require.<sup>214</sup>

To that extent, the blueprint and Volcker proposals may seem to promote federal regulatory monopoly that could result in inefficient laws. But the grand visions part ways in their respective responses to globalization and resulting global regulatory competition. The blueprint seeks to promote US capital market competitiveness, consolidating oversight in Washington but adopting a relatively loose supervisory approach with considerable delegation to

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<sup>206</sup> See Howell E. Jackson, *A System of Selective Substituted Compliance*, 48 HARV. INT’L L. J. 105 (2007).

<sup>207</sup> James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200 (1999).

<sup>208</sup> 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); Andreas Fleckner, *Stock Exchanges at the Crossroads*, 74 FORD. L. REV. 2541 (2006).

<sup>209</sup> Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435 (2008).

<sup>210</sup> *Id.* [Brummer, *New Markets*].

<sup>211</sup> *Id.* [Brummer, *New Markets*].

<sup>212</sup> See Lawrence A. Cunningham, *The New Federal Corporation Law?*, 77 GEO. WASH. L. REV. \_\_\_\_ (2009).

<sup>213</sup> See *supra* text accompanying notes \_\_\_\_; VOLCKER II, *supra* note \_\_\_\_, at \_\_\_\_.

<sup>214</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

industry self-regulators. This attempts to put US financial firms, and the US federal regulatory apparatus, in a favorable competitive position with other nations. In effect, the blueprint first concentrates US financial regulation using a consolidated federal structure and then embraces global fragmentation among competing national structures participating in global competition.

These implications of the blueprint entail a re-conception of federalized financial regulation that would essentially reverse contending stances in regulatory theory debates. Proponents of federal financial regulation have urged it as an antidote to state law's perceived laxity. Opponents express concern about how resulting regulatory monopoly may yield inefficient laws. But if the US federal regulatory monopoly in securities regulation is abating, and global regulatory competition intensifying, then risk of inefficient laws from US regulatory monopoly declines. So the blueprint sides with those otherwise averse to federal regulatory monopoly by using it to embrace global regulatory competition and committing the US to succeed in it.

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

### *C. Political Reality*

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

The Volcker vision sees extensive collaboration among national regulators in a large number of countries who will not only agree to share information but also coordinate on setting, maintaining and enforcing agreed regulations of financial markets. Although there is some modest support for such a prospect in certain discrete contexts, such as the Basel Accords, and some progress evident in converging of international accounting standards, it is not obvious that the requisite coordination for broad financial regulation will occur or be sustainable.<sup>215</sup>

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<sup>215</sup> See Benedict Kingsbury, Nico Krisch & Richard B. Stewart, *The Emergence of Global Administrative Law*, 68 LAW & CONTEMP. PROBS. 15 (2005).

In times of economic crisis, such as during 2008, there may be greater willingness among nations to join together, even to sign cooperation agreements and join periodic communiqués, such as the G20 overture cited earlier.<sup>216</sup> Yet crisis also can induce national leaders to concentrate more intensively on domestic affairs and interests,<sup>217</sup> even among members of otherwise successful economic blocs, such as the European Union.<sup>218</sup> It is difficult to predict international propensity toward regulatory cooperation during periods of economic expansion, particularly considering how the globalization of finance and related competition is a relatively recent phenomenon.

Cold comfort appears in various initiatives to develop bilateral and multi-lateral platforms to coordinate undertakings among financial regulators from different countries.<sup>219</sup> A main example is the SEC's developing mutual recognition program.<sup>220</sup> Despite much fanfare, the SEC has formally entered into only one such agreement, with Australia, concerning only one such participant, brokers. Furthermore, even the considerable SEC and international cooperation and convergence that has been achieved concerning international accounting standards is beset with hold-outs and disagreement.<sup>221</sup> In part, this reflects extensive variation among nations in legal origins, and historical, political, sociological and economic orientations towards capital markets, securities investment, corporate governance and the roles of markets and the state in national affairs.<sup>222</sup>

The appetite for international coordination in financial market and regulation matters is constrained by inherent national interests to promote capital markets and financial industries domestically.<sup>223</sup> There is ongoing and increasing regulatory competition among national

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<sup>216</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>217</sup> See Roger Altman, *The Great Crash of 2008*, 88 FOREIGN AFFAIRS 2 (2009).

<sup>218</sup> See Editorial, FIN. T., *Protecting European Unity Against Crisis* (Feb. 19, 2009).

<sup>219</sup> See Chris Brummer, *Post-American Securities Regulation* (draft Dec. 2008).

<sup>220</sup> This enables foreign firms to operate in the US without local registration or supervision, so long as they are overseen sufficiently by a regulator comparable to the SEC and with comparable regulations. See Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Broder Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L. J. 31 (2007).

<sup>221</sup> See Zaring, *International Law by Other Means*, *supra* note \_\_\_\_; Cunningham, *The SEC's Global Accounting Vision*, *supra* note \_\_\_\_.

<sup>222</sup> See Cunningham, *The SEC's Global Accounting Vision*, *supra* note \_\_\_\_, at 40-53 (documenting these variations in the context of assessing the prospects for sustained international commitment to uniform financial accounting standards).

<sup>223</sup> See Otmar Issing & Jan Krahn, *Why the Regulators Must Have a Global "Risk Map,"* FIN. T. (Feb. 19, 2009) (attributing lack of international coordination concerning systemic risk to "the competitive situation in international financial markets, with governments aiming at preserving the competitive advantages of national banking industries").

securities regulators, operating in part and indirectly through their stock exchanges.<sup>224</sup> That competition is mediated, but only slightly, by efforts to harmonize regulation that IOSCO and entities like it have made.<sup>225</sup>

Despite occasional signs of mild collusion among national regulators, this may simply reveal that it is necessary to engage with one another, and this often means competing to attract capital to their home markets. These limitations may diminish prospects for the kind of regulatory collaborations that the Volcker plan would need and, without them, the Volcker vision's stringent regulatory impositions could put the United States at a competitive disadvantage internationally.<sup>226</sup> That remains true despite occasional expressions of international unity, amid the 2008 crisis, when certain countries long deemed to be out of step with international financial regulatory norms got into step.<sup>227</sup>

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

For example, the blueprint notes that "the requirements for financial capacity and managerial expertise should vary by type of financial product being sold."<sup>228</sup> It distinguishes consumer/retail transactions from business/wholesale transactions and distinguishes firms with government guarantees from those without them. It recognizes differences between securities and futures firms, even though it recommends having them supervised by a single agency. It distinguishes these firms from banks and insurers, which are also acknowledged to be different kinds of institutions. The customers of all these firms have different needs and related regulations probably should reflect them. That means inherent fragmentation. Nothing in the Volcker proposals counters these realities.

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<sup>224</sup> Brummer, *Post-American*, *supra* note \_\_\_\_.

<sup>225</sup> See David Zaring, *Informal Procedure, Hard and Soft*, in *International Administration*, 5 CHI. INT'L L.J. 547 (2005).

<sup>226</sup> True, more informal networks may enable substantial coordination of international financial regulation. See Zaring, *supra* note \_\_\_\_\_. But the Volcker vision seems to recognize that much more than that would required and, in our view, does not seem highly probable.

<sup>227</sup> E.g., Haig Simonian, *Haven to Relax Rules on Bank Secrecy*, FIN. T. (March 13, 2009) (noting that Liechtenstein, under pressure from the Organization for Economic Cooperation and Development, OECD, agreed to conform its banking laws more closely to internationally ordained standards).

<sup>228</sup> TREASURY BLUEPRINT, *supra* note \_\_\_\_, at 170.

Furthermore, the vaunted two-peaks model endorsed by both visions may not have proven its mettle. These and other proponents invariably mention that numerous other nations have moved to the two-peaks model in the past decade, including the United Kingdom. Yet the 2008 crisis rocked the financial markets and many specific financial institutions in those countries at least as severely as in the United States. This certainly gives reason to wonder whether any regulatory authority, no matter how centralized, ever could be in a position to become aware of excessively concentrated systemic risk. It does not mean there isn't value to the structure or the quest, but experience does not demonstrate superiority of the two-peaks model compared to alternatives, including the battle-tested traditional fragmented US approach.

Accordingly, it is not clear the blueprint's ordered coherence or the Volcker reports' coherent ambitions will help their kind of centralization to triumph over contenders, including remnants of the traditional fragmented system as changed by the new model Fed's on-the-fly responses to the 2008 crisis. The on-the-fly approach appeared to reinvigorate the President's Working Group; it is possible that political realities of transforming multiple regulators into a putative single regulator would stop at the regulation-by-committee form that the PWG resembles.<sup>229</sup> Although the resulting quasi-concentration's sustainability cannot be assured, its accomplishment attests to at least some staying power. In any event, the de facto reform remains less sweeping than that imagined under either the Paulson or Volcker visions.

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

We believe reforms such as these offer a more sensible and pragmatic response to the events we have catalogued. After all, what are the prospects for adoption of either of these grand visions or any of the discrete reforms that each contains? Although we disclaim political scientific expertise, the content of reform post-crisis depends on a number of factors that turn a bit more on political economy than on law. For example, although it raises the possibility of capture, recognized in public choice theory, industry support does help to overcome the status quo bias of both regulators and the legislature.<sup>230</sup>

We have seen some evidence of this, including a number of tacit bows to the coming regulatory expansion, ranging from apparent acquiescence of hedge funds to some degree of oversight, to the willingness of senior bank officials to accept bailout largesse—even at the cost of their own executive compensation. One reason for crisis-generated reform may be consistent with another strand of public choice theory: it takes events of widespread consequence to

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<sup>229</sup> See *supra* notes \_\_\_\_-\_\_\_\_ and accompanying text.

<sup>230</sup> See SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* 17-25 (1981).

motivate poorly engaged and disaggregated majorities to re-examine institutionalized regulatory schemes, which between crises are likely to be responsive to more easily organized minorities.<sup>231</sup>

Amid the 2008 crisis, political sensibilities undoubtedly galvanized and possibly shifted. The blueprint's deregulatory posture, along with delegation, was offered essentially pre-crisis, when appetites had been building for several years, after Sarbanes-Oxley, for just such a deregulatory commitment. Its origins are in a series of reports lamenting a decline in US capital market competitiveness.<sup>232</sup> It is a call to reform that, in that pre-crisis period, may have enjoyed considerable political traction, certainly among market devotees and perhaps commanding appeal across wide parts of the center of the political spectrum.

While market purists may yet prefer a blueprint type of approach that embraces global regulatory competition, more vocal advocates of regulation's virtues, and a wide swath across the political center, may be prepared to embrace the more controlled regulatory vision set out in the Volcker reports. Even so, when a triggering event inspires reform and even generates requisite political will to make change, the event and the reform are not always closely connected to each other, as Part I illustrated.<sup>233</sup> These political and practical realities may point toward following America's more traditional response to crisis of targeted incremental reform rather than pursuing the more sweeping visions offered by Paulson's blueprint or the Volcker reports.

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

## CONCLUSION

Proposed reforms in light of the 2008 crisis are certainly sweeping. The Paulson blueprint calls for the alteration or disbandment of federal governmental agencies that have been around for a century, and the Volcker plan echoes those calls. The Fed was created in 1913 and the Securities and Exchange Commission in 1933.<sup>234</sup> The Federal government got involved with futures regulation with the 1922 Grain Futures Act, and established thrift oversight in the 1932 Federal Home Loan Bank Act.<sup>235</sup> The McCarran-Ferguson Act, which formally delegated authority to establish insurance laws to states, dates to 1945. Reform under either grand vision

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<sup>231</sup> See, e.g., BANNER, *supra* note \_\_\_\_; Ribstein, *supra* note \_\_\_\_.

<sup>232</sup> See McKinsey & Company, *Sustaining New York's and the US' Global Financial Services Leadership*, available [http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20FINAL.pdf](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20FINAL.pdf). The Committee on Capital Markets Regulation issued similar reports, available at <http://www.capmksreg.org>.

<sup>233</sup> See *supra* text accompanying notes \_\_\_\_-\_\_\_\_.

<sup>234</sup> Although the Commodity Futures Trading Commission was not organized until 1975, the federal government has asserted regulatory authority over futures trading since at least the 1920s. See Futures Trading Act of 1921, (declared unconstitutional in *Hill v. Wallace*, 259 U.S. 44 (1922)); Grain Futures Act of 1922, see *Board of Trade of City of Chicago v. Olsen*, 262 U.S. 1 (1923).

<sup>235</sup> Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932).

would mean that these agencies and statutes be replaced, in whole or in part, with a new set of laws and financial regulators that would have very different responsibilities. Under both Paulson and Volcker proposals, broad supervisory responsibilities would be consolidated in one or two senior federal regulators.

To some, of course, financial reform, like much of corporate regulation, is not so important, and grand visions like these may be mere visions.<sup>236</sup> When the Paulson blueprint was first mooted, moreover, some observers thought that its recommendations did not amount to much. Economist Paul Krugman, a member of the Volcker report team, sniffed “To hide their lack of any actual ideas about what to do, managers sometimes make a big show of rearranging the boxes and lines that say who reports to whom.”<sup>237</sup> *The Wall Street Journal’s* editorial board quipped that “No bureaucratic deck chair goes unmoved” under the plan, and otherwise exhibited little interest in its substance.<sup>238</sup>

This sort of early dismissal, and the regulatory triviality argument more generally, is curious in light of what has happened since Treasury first mooted widespread reform. Since then, the United States federal government devoted some \$500 billion to bailing out the financial system, which collapsed in a way that rendered investment banking as we knew it, extinct, drastically altered the structure of commercial banking and mortgage finance and caused severe hardship in the real economy.

Despite early dismissal, since its release, the blueprint has garnered considerable, and as the crisis widened, escalated, attention. The Volcker group’s reports, commanding equal interest, address some of the same territory directly. One describes the blueprint as “far-reaching,” and says that the “fact that Treasury has put these proposals on the public agenda, together with the seriousness of current conditions, suggests that there will be an active debate” on approaches to financial regulation.<sup>239</sup>

The increasing focus on bold reform to concentrate regulatory authority should be taken seriously but cautiously. After all, our evaluation suggests some enduring merits of the traditional US fragmented approach and the accomplishment of extensive reforms to it that significantly concentrated the structure of US financial regulation. Additional concentration may not be necessary and may in any event prove unsustainable. A grab bag of reform ideas appears in the otherwise grand visions for planned centralized reforms. Adopting some of those would follow an American tradition of crisis response, using its traditional fragmented system. In any

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<sup>236</sup> E.g., Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. L. REV.542 (1990).

<sup>237</sup> Paul Krugman, *The Dilbert Strategy*, N.Y. TIMES, Mar. 31, 2008, available at [http://www.nytimes.com/2008/03/31/opinion/31krugman.html?\\_r=2&ref=opinion&oref=slogin&oref=slogin](http://www.nytimes.com/2008/03/31/opinion/31krugman.html?_r=2&ref=opinion&oref=slogin&oref=slogin).

<sup>238</sup> *Reforma a la Glasgoow*, WALL ST. J., Apr. 1, 2008, available at <http://online.wsj.com/article/SB120701058752178921.html>.

<sup>239</sup> VOLCKER II, *supra* note \_\_\_\_, at 224.

event, one of these three or four approaches to financial regulation seems destined to become the approach we take into the next crisis—and perhaps to pull us out of the current one.