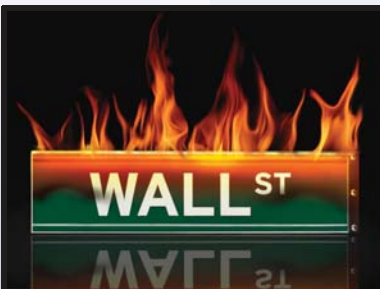




The Voice for Public Pensions



ORIGINS OF THE FINANCIAL MARKETS MELTDOWN, THE NEED FOR FINANCIAL REFORM, AND THE DODD-FRANK BILL RESPONSE

January 2011



Report commissioned by The National Conference on Public Employee Retirement Systems (NCPERS).

NCPERS is the largest trade association for public sector pension funds, representing more than 500 funds throughout the United States and Canada. We are a unique network of public trustees, administrators, public officials and investment professionals who collectively manage nearly \$2.75 trillion in pension assets. Our core missions are federal Advocacy, conducting Research vital to the public pension community, and Educating pension trustees and officials—it's who we ARE.

Prepared by Larry W. Beeferman, Director, Pensions and Capital Stewardship Project, Labor and Worklife Program, Harvard Law School.

Larry Beeferman joined the Labor and Worklife in 2004 to establish the Pensions and Capital Stewardship Project which educates and informs workers, scholars, researchers, and practitioners on issues of retirement security, including employment-based retirement plans, and of pension fund governance, management, investment, and related matters. The Project carries out its work through research, engagement, and education, the latter of which includes the Program for Advanced Trustee Studies in partnership with NCPERS.

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INTRODUCTION: THE PENSION FUND STAKE IN REFORM

Pension funds have a significant stake in financial markets and their regulation. First and foremost, tens of millions of American workers and their families rely or will rely on retirement benefits paid by pension fund plans. Those benefits are their primary source of income in retirement or a major complement to what Social Security provides. For those whose public employers, by state law, are barred from participation in Social Security, pensions loom even larger as a source of income. Moreover, a number of studies show the tremendous positive economic impact that nearly 8 million people who receive retirement, disability, or survivorship benefits from those plans have on local economies.

Pension funds must invest in accord with fiduciary duty and, in doing so, invest wisely enough to ensure that promises to pay benefits are kept. In turn, the appropriate and effective functioning of financial markets in which pension funds invest is critical to their ability to succeed in keeping their promises. Immediately prior to the recent financial meltdown, pension funds' stake in financial markets was roughly \$5.5 trillion. State and local pension fund assets made up about \$3.2 trillion of that total. Between the stock market peak in October 2007 and the month after the bankruptcy of Lehman Brothers Holdings Inc., state and local pension funds lost about \$900 billion in value. They suffered further losses after this, reaching their low by February 2009. Private-sector pension funds lost even more. For these reasons alone it is essential that pension funds be well-informed, express their concerns, and have their voices heard in debate over what caused those failures and how to prevent them in the future.

But pension funds have even stronger reasons than these to press for meaningful reform. Although the recent crisis largely originated in financial markets, its negative impact on the larger economy has been severe and may very well be sustained. The ensuing sharp drop in the economy has resulted in dramatically lower state and local revenues. Those revenues are, of course, important to sustaining a broad range of very important public-sector services. But they are also essential to public pension funds. On average, roughly 75 percent of funds' revenues are derived from investment income. The extraordinary and unanticipated investment losses suf-

fered recently have generated understandable pressures to increase public employer and worker contributions to keep fund finances on an even keel, placing strains on both. (There are, of course, analogous issues in the private sector.) These pressures have fed longstanding attempts to reduce public-sector pension benefits or even close down defined benefit plans.

The special concern of pension funds with the causes and economic implications of the financial meltdown arises as well from some of their distinctive attributes as investors. By its very nature, a fund's investment horizon needs to be the long term. Funds must anticipate, plan, and invest for participants whose association with their public employers as active workers, former workers with vested benefits, retirees, and survivors of retirees may extend as much as 70 or 80 years. No doubt there may be exceptional occasions and incentives for pension funds to view investment decisions with an eye to the short term. However, their principal tasks are to search out, assess, and invest in enterprises that are sustainable and economically productive over the long term. As the discussion below will suggest, the meltdown originated, in some measure, from problematic or even pathological short-termism on the part of key financial market players. Pension funds have a considerable stake in seeing the causes of such

Pension funds have an important stake in what steps have been taken so far to avert a future financial crisis and in assessing whether more needs to be done.

short-termism identified and remedied. Moreover, pension funds and other institutional investors together make up more than half of the shareholders in the vast majority of large and many smaller corporations across the United States economy. As a result, they have particular concerns about corporate behavior and are well aware of a corresponding need and responsibility to strive, through exercise of their shareholder voice, to make sure that those concerns are addressed. In turn, they also have a considerable stake in seeing that through law, policy, and practice the necessary tools, resources, and processes are available for the proper and effective exercise of shareholder voice.

Further, pension funds are invested across a broad range of assets (from publicly traded equity and bonds to private equity and hedge funds to infrastructure, commodities, etc.) and within asset categories (typically having a stake in publicly traded companies whether through indexes or otherwise). As a result of the meltdown, pension funds have suffered losses across and widely within asset classes. For those reasons and insofar as the meltdown was the consequence of systemic failure, pension funds have an especially or even acute concern. Their trustees and managers must

understand the origins of that failure and press for strong and effective measures to prevent such failures in the future. Moreover, pension funds, along with other investors in various asset classes and kinds of financial instruments, have a strong interest in receiving sufficient, relevant, and accurate information about the financial products they are offered. Likewise, they have an interest in transparency of the markets in which such products are bought and sold. They have a corresponding concern about anti-competitive behavior in those markets. Finally, they also have a stake in preventing conflicts of interest and self-dealing, and in deterring fraudulent and deceptive practices. These issues go well beyond the relationship pension funds and other institutional investors have with financial service providers. They extend as well to individual consumers of these services, who in many cases are also pension fund plan participants. The crisis shows how harms caused to consumers by abusive and other wrongful practices can be closely linked to harm suffered by pension funds as investors in financial companies that engage in such practices. Moreover, both actively working plan members and retirees are among those consumers who are hurt by these behaviors.

In sum, then, pension funds have an important stake in what steps have been taken so far to avert a future financial crisis and in assessing whether more needs to be done. Toward that end, this document focuses on the Dodd-Frank Wall Street Reform and Consumer Protection Act (referred to herein as “the Act”), signed into law on July 21, 2010.

Assessing what preventive steps have been or might be taken requires an understanding not only of the scenario that was played out over 2007 and 2008 but also of events during the months and even years leading up to that period. However, it is likely that many of the specific factors and circumstances that might trigger a crisis of comparable magnitude in the future would be rather different from those seen as direct or indirect causes of the 2008 meltdown. If so, then it is essential to have a grasp of the more general factors that were critical in the recent scenario and probably would be present in any future one. It is not clear that such an understanding was fully at hand when the Act was being crafted or even now.

Many months before the passage of the Act, the current Administration released a white paper proposing a wide range of reforms. But neither that document nor any others released by the Administration have come close to providing a thoroughgoing and well-grounded narratives as to why the changes they proposed were warranted. Certainly the many hearings held by various congressional committees

and touching on the causes of the crisis and what reforms are needed have been informative. Individually and collectively, however, such hearings are, by their nature, hardly up to the larger task. Though the work of the Congressional Oversight Panel (and others) has been valuable, its mandate is to focus largely on the operation and impact of the Troubled Asset Relief Program (TARP). The Financial Crisis Inquiry Commission (FCIC), created by Congress in May 2009 to “examine the causes, domestic and global, of the current financial and economic crisis in the United States” might have supplied such an understanding and yielded other invaluable insights had it acted in a timely fashion. However, the FCIC held its first hearing only in January 2010. Since then it has held only a modest number of hearings. It was only eleven months after its creation that the FCIC first began to exercise its subpoena power to obtain needed documents. With a deadline of December 15, 2010, to submit its report, the time for further gathering of facts is late if not past.

To be fair, in the wake of crises such as the recent one, elected officials do not necessarily have the luxury of extended time to gather information, come up with ideas for reform, and decide on what to do. The pressures to act (relatively) quickly and (seemingly) decisively on the basis of (what can be argued to be) a (sufficiently) credible and substantive grasp of relevant facts are great. Also, the fact that many of the Act’s reforms demand far greater transparency about the actions of numerous key players is testimony to the challenges officials have faced in penetrating the opaque, interlocking, and complex actions by these players that led up to the crisis. For these reasons alone, it would seem that the Act should not be – and may well not be – the last word on what reforms are needed.

Moreover, serious and well-informed papers, articles, and other documents on the subject run into the thousands of pages. So do prescriptions—both putatively expert and popular—for what should be done in the face of one or another conclusion as to the causes. Not surprisingly, then, the provisions of the Act run over 2,000 pages. It is not possible and certainly not useful in a publication such as this to canvas in detail the previously published descriptions, theories, analyses, and prescriptions on the matter.

For these reasons, the goals for this paper are to identify (1) what typically are seen as important near- or short-term causes linked to the financial crisis, (2) the kinds of individual and institutional behaviors that many believe contributed to these causes, (3) the most important among the Act’s provisions seemingly calculated to change those behaviors, and (4) some critical perspective on whether the provisions are suited to the task.

Toward that end, in the next eight sections, one for each of eight important areas of concern, we first recount many broadly shared and some disputed contentions about how, why, and the extent to which activities in that area contributed to the crisis (“Background”). The first Background section includes an extended discussion in two segments to provide a context for that and subsequent sections. One segment describes practices and behaviors of key institutional and other players that were of significance to how events unfolded. The other gives a chronology of events leading up to the financial market meltdown and its aftermath.



PART I. IDENTIFYING SYSTEMIC RISK AND REGULATING FIRMS THAT POSE SYSTEMIC RISK

A. IDENTIFYING SYSTEMIC RISK

BACKGROUND

At the top of the list for reform have been steps to avert recurrence of the kind of serious financial instability of the financial system reflected in the dramatic events of September and October 2008 and ensuing months. The following characterization of the role and actions of key players, along with a chronology of events before and during this period, provide a backdrop against which to consider what those steps might be.

Key Players and Their Behaviors and Practices

For decades commercial banks and savings institutions were preeminent intermediaries between depositors on one hand and consumers and businesses on the other. Depositors placed money in checking and savings accounts with those institutions. The institutions in turn lent money to consumers for home, automobile, and other consumer purchases and to businesses to operate and expand their enterprises. Commercial banks were not the only depository institutions that operated in this way. Others were thrifts – including savings banks, savings and loan associations, and credit unions – which mainly took deposits in the form of savings accounts and lent it primarily for home mortgages.

Investment banks were different from commercial banks. They did not accept deposits or make loans to individuals. They earned fees from the role they played in the issuance of equities by companies and debt securities by companies and municipalities. They earned income from the sale and

purchase of securities for others as well as by themselves. They also made profits from advising investors and helping to effect the sale, merger, acquisition, or restructuring of companies.

Because of their importance as depository and lending institutions and parties central to the payments system, special rules were set up for investment banks. For example, Depression-era bank failures were associated with the combining of commercial banking with what were seen as speculative, self-dealing, and abusive investment bank practices. The Glass-Steagall Act (also known as the Banking Act) in 1933 largely required the separation of those activities. In addition, a system of deposit insurance was established with the aim of assuring depositors of payment in the face of bank failures and calming the kind of depositor fears that had led to runs on banks. A regulatory structure was also created to avert bank behaviors that would put deposits at risk unnecessarily. For example, rules were established governing how banks that accepted deposits operated to limit the lending risks they took, how much in assets they had to keep as a cushion against significant losses in their loan portfolios, and so on.

Over the years, for a variety of reasons—among them changes in laws and regulations—the picture changed dramatically. Individuals shifted their money from commercial banks (as well as thrifts and credit unions) and into a wide range of mutual funds—including money market funds (MMFs), equity and bond mutual funds, hedge funds, and other special investment vehicles—as well as into pension funds.

This change was associated with an enormous shift in lending from traditional, bank-based to market-based borrowing. Previously, bank lenders had made and kept on their books loans to people to buy homes, purchase cars, finance their consumer purchases or small businesses, and more recently, pay for college. Now, these loans were increasingly packaged and sold in the form of asset-backed securities (ABSs). Insofar as the original lenders did not keep the loans, they no longer bore the risk of borrowers defaulting on their obligations to pay. At the same time, they made money for arranging the original loan, perhaps from servicing it (tracking and collecting payments), and perhaps even from their roles in the creation and sale of the ABSs.

Actions by the federal government spurred these developments, especially as they related to home mortgages. In 1938, in the wake of the Depression, the government had established the Federal National Mortgage Association (known as Fannie Mae) to buy federally insured home mortgages. In 1968, the Government National Mortgage Association (Ginnie Mae) was split off from Fannie Mae. Ginnie Mae’s mis-

sion was to buy an expanded range of federally insured mortgages. A couple of years later, Fannie Mae was authorized to purchase non-federally insured mortgages as well. The Federal Home Loan Mortgage Corporation (Freddie Mac) was established as a would-be competitor with Fannie Mae. Both Fannie Mae and Ginnie Mae were created as wholly owned government corporations. In 1968, Fannie Mae was changed into a federal government-chartered private corporation operating under government strictures and with the seeming endorsement and support of the government. A corporation that operates under such an arrangement is sometimes referred to as a government sponsored enterprise (GSE). Freddie Mac was established as a GSE. Important for this discussion are the roles of each of these entities in relation to a particular kind of ABS, a (home) mortgage-backed security (MBS). Ginnie Mae provided the first guarantee for an MBS. (Ginnie Mae's role is now limited to such guarantees.) Freddie Mac and Fannie Mae issued their first MBSs in 1971 and 1981, respectively.

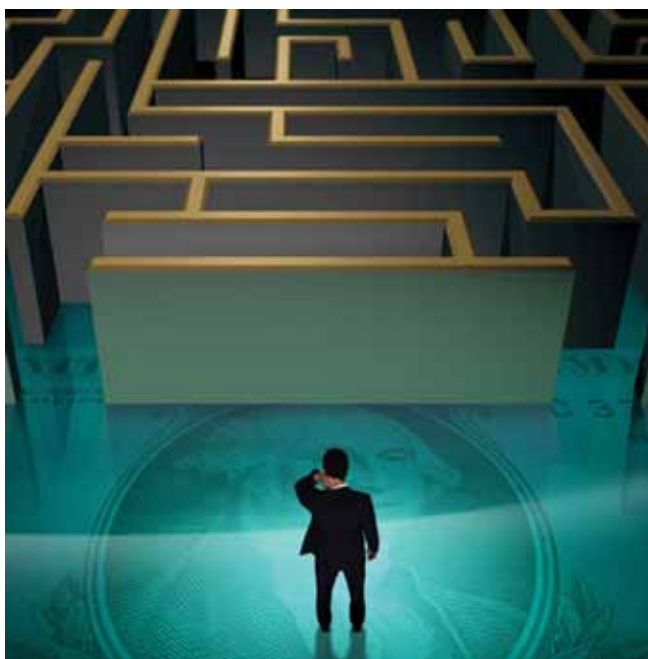
In the years that followed, there was an enormous expansion in the operations of Fannie Mae and Freddie Mac, which both purchased and held individual mortgages and both issued and guaranteed MBSs. At the time of Lehman's demise, Fannie Mae and Freddie Mac combined had over \$2 trillion in MBSs outstanding and over \$1.5 trillion in debt obligations. However, other, private parties, such as banks and brokers, also entered the MBS market, though they typically would not provide guarantees against default. (MBSs of the GSEs are referred to as agency MBSs, those of others non-agency MBSs.)

Two major developments in connection with ABSs in general and MBSs in particular are key to the meltdown story. ABSs were at first relatively simple. Buyers had expectations of income from payments of interest and repayments of principal on the loans in the package. They also bore the risk that some among the loans would turn sour when borrowers defaulted on their payments. But more complicated versions of ABSs, called collateralized debt obligations (CDOs), were constructed and sold. Simple ABSs were sliced up into tranches, each with different return and risk characteristics. The slices ranged from seemingly high-risk, higher-return equity-like

tranches to apparently low-risk, low-return bond-like tranches to suit the diverse tastes for risk and reward of individual tranche purchasers.

Later, even more complicated versions of ABSs were created and sold. For example, CDO tranches could be combined into a package and that package in turn sliced up and sold as a collateralized debt obligation squared (CDO-squared).

As noted, the different tranches of these securities posed varying financial risks to their owners. Purchasers of these tranches hedged that risk in part by also buying protection in the form of so-called credit default swaps (CDSs), a form of derivative discussed in further detail below. Other purchasers of CDSs included financial entities that had played a role in the creation and sale of these securities and that, for a variety of reasons, held some of the tranches themselves or promised buyers some guarantee in the face of the risk the buyers had acquired.



In addition, financial institutions created so-called special purpose (investment) vehicles (SPVs) as conduits for the sale of ABSs that those institutions may have packaged and that they supplied. While the institution was the sponsor of the SPV, the SPV itself was the legal owner of the assets. How the SPV was constructed determined whether it had to be accounted for on the balance sheet of the sponsor.

This was, of course, an important distinction. An SPV that did not have to go on the balance sheet could offset some of the regulatory requirements for the amount of capital the sponsor was required to hold in light of its risks. The lower capital requirements meant the sponsor could lend more and make more profit – in addition to the profit made from setting up the SPV.

With respect to MBSs, there was a shift in who originated the mortgages, the terms of the mortgages that were originated (and then later, in many cases, sold as packages in the form of MBSs and others of the complicated securities described above), and who qualified as borrowers. As noted, in prior years it had been banks that originated mortgages. But then mortgage companies entered the field. Some were indepen-

dent; others were owned by or affiliated with other financial institutions (including depository institutions). By 2006, independent mortgage companies' share of originations ranged from around 30 to 50 percent, depending upon the price of the mortgage. At the same time, there was a substantial shift away from what had been the traditional 30-year, fixed-rate mortgage. By 2006, nearly 30 percent of new mortgages were ones that allowed borrowers to pay only interest on the loan or pay less than the interest (thereby automatically increasing the amount borrowed) or that required them to make balloon payments (which would leave large balances due at the end of the term of the mortgage note). Moreover, an increasing fraction of loans – termed subprime loans – were made to riskier borrowers. (So-called Alt-A loans were made to borrowers somewhat less risky than borrowers in subprime loans but riskier than those in traditional ones, who got what are termed prime loans.) Finally, there was a decline in underwriting standards, that is, the quality of the documentation that supported the applicant's qualification for being given the loan.

Shadow banking entities were generally not subject to the rules that applied to depository institutions. (They were not necessary totally unregulated but rather more weakly so.) Correspondingly, those who invested their money in the products those entities sold did not have the equivalent of government-backed deposit insurance. (Arguably, by virtue of no or weaker regulation, the firms selling the products were also able to engage in riskier behaviors.) For example, over time individuals and businesses came to buy trillions of dollars of shares in money market mutual funds (MMFs) in the pursuit of investment returns higher than they could get from savings and checking accounts at depository banks. MMFs were able to yield those returns in part because they lent money to financial entities that created the kinds of ABSs described above or lent money for the purchase of such ABSs, or both. Because the expectation of investors in MMFs was that they could take their money at any time with minimal advance notice (and get their principal back dollar for dollar), MMFs lent money out over very brief time periods, as short as 24 hours. The security for this lending was, directly or indirectly, the ABSs they were in effect helping to finance. In other words, insofar as the risks in the markets for ABSs became real for players in those markets, they became real for the MMFs as well.

Various forms of short-term funding (or its rough equivalent) were the lifeblood of many of the activities just described. A major source of that funding was commercial paper—technically defined as having a term of 270 days or less—issued by corporations or other entities such as the SPVs described above. In most instances it was anticipated that on the due

date the borrower would issue new paper to pay off the old one and continue the cycle. (That is, it was expected that the debt could and would be “rolled over.”) Corporate paper is typically unsecured, not backed up by any assets. Paper issued by entities such as SPVs was backed up by the assets they held. In the years leading up to the meltdown there was a massive increase in commercial paper issued (beyond what blue chip companies had previously typically issued to meet their needs) to fund entities such as SPVs.

Another major source of funding was from so-called repos. These are arrangements under which one party sells an asset to another party but promises to buy back the asset within a specified amount of time at a premium. The asset serves as collateral in the event the repurchase is not made. In effect these arrangements are the equivalent of a loan. The period between the time of the sale and the required repurchase varies and can be as short as one day. In the years leading up to the meltdown there was a massive increase in repos as a funding source.

Securities lending was yet another source of what in effect was funding. Hedge funds and others who wanted to short markets needed to borrow securities (from pension funds and other asset owners). Their objective was to sell the securities immediately at a relatively high price in anticipation of later buying them back at a lower price (and hence, at a profit), and returning them to their original owner. By doing so, they anticipated a profit equal to the difference between the sale price and the repurchase price, less the cost of borrowing. In some cases, financial institutions that held securities in custody for their customers were in a position to lend not only their own securities but also those of customers.

The links among institutions were numerous. For example, on one hand, as noted, hedge funds relied on both securities lending and repos (for which the securities they held were collateral) to get their funding. Investment companies relied heavily on repo arrangements. Finance companies, which provided financing for housing, automotive, and other consumer purchases, depended on commercial paper and bonds. SPVs and similar intermediaries were funded by commercial paper as well as other forms of debt. Depending on the intermediary, the borrowing might be backed up by anything from the moneys owed by credit card holders to the debts of businesses' customers for goods and services provided. On the other hand, MMFs were among the important sources of funding for commercial paper and repos.



CHRONOLOGY

1998

- Housing prices begin a dramatic rise starting in 1998.

2006

- House prices reach a peak in early 2006. Delinquencies on mortgage loans and foreclosures begin to rise.

2007

- The situation worsens in 2007.
- Starting early in 2007 credit rating agencies downgrade financial instruments – MBSs and CDOs – linked to subprime mortgages.
- Beginning in early 2007, major subprime mortgage lenders are forced to set aside large sums in the face of large subprime credit losses. The second largest among them files for bankruptcy.
- In the spring of 2007, two hedge funds run by Bear Stearns Asset Management – then the fifth largest investment bank in the United States – face losses from their large investments in subprime mortgage–related assets. Bear Stearns refuses to honor client requests to redeem their investments in the face of the funds’ deteriorating condition. Lenders to the hedge funds refuse to provide additional credit and demand payments from collateral. Despite Bear Stearns’ efforts to bail out the funds, they end up in bankruptcy in July.
- In mid-summer, a major French bank refuses redemptions from three investment funds because of the uncertain and deteriorating subprime assets–linked securities in their portfolios. Also, many hedge funds that use very similar strategies for equity investments suffer dramatic losses within the span of a few days.
- Confidence also drops in the money market and commercial paper markets linked to subprime mortgages. The lack of confidence spills over into other commercial paper markets not linked to such loans. The commercial paper market is further stressed when a major German bank is unable to borrow in that market to finance its holdings whose quality is seen to be deteriorating.
- The interbank lending market comes under pressure. That is, banks become fearful of lending to one another because of concern about the credit and liquidity problems that borrowing banks may have due to their heavy involvement with asset-backed commercial paper.
- In mid-August, the Federal Reserve System (the Fed) attempts to stem these fears by reducing the interest rates at

which banks can borrow from it, easing the collateral that must be posted to borrow, and taking other steps to make it easier for banks to borrow.

- In late 2007, credit rating agencies (CRAs) issue warnings on the condition of insurance companies that provide financial guarantees in the form of credit default swaps (CDSs. See below.) linked to CDOs. Because of fears about the condition of these companies, markets for certain types of municipal bonds also insured by these companies come under pressure, with interest rates skyrocketing and investors in these bonds unable sell them.

2008

- In early 2008 a hedge fund to which Bear Stearns is exposed fails, helping to drive down asset prices further and sapping confidence in Bear Stearns, which is deeply involved in mortgage-related assets. Short-term repo lending to Bear Stearns dries up as lenders demand increased collateral as security.
- Fears driven by these events lead major prime brokerage clients of Bear Stearns to withdraw their accounts, draining assets from the firm. At the same time parties with whom Bear Stearns enters derivative contracts demand terms that put further pressure on its liquidity.
- On March 13, 2008, facing imminent bankruptcy, in a deal engineered by the Fed, Bear Stearns agrees to its sale to JPMorgan Chase, a transaction supported financially by the Fed.
- That same month, to reduce pressure on mortgage-related assets markets, the Fed allows prime dealers to use certain mortgage-related securities as collateral to acquire securities from the U.S. Department of the Treasury, which they can then sell for cash. As a result of losses on their multi-trillion-dollar portfolios of mortgages and mortgage-backed securities, Fannie Mae and Freddie Mac are forced into a government conservatorship.
- Lehman experiences problems similar to those faced by Bear Stearns: loss of overnight (repo) funding, demands for more collateral, and departure of prime brokerage clients. Over a period of months it makes efforts to raise capital to protect its liquidity, even going so far as to seek buyers for the firm. Confidence in the survival of the firm drops sharply after a high-profile would-be buyer drops out and the firm announces large quarterly losses.
- Efforts to engineer a last-minute purchase of Lehman fail, marked by the Fed and the Treasury declining to provide support like that given to effect the sale of Bear Stearns. Lehman files for bankruptcy on September 15, 2008.
- The Lehman bankruptcy has a shattering effect on financial markets. Withdrawals from money market funds dramatically rise. These, along with the weakening of commercial paper markets, make it increasingly difficult for investors in money market funds to be paid at par when making withdrawals.

In the wake of Lehman’s filing, assets of hedge funds held by Lehman are frozen. Fearful of similar freezes with other prime brokers, the funds pull their cash and securities from others. These actions put a squeeze on the cash available to and the income stream of prime brokers.

- In early September 2008 the massive financial conglomerate American International Group, Inc. (AIG) faces bankruptcy because of its inability to meet calls on collateral that back promises it made – by the sale of CDSs – to guarantee payments of certain mortgage-backed securities, particularly subprime ones.

Its own and government-supported efforts to find a buyer do not succeed. On September 16, 2008, the Federal Reserve Bank of New York (FRBNY), supported by the U.S. Treasury, creates an \$85 billion lending facility to rescue the firm. (Other substantial financial aid will be given to AIG in the following months.)

- In the wake of the Lehman failure, the Fed and Treasury take a series of dramatic steps to bolster financial markets.
- Congress hurriedly enacts the TARP in early October to stem what seems to be the potential collapse of the (international) financial system.

WHAT THE ACT DOES

Not surprisingly, the financial meltdown raised concerns about the risks that financial companies had posed and could pose to the stability of financial markets (“systemic risk”), thereby causing serious harm to the economy. It highlighted first a need to be able to identify such risks. Then it stressed the need, once a sufficient risk is identified, to take action to prevent that risk from ripening into a serious threat to financial system stability. Third, it emphasized the need to take swift and dramatic action to minimize the harm should it ripen into a near-term or even immediate threat to stability.

With regard to identification of risks, the Act’s provisions start from the premise that existing federal and state agencies in and of themselves were not and will not be adequate to the task. To be sure, those agencies focus on the behavior of particular categories of financial companies, the services and products they offer, and the markets in which they operate. But even if those agencies perform their assigned tasks, there was thought to be no governmental agency that looks at how the interplay of those companies, products, markets, and other factors might create systemic risks.

To meet this perceived need for such an agency, the Act mandates the creation of a new body, the Financial Stability Oversight Council (FSOC). Its voting members include the Secretary of the Treasury as chair, chairs of nine federal financial

regulatory agencies—such as the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)—and one independent member appointed by the president with the advice and consent of the Senate. Nonvoting members are directors of five other federal and state regulatory agencies.

Broadly speaking, the FSOC’s mandate is threefold. It is to identify risks to financial stability in the United States both from the activities of large, interconnected bank holding companies or nonbank financial companies and from outside the financial services marketplace. It is to eliminate expectations on the part of various parties that the government will shield them from losses in the event of failure. Finally, it is to respond to emerging threats to the stability of the U.S. financial system.

Thus, among the FSOC’s duties – others are discussed below – is to “monitor” the financial services marketplace to identify potential threats to the financial stability of the United States. It can also make recommendations to the Fed and primary financial regulatory agencies concerning standards and safeguards related to financial stability. It can recommend to primary financial regulatory agencies heightened standards for activities or practices relating to the creation of products that increase the risk of spreading significant liquidity, credit, or other problems among bank holding companies and nonbank financial companies. It is obliged to report to Congress if any such agency fails to implement those recommendations. It has the authority to resolve jurisdictional disputes among its member agencies.

The Act more specifically focuses the FSOC on the risks of activities of large, interconnected bank holding companies or nonbank financial companies or from outside the financial services marketplace. In pursuit of those duties it can require any very large (having \$50 billion or more in assets) bank or nonbank financial company supervised by the Fed to submit reports regarding its operations and their potential adverse impact on the financial stability of the United States.

Toward these ends, the Act establishes within the Treasury an Office of Financial Research (OFR). The OFR is headed by a director appointed by the president with the advice and consent of the Senate. One of the OFR’s purposes is to standardize and collect financial transaction and position information as well as other data. It is also to do research, develop risk management tools, and perform other work that would be made available to the FSOC and other financial regulatory agencies. The OFR has subpoena power to gather the data it needs. The OFR is funded initially by the Fed for two years. Thereafter it and the FSOC are supported by an FSOC-

approved assessment applicable to large (having \$50 billion or more in assets) bank holding companies and nonbank financial companies. The OFR director is required annually to report to and testify before one House and one Senate committee (specified in the Act) that have a key role in financial services matters. The director's report and testimony must include the OFR's assessment of financial market developments and emerging potential threats to the financial stability of the United States.

In turn, the Act establishes within the OFR a Data Center (DC) and a Research and Analysis Center (RAC). Broadly stated, as the names suggest, the DC's task is to collect data relevant to assessments of financial stability while that of the RAC is to develop means for characterizing, measuring, and evaluating risks to financial stability and to make such evaluations.

More specifically, the DC – at behest of the OFR and its director (after consultation with the FSOC) – appears to have broad-ranging power to require any financial company to submit information for the purpose of the FSOC's assessment of threats to financial stability. At the behest of the director (and after consultation with the FSOC), the DC is to collect financial transaction and position data from financial companies. The data collected is available to the FSOC and its member agencies. There is a provision for public access to the financial company and financial company instrument database. The scope of this database and the nature of this access are not clear. In any event, the Act makes access to the database subject to confidentiality requirements. A different, though murky, provision authorizes the OFR to provide "certain" data to financial participants and to the general public to increase transparency and facilitate research.

The RAC's tasks are manifold. It develops metric and reporting systems pertaining to systemic risks. It evaluates and reports on stress and other stability tests on financial entities overseen by FSOC member agencies. It investigates and reports on disruptions and failures in financial markets. It studies and advises on the impact of systemic risk policies. Finally, it monitors, investigates, and reports on systemic risk levels and patterns. Apparently, only concerning the last task is there a specific obligation for the RAC to report to Congress. However, generally, the RAC must submit to Congress an annual report on the state of the financial system. The report must include threats to financial stability and key findings from OFR's research on and analysis of the financial system.

DISCUSSION

At first blush, the FSOC's mission and resources appear to be limited. Indeed, it is largely assigned tasks that arguably

could be done in any event at the direction or request of the president. That is, in certain respects the Act largely formalizes the convening of a special interagency group for the specified purposes. However, the FSOC's structure and certain of the Act's provisions requiring agency reporting and responses might spur more information sharing and collective discussion about developing threats to the financial system than would occur without the Act. It might also spur dispute resolution among the constituent agencies in the event of conflicting agendas when facing those threats. The FSOC as a venue for discussions might also result in more coordinated, timely, and effective action on the part of individual FSOC agency members. But otherwise the member agencies (and especially the Secretary of the Treasury) are largely left to act on their own.

It would appear that the FSOC has no staff of its own. In effect, it must rely on information provided by OFR staff, who are employees of the Secretary of the Treasury. The FSOC does appear to have a dedicated funding stream. However, it is the secretary – with the FSOC's approval – who establishes the assessment that is the basis for that funding. For these reasons and the fact that the secretary is chair of the FSOC, its agenda would seem to be strongly driven by the secretary.

On one hand, this arrangement might be thought to be appropriate. People would look to the president, acting through the Secretary of the Treasury, to act in a decisive, informed, and well-prepared way to threats to financial stability. On

It is not obvious that the Act's requirements of reports by the FSOC and secretary, through the OFR, are sufficient to the task.

the other hand, the recent crisis raises concerns about political and other pressures on the executive branch to deny or downplay such threats. This suggests a need for potential qualified critics of mainstream views to have access to relevant information and the opportunity to challenge these views and be heard. Certainly, legislators who are able to resist political pressures can be the source of such contrary views. But that requires legislators to be well informed of relevant facts and their import in a meaningful and timely way. It is not obvious that the Act's requirements of reports by the FSOC and secretary, through the OFR, are sufficient to the task.

But for possibly its one "independent" member, the FSOC lacks formal participation by those with valuable knowledge and expertise and novel perspectives on critical issues. In

fact, a key to the FSOC’s success in achieving the goals set for it may very well be its ability to confront and challenge received wisdom or entrenched interests. Interestingly, the original House Finance Committee bill would have authorized the equivalent of the FSOC to create “special advisory, technical, or professional committees as [it might find] useful in carrying out its functions.” Such committees might uncover additional, independent sources of information and perhaps a range of different quasi-official analyses of or perspectives on the issues.

In all events, to be effective the FSOC has to keep up with what will likely continue to be a flood of new, arguably different, perhaps rapidly changing and complex products. It has to stay abreast of attendant claims about the novelty and merit of such products, put forth by financial firms. It has to keep up with the likely different and shifting interconnections within and across domestic and international markets. There is great uncertainty about what might trigger systemic problems and what scenarios would be played out. Hence, the demands on FSOC/OFR information-gathering and analytic power could be considerable. Certainly, the knowledge and expertise of agencies represented on the FSOC can be brought to bear in its deliberations. Further, at least in the abstract the Act would appear to provide through the DC and FAC the mission and tools to do the job. Whether in fact the job is done, though, will depend upon what the secretary and perhaps in some measure the FSOC deems is needed to do it well. In turn, that will depend upon the willingness of the secretary in conjunction with the FSOC to fund what is needed through the required assessment.

In tone and emphasis the Act focuses primarily on systemic risk associated with behaviors of and possible deterioration of particular financial companies, especially ones that pose risks by virtue of the size or scale of their activities. (See the “designation” provisions discussed in the next section.) But a firm’s size or scale may not necessarily be the problem. Rather, it may be how interconnected with others it is. Moreover, it is not just a matter of a firm failing but why and how it has come to fail that is relevant to assessing systemic risk. Thus, through the aggregate impact of problems common to numerous small(er) institutions, across particular asset classes or markets, pervasive difficulties with risk management

might result in systemic risk. So, too, might interrelationships among practices, providers, products, and the operation of markets result in systemic risk. Further, while a primary focus must be on financial firms and the financial system and on risks defined ultimately in financial terms, some financial threats may have origins in other than the financial system. Terrorism, natural disasters, and epidemics, among other factors, might also have serious consequences for financial firms and the financial system. (This issue circles back to the kind of staff expertise and resources the FSOC requires and the extent to or manner in which the OFR services the FSOC.)



B. REGULATING FIRMS THAT POSE SYSTEMIC RISKS

WHAT THE ACT DOES

The FSOC’s second set of duties is to play a very narrowly defined, though important, role in the face of emerging and imminent threats to the stability of the U.S. financial system. However, once it has played that role the dominant player by far is the Fed.

More particularly, by a two-thirds vote (which must include the secretary), the FSOC can “designate” a U.S. or a foreign nonbank financial company if distress or other attributes or activities of that company could pose a threat to the financial stability of the United States. By a similar vote, the FSOC can designate any company that attempts to organize itself or operate in a way that would evade its authority.

Once companies are so designated (termed “designated companies”), a range of special requirements applies to them, presumably geared to changing their behaviors and attributes in ways that will reduce the risks they are thought to pose.

Most generally, they are subject to the Fed’s supervision and prudential regulation. This includes establishing standards as to how much leverage the companies can use, the level of risk-based capital they must maintain, how much liquidity they must have, and so on. These standards must be higher than those applicable to non-designated companies. The Fed may also impose higher standards relating to matters such as how much contingent capital they must have, the ex-



tent of public disclosures they must make, and the like. The Fed may in addition require designated companies to submit sworn reports about their financial condition and may examine the companies. The Fed is authorized to take certain enforcement actions against them. Designated companies are also subject to certain Fed-specified capital requirements that apply to insured depository institutions and depository institution holding companies.

There appears to be one provision related to the corporate structure of designated companies as it relates to risk taking: The Fed must require them to have a committee to oversee enterprise-wide risk management. That committee has to have a minimum number of independent directors.

The Act imposes other requirements not only on the nonbank financial companies the FSOC has specifically determined to present systemic risks but also on bank holding companies that are sufficiently large, namely ones with over \$50 billion in assets. Presumably such companies (termed “interconnected bank holding companies”) are assumed to be threats simply by virtue of their size. Again, the requirements are aimed at mitigating risks that both kinds of companies might pose. For example, the prudential standards referred to above also apply to interconnected bank holding companies. Also the Fed must prescribe limits on the credit exposure of both designated and interconnected bank holding companies to their affiliates. It may place limits on their use of short-term debt. To enable the Fed (and the FSOC) to stay current with and have a better sense of the affected companies’ ability to sustain losses, they must submit to stress tests done by the Fed.

There are additional size-driven requirements. One is aimed at taking the risk “temperature” of affected firms. All financial companies regulated primarily by a federal agency and with more than \$10 billion in assets must conduct self-stress tests. Another starts from the premise that it is too late in the game to start to figure out what do with a company when it starts to experience very serious problems. Thus, the Fed must make them submit what some have termed a “living will.” That is, they must map out a plan for the orderly resolution of the company in the event it experiences material financial distress. Similarly, at the time of such distress it is too late to start to figure out the impact on others of its reaching a near-“terminal” condition. So the companies must report to the Fed on their credit exposure to other designated companies and interconnected bank holding companies. The Act prescribes even stiffer and more dramatic measures than those just described when financial companies present especially serious problems. That is, the Fed may determine that a designated company or an interconnected bank holding company poses a “grave” threat to financial stability.

Should the FSOC concur in that determination by a two-thirds vote, the Fed could limit the company’s relationship through merger, acquisition, affiliation, and the like with other companies and restrict its ability to offer financial products. The Fed could go so far as to bar the company from engaging in certain activities or impose conditions on how it does so. It may even compel the company to sell assets or off-balance sheet items.

DISCUSSION

As noted, the FSOC has very limited decision-making authority in this area, namely by a two-thirds vote to officially label companies as designated companies. The labeling triggers certain significant mandatory actions and authorizes certain discretionary actions by the Fed that govern reporting by those companies on their condition, potential examination by the Fed, and constraints imposed by the Fed on their potentially risk-linked activities and behaviors, some possibly major ones. Other financial companies simply by virtue of their size (over \$50 billion in assets) are automatically – that is, without any FSOC action – subject to roughly the same requirements.

The flip side of the narrow role accorded to the FSOC by the Act is an immensely more powerful Fed. The Fed becomes the locus of authority to set standards for and monitor the behavior of statutorily or FSOC-designated companies as a primary means for averting systemic risk. But the Fed would also have the power to require dramatic structural and other changes in those companies. That the Fed might have such power is worthy of serious scrutiny.

Part of the need for such scrutiny relates to the Fed’s track record. Commentators have taken note of Fed failures concerning monetary policy, a role at the core of its mission. They also assert that the Federal Reserve fell short in other ways. They say it did not grasp the significance of changes in financial markets and the import of events that, combined, threatened U.S. financial stability and led to a financial crisis. They suggest that such failures were not just lapses on the part of prior Fed Chairman Alan Greenspan. Rather, they contend that the current and recently re-appointed chairman, Ben Bernanke, fell short as well. They argue that the Fed mistakenly stood by as companies within its oversight greatly increased the leverage they used. They say that the Fed allowed those companies to accumulate enormous quantities of securitized products that were both complex and risky. The Fed, they say, refused to use its regulatory power to rein in mortgage underwriters and lenders and protect consumers of financial services. They claim that even where the Fed might have lacked regulatory power it failed to speak out loudly and strongly for needed power to be granted and effectively exercised.

Other concerns relate to the Fed's organization, structure, and culture, and its relations with financial service industry providers and others. Some see the Fed's structure as undemocratic, interest-group driven, and laced with conflicts of interest because banks (which are regulated by the Fed) have a major role in its board of governors, its important Federal Open Market Committee, and regional Federal Reserve banks. This concern is reinforced insofar as people chosen to chair the Fed have had close relationships with the banking industry and, more generally, with the financial services industry. The Fed is said to have a culture of "secrecy," which in some measure might be warranted given its role in monetary policy. But secrecy poses problems for needed transparency with Congress, consumers, and investors, among others.

It has been noted that the Fed already has much to do, especially with monetary policy but also with bank oversight and the U.S. payments system. So the responsibilities the Act assigns to the Fed might well strain its capacity. More important, fears that financial service providers that are too large and too integrated might become too complex to be effectively managed (see discussion of corporate governance below) might apply here as well. An overburdened Fed could be distracted from or just not be able to keep up with its new responsibilities. It has been observed that any systematic risk regulator would be focused on the tasks of examination, accounting, and civil and criminal enforcement, activities that are not necessarily characteristic of Fed operations. In that connection, it has been suggested that in its new, multiple roles the Fed would need different kinds of leadership and skills—for example, those of lawyers—that its current predominantly economist staff does not have.

Certainly a number of points have been raised in favor of the Fed's playing the role mandated by the Act. The Fed clearly has primary responsibility for oversight of financial markets. So, arguably, there is some wisdom in its having oversight of financial companies that are key to the effective operation of those markets. Moreover, insofar as the Fed has an understanding of those firms through its role in monetary policy, it could be valuable in overseeing them with regard to matters of system-level risk. (At the same time, though, the Fed may have much more understanding of banks than of other financial companies, such as hedge fund and private equity fund managers.) Also, as suggested above, the ability to establish and enforce effective regulatory measures domestically must take into account legitimate concerns about global competition for the provision of financial services. This requires international engagement, collaboration, and coordination. The Fed, as one among many central

banks, has regularly consulted and worked with others at the international level—especially so during the recent financial crisis. That experience may have afforded it a level of knowledge, experience, and respect from other countries that no other agency currently has and any new agency would not readily be able to acquire.

Even if, other factors being equal, the Act's assignment of roles makes sense, some of these concerns might have been addressed had the Act taken them into account. For example, it has been suggested that the boards of directors of regional Federal Reserve banks be restructured. Bank representation could be reduced and representation overall broadened. Bank presidents could be subject, as they are not now, to Senate confirmation. Those responsible for examination of companies might report directly to the Fed rather than to the regional banks.

There is concern that the Federal Reserve is too independent from public accountability, including financial accountability. The Act appears to do little to change that. One thing it might have done is to limit the current practice of the Fed's funding itself through earnings from its operations. Fed expenditures, or expenditures for certain purposes, might have been made subject to the congressional appropriation process. Even prior to the crisis, critics had argued that at least the Fed's operations should be made more transparent to Congress. In the wake of the meltdown and the great power the Act accords the Fed, there is even more reason for greater transparency. However, the Act authorizes the Government Accountability Office (an arm of Congress) to audit only the Fed's actions only during the crisis and in relation to limited aspects of the Fed's operations. Disclosure of who has borrowed from the Fed and on what terms is required some time after the fact.

In all events, there was great concern about whether financial institutions were sufficiently capitalized to withstand the kinds of stresses experienced during the meltdown. There were calls to limit how leveraged big firms could be. Moreover, a number of commentators assert that the financial crisis was, at its core or at critical junctures, a liquidity crisis. But the Act does not establish new requirements for capital,

There is concern that the Federal Reserve is too independent from public accountability, including financial accountability. The Act appears to do little to change that.

liquidity, or leverage. Rather, it leaves to regulators what the requirements will be. So, for example, a broad-based amendment to the cap leverage at a 15 to 1 ratio of debt to equity was sharply narrowed down. It now can be applied only when the FSOC determines that the firm is a "grave threat"

to financial system stability. Similarly, it would appear that more aggressive actions on capital, leverage, and liquidity are triggered only when companies become designated, that is, when they are sufficiently large or have been deemed to pose an unacceptable risk to the financial system. (It should be noted that in the middle of September an international accord was reached in support of particular new capital standards, standards that have been criticized as inadequate to the task. In any case, individual action at the national level is required to implement the accord. Similar concerns are present concerning liquidity and other issues formulated in this way.)



PART II. RESOLVING (OR RESCUING?) COMPANIES WHOSE FAILURE POSES IMMINENT SYSTEMIC RISKS

BACKGROUND

The preceding section largely focused on provisions of the Act aimed at identifying systemic risks and acting to prevent them from becoming realized. It examined risks that are thought to be linked to financial companies of a particular size or type. Still, despite all efforts a financial company may become severely stressed and its failure may appear to threaten imminent systemic harm. Under those circumstances, a decision has to be made concerning what to do: Should government let it fail? Or let it fail, but only in a particular way?

The recent crisis made apparent how critical and controversial are the real-time and practical answers to these questions. On one hand, in early 2008, acting pursuant to special emergency powers it had under section 13(3) of the Federal Reserve Act, the Fed engineered the acquisition of the rapidly failing large investment bank Bear Stearns by JPMorgan Chase. The deal involved \$30 billion in short-term Fed loans to JPMorgan to make the purchase and \$29 billion in Fed guarantees against the toxic mortgage assets that Bear Stearns held. On the other hand, when Lehman was at the brink, the federal government refused to step in. Among the predominant reasons given was the claim that Lehman did not have the collateral needed by law for the Fed to lend to it. Some contend the real reasons were political, driven in part by sharp criticism of the supposed “bailout” of Bear Stearns. Despite that and shortly thereafter, the Fed again exercised its emergency authority to make \$85 billion in loans to the massive financial conglomerate AIG, which was at the brink. A few months before, under authority given a month earlier, the Treasury bought \$100 billion in preferred stock of the

massive government-sponsored housing finance corporations Fannie Mae and Freddie Mac, which were also at the brink, upping the amount to \$145 billion shortly thereafter. At the same time, the Fed bought \$1.6 trillion in debt and MBSs issued by Fannie Mae and Freddie Mac.

The federal government also provided other, indirect sources of funding for failing or threatened companies. The Federal Reserve Bank of New York, pursuant to authority granted to it by the Fed, allowed a number of large securities firms that were primary dealers to take what were in effect low-interest overnight loans to stave off threatened liquidity problems. The Fed later expanded the kinds of collateral such firms could offer to get such loans. The Fed took similar steps relative to those trading in the commercial paper market. These efforts were, in turn, linked to efforts to protect money market funds, major players in that market, from serious threat. The Fed gave additional financial lifelines to allow Goldman, Sachs & Co. and Morgan Stanley to convert to bank holding status, which gave them access to special low-interest borrowing facilities limited to companies with that status. Later, the Federal Deposit Insurance Corporation (FDIC), pursuant to authorization under the Fed’s emergency powers, agreed to guarantee unsecured senior debt of FDIC insured institutions, banks and thrifts, United States bank holding and financial holding companies, and certain U.S. savings and loan holding companies, and to broadly expand guarantees for deposits in institutions it insured beyond what the law had previously provided for.

All of these actions (and others) were largely prior to and apart from what was done pursuant to the TARP. Some suggest that the extremely precarious situation that was used to justify enactment of the TARP was so precarious because the government did not avert the failure of Lehman. Although the TARP was largely pitched as a means to stem the financial crisis by the purchase of toxic assets held by major financial companies, in practice much of it took the form of the Treasury’s funneling money into severely troubled banks by purchasing hundreds of billions of dollars in preferred stock.

All of these decisions have been highly controversial, rife with concern about government bailouts, poor timing, poor judgment, political favoritism, and the like.

In sum, the kinds of decisions demanded under the extreme circumstances described here raise important questions. If following the ostensible approach to Lehman – letting a financial company fail – is the choice, are otherwise available means for resolution such as bankruptcy appropriate to the task? Who should decide that any special resolution process is required? If a special process is mandated, who should manage it? What financial resources, among them equity, debt,

and guarantees, might be brought to bear in the resolution process? In addition, who would provide them? Under what circumstances? What losses should company stakeholders, among them shareholders and unsecured creditors, bear in any resolution process? Finally, if the costs of resolution (and management of the process) exceed the assets of the company, from whom should those expenses be recouped?

Whatever the particular agents and mechanisms chosen, the process for decision and execution needs to be timely, speedy, and orderly. For if it is not, the process in and of itself may engender such fear, uncertainty, and confusion as to cause or exacerbate systemic harm. Moreover, notwithstanding whatever general rules are formulated for making decisions, the decisions themselves will almost certainly be specific to particular companies and situations. Hence they will almost certainly be subjective – or at least be perceived as subjective – decisions on financial and other matters for which the stakes are very high. This subjectivity will likely have profound consequences for those affected by the decisions. The greatest challenge is to craft a scheme calculated to ensure that the public will have confidence in it. That confidence, in turn, depends on perceptions that the seeming threatened harm was real and that it has been averted. It also rests on a belief that the means used were not flawed by favoritism, abuse, or unnecessary cost to the public. Finally, it requires that if the means turn out to be flawed and the outcomes unsatisfactory, those who made the decisions be known and held accountable.

WHAT THE ACT DOES

The Act in effect acknowledges that despite regulation and supervision, and despite preventive and remedial action, financial companies may fail. It recognizes that how that failure is played out (or managed) is critical to minimizing the harm that the process can cause to the financial system. The Act addresses these issues in the following way: Should the FDIC or Fed recommend receivership, and by a two-thirds vote the boards of each should approve it, the Secretary of the Treasury, in consultation with the president, must decide whether to appoint the FDIC as receiver of a particular financial company. That decision must take into account many considerations, including the company's risk of default; the adverse impact of the company's failure or resolution by other legally available means; other available private means for averting that default; the impact of the proposed action on creditors, counterparties, and shareholders; the extent to which the action would avert the anticipated harmful effects of default; the extent of exercise of federal regulators' power to compel conversion of the company's debt obligations to equity obligations; and the company's status as a "financial

company." The decision of the secretary is subject to a very deferential standard of judicial review. Moreover, if a court does not rule within 24 hours of receipt of a petition challenging that decision, the receivership process must proceed.

If the secretary determines that the FDIC should be appointed receiver of a company (which then becomes what the Act calls a "covered company"), then it must be liquidated. The receivership decision is subject to only very limited review by the courts, and the courts are required to give great deference to the secretary.

The FDIC is directed to play the receivership role with financial stability as the paramount goal. But within that context the Act gives specific directions to the FDIC concerning how resolution affects various stakeholders in the company. The FDIC's costs as receiver can include those incurred through providing moneys, loans, and guarantees to the affected company. The Act gives claims for the recovery of such funds priority over all other claims. Shareholders stand last in line for recovery of any claims. Unsecured creditors can recover or suffer losses in accordance with priorities set forth in the Act. Management and board members the FDIC deems responsible for the company's condition must be removed. In addition, in response to dismay (or worse) about the costs to taxpayers of the government's decision to become a shareholder in failing companies such as Citigroup Inc. as part of the bailout process, the Act bars the FDIC from taking an equity interest or becoming a shareholder in the affected company.

The Act reflects other concerns about the immediate expense of the liquidation process. It makes clear that no taxpayer funds can be used to prevent the liquidation of the financial company. Also, any funds spent to liquidate the company must come from the assets of the company or from the financial sector as described below.

More particularly, subject to the secretary's approval of the FDIC's proposed liquidation plan, the FDIC can issue and draw upon obligations to be bought by the Treasury. However, the Treasury is barred from providing the funds unless there is a specific agreement and plan for ensuring that the Treasury is to be repaid within a specified time.

The moneys derived from the sale of the FDIC-issued securities are to be placed in an orderly liquidation fund (OLF). There are two ways the FDIC can collect moneys to repay its obligations. First, during the liquidation process, the FDIC has the power to make payments to certain claimants beyond what they would receive through the standard receivership process. The FDIC may also claw back those payments. It also

may claw back compensation from senior executives and directors who were “substantially responsible” for failure of the company from two years before the receivership. If fraud was involved, the FDIC may reach back further in time.

Second, if these sources are insufficient, the FDIC can impose risk-based assessments on interconnected bank holding companies and designated companies as well as other financial companies with assets equal to or greater than \$50 billion. The Act prescribes some factors the FDIC must take into account in making that assessment and leaves others to the FDIC’s discretion. Factors that must be considered are the economic conditions affecting financial companies, the extent of certain other financial regulatory risk-related assessments imposed by law on that company or its affiliates, the risks posed by the targeted company to the financial system and the extent to which the system would benefit from liquidation of the company, and the extent to which the company contributed to its own failure.

No doubt driven by concerns about how the Fed bailed out companies during the meltdown—perhaps the most prominent case in point being the Fed’s loans to prop up AIG—the Act cuts back on the power the Fed previously had to make emergency loans. Now it cannot exercise such power to make loans to any particular firm. Rather, the lending must be “broadly available” and only to provide liquidity to the financial system, not to prop up insolvent companies. Moreover, the Act also diminishes power the FDIC previously had to guarantee the debt of particular depository institutions in emergencies. Now it can do so only in conjunction with receivership or pursuant to a widely available program that has already been approved by Congress. It cannot provide equity.

DISCUSSION

Under the Act, the designation of receivership for a company is a death sentence: It means liquidation. As such, the Act’s receivership/liquidation provisions appear to send a strong message that firms that suffer severely and thereby pose a systemic threat will not be bailed out. They also starkly communicate the intent that taxpayers not pay, directly or indirectly, for failed companies. Finally, they send the message that various company stakeholders must take “haircuts” – that is, in relevant ways they must bear the burdens of the losses the company has incurred up to and through liquidation.

As discussed in part I above, when a company is in “grave” financial condition and presents a sufficient threat to the financial system, the Fed, with the FSOC’s concurrence, can

step in to compel changes to the operation of that company. However, the Act’s loan-related restrictions on the Fed and FDIC prevent any government infusion of funds into a company to keep it operating while the Fed seeks to diminish the threat it poses. Rather, if the changes that the Fed can compel a firm to make are not successful in stemming the deterioration in its condition, the sole next step is resolution in the form of compulsory liquidation.

The foregoing discussion raises several questions. One is whether it is important to make available an intermediate step short of receivership/liquidation. Another is whether it is realistic to expect that a receivership will be imposed or, if imposed, that it will be done in a meaningful way given the exigent circumstances.

On one hand, arguably the prospect of such draconian action might render a company or its stakeholders more amenable to taking timely and effective remedial action to avert liquidation. On the other, precisely because the consequences are so severe, the decision to take action would probably not be an easy one. For example, there might be concern that the mere prospect of drastic measures might in and of itself shake confidence in financial markets generally. Such a prospect might very well greatly unsettle domestic and perhaps international creditors, counterparties, and, in particular, others who have significant financial relationships with the company. There is the possibility that receivership of one company might drive others into it as well. Moreover, any decision about receivership would very likely be made in the face of opposing pressures from individual company, industry, political, and other institutional interests. Further, those interests might well play out with regard not only to whether and when resolution is triggered, but also to the nature of the resolution process itself. (To be sure, few concerns of this sort seem to have been raised over the many years during which the FDIC has been called upon to serve as receiver for depository banks within its authority. Nonetheless, the scale and scope of what the FDIC would be called upon to do under the Act and the high stakes involved might represent a quite different situation.)

The more problematic liquidation and receivership are as the sole means for minimizing the harm from a company’s distress, the more attractive having an intermediate step – substantial financial help by way of the Fed, the FDIC, the Treasury, or other means – might be. But with such an intermediate step, there is the problem of moral hazard. That is, will companies engage in riskier behavior if they know they will in all events have a financial lifeline? Also, there is the matter of who pays back the moneys being lent or the cost of the guarantee being provided. As noted, in the context of

receivership/liquidation, the Act puts the FDIC first in line to recover the costs it has incurred as receiver from the assets of the liquidated company. Whether the same could be done for pre-liquidation support is not clear.

Some would argue that rescue attempts should not be made by burdening the Fed's or FDIC's finances. Rather, the moneys could come from an assessment on financial companies as a matter of course—that is, in advance of emergency or crisis and not in connection with any particular rescue. The wisdom of doing so and possible alternatives are discussed below.

The difficulty is how to determine when some intermediate means of relieving a company's distress might be employed and who should make the determination. Given the Fed's and FDIC's lack of direct political accountability, giving them decision-making power individually or in combination would be a problem. Arguably the same mechanism used to trigger resolution could be employed here – that is, the secretary could make the determination after the FDIC, the Fed, or both have recommended the action. Neither the receivership-liquidation scenario nor the proposed intermediate process would involve the FSOC. Arguably, as evidenced by its role in deeming firms as designated companies or in "grave" condition, both of which warrant direct Fed intervention, it would seem that the FSOC has the expertise and resources to assess the imminence of company's failure, the prospects for averting that failure, the bearing of an infusion of moneys on those prospects, and the ramifications of any failure. In turn it would be in a position to make an informed recommendation about whether financial support from the Fed, FDIC, or both is warranted or whether resolution/liquidation is the only proper course.

However, as discussed, according to the Act, the FSOC has no role in the resolution/liquidation decision. Why? Perhaps time might be thought to be of the essence of such a decision and the FSOC, as a large body, is thought to be unable to reach a conclusion swiftly. Perhaps the decision might be thought to require focused responsibility and accountability, especially political accountability, which the FSOC does not have. Perhaps the special role accorded the FDIC in implementing the decision, the likely prior Fed intervention with the operation of the company, and the implications for both

agencies of doing so warrant their being key arbiters of what the resolution/liquidation decision is. All of these considerations would seem to apply to any decision to buttress companies with loans or loan guarantees.

As suggested above, the Act makes clear that all of the cost of liquidating a particular financial company must come from that company or from assessments on other financial companies. But it provides for assessments to be made only after the fact. This is a change from earlier versions of the legislation strongly supported by the current head of the FDIC, which would have established, before the fact, an assessment-based fund of as much as \$150 billion. In general, financial firms' ability to bear any assessment would be stronger prior

to any period of stress in the financial system. Practically speaking, it would seem that the time when a company is liquidated pursuant to the Act would be one of considerable stress on other financial companies. As a result there would likely be massive lobbying and great political pressure not to impose assessments on seemingly weakened companies. But if companies are not or cannot be made to pay, the likelihood of taxpayers' ultimately footing the bill, notwithstanding the language of the Act, would seem not inconsiderable.

It should be noted that some have pressed for reliance on the conventional bankruptcy process – or something close to it – as a more workable and better way to go. Among other things, these critics say that the process is well known and understood. They argue that potential parties to proceedings

would have well-informed expectations for how they would be treated and come out of the process. Perhaps not without warrant, parties may have more confidence in a process managed by an independent judiciary. The notion is also that judges are well experienced in dealing with the complex issues that might arise. However, bankruptcy seems most appealing primarily when the private interests of individual stakeholders are in play; the appeal fades when resolution of a financial company in default has serious implications for many other financial companies (and perhaps those in other industries), for the financial system, and perhaps even for the economy as a whole.

It appears that in earlier versions of the reform legislation, the secretary had to report to House and Senate committees on certain critical decisions he made, and the Government



Accountability Office, separately, had to review and report to Congress on them as well. The Act does require the FSOC to report to Congress its reasons for classifying a company as a designated company. There does not seem to be any similar provision in the event the FSOC determines that a threat posed by a company's "grave" condition warrants subjecting it to special oversight and control by the Fed. There also appears to be no similar provision for a report to Congress on the decision to place a company in receivership by the FDIC. To be sure, at any such time events would be swift moving and game changing actions would be taken. Hence it might be highly unlikely that Congress could play any appropriate and meaningful role in relation to any receivership/liquidation decision or process or perhaps even in the next prior ("grave" condition) stage. Nonetheless, a requirement to report in a timely fashion could have a salutary effect on decision making and implementation.

As noted, the Act insists that the companies and stakeholders, not taxpayers, bear the costs of the resolution process. Under current law, the FDIC already has authority not only to resolve troubled depository banks but also to charge all supervised banks fees, in advance of their failing, to cover the costs of FDIC operations, including its resolution operations. (It appears, though, there are limits to how much the FDIC may accumulate in advance. Of course, the continuing failure of more and more banks has required the FDIC to impose additional assessments.)

In any event, under the Act, the FDIC would have to pay interest on moneys it borrows from the Treasury in the course of its receivership duties. Presumably, those payments would deplete the orderly liquidation fund (OLF). It is not clear how the assets in the OLF would be invested and, hence, what income might be generated. Recovering moneys expended by the OLF would appear to be a complicated, time-consuming, untimely, and otherwise problematic after-the-fact process. The Act's criteria for assessment implicitly acknowledge that some, perhaps many, of the (larger) companies might have great problems of their own at the time any company goes into receivership. Those companies and their supporters would very likely argue for no, small, or delayed assessments. It is precisely at that point that the play of political and interest-group forces would be strongest. While the FDIC arguably would appear to have final authority for imposing assessments, it must consult with the Secretary of the Treasury and the Federal Reserve in specifying regulations to implement these provisions. As a result there may be an addition play of contending forces at a sensitive and difficult time.

Further, the rationale for barring assessments on companies with less than \$50 billion in consolidated assets is not clear. (In earlier versions of the reform legislation the figure was

\$10 billion.) The \$50 billion figure seems arbitrary in the first place. Moreover, the limitation appears to assume that companies of that size after resolution(s) have occurred would be the only ones that had ever been at risk of imposing costs on the OLF by having to undergo resolution. To be sure, the Fund in effect provides "insurance" to cover losses associated with the resolution process and, in that sense, those who might cause such losses should pay the "premiums." But it could be argued that all financial companies have a stake in a resolution process that helps avert system-wide harm that would likely affect them as well.

It should also be noted that the provisions for resolution apply only to domestic operations. But major financial companies have a global reach in terms of affiliates, activities, and their potential impact. There appears to be an absence of means – or even the prospect of acquiring the means – for operating resolutions mechanisms across borders.

The practical fact of the matter is that there is tremendous discretion built into the legislative prescription.

Perhaps not surprisingly, the focus of the Act is on the problem of firms deemed too big to fail. Some observers note that systemic problems might result from the failure of a large number of smaller companies. Certainly the FSOC has to attend to that possibility. But the diversity of practice across smaller, competing companies might operate against such common failure. At the same time, the possible losses of a smaller number of different creditors of many of those companies might be viewed differently than massive or concentrated losses from an individual or small group of companies.

It should be noted that among the factors in the meltdown was financial companies' lack of capital to buttress themselves in the face of distressed conditions, including runs. Part of the answer is, of course, greater capital requirements up front. Too high capital requirements are resisted by companies because of the cost of fallow capital. In response, one proposal would require a financial company to maintain a minimum amount of long-term hybrid debt that is convertible to equity – referred to by some as "contingent capital" – if and when that company fails to meet prudential standards, or if and when the relevant authority determines that threats to the U.S. financial system make such a conversion necessary. It is not clear whether such an approach was seriously considered. The Act provides only that the FSOC is to study the matter.



PART III. ACROSS-THE-BOARD LIMITS ON COMPANY SIZE, STRUCTURES, OR OPERATIONS

BACKGROUND

As noted, many of the Act's provisions are largely concerned with identifying financial companies whose troubles might cause systemic problems. They also relate to imposing limits on and special oversight of companies when they do run into trouble. And they pertain to taking dramatic action – resolution/liquidation – when the distress is severe and harm to the financial system imminent. By contrast, there appear to be few provisions concerned with the actual or potential harm directly associated with the very size or complexity of companies as well as the attendant impacts on markets in which they might dominate. There are few provisions specifically addressed to the internal structure of financial companies and the resulting consequences for the riskiness of their operations. As described in Part VI below, some provisions in the Act related to executive compensation and accountability to shareholders, which are applicable to all corporations, might bear upon risk taking, including risk taking by financial companies.

For example, as noted below, some contend that firms – perhaps especially financial companies – that are too large and complex might be less effective in identifying and managing the risks they face. Yet others assert that there could be serious and hard-to-prevent conflicts of interest among the diverse activities encompassed by these enormous organizations. Still others argue that by virtue of their size these corporations have the ability to thwart competition and exercise inordinate political influence. For some critics the issue is the unwarranted and ultimately harmful influence such companies can exercise in government and politics. Thus, at one end, some with powerful and respected voices here and in the United Kingdom have been heard to insist that breaking up large financial conglomerates is both important and practicable. Others have pressed to bar firms from engaging in certain activities. Some less dramatic prescriptions have involved compelling the separation of certain functions within firms or imposing greater capital and other costs for certain activities.

WHAT THE ACT DOES

Among the few provisions of this sort included in the Act are

ones said to embody a version of the Volcker Rule. The rule is named after its most prominent advocate, Paul Volcker, who was chairman of the Fed just before Alan Greenspan. Currently Volcker heads the President's Economic Recovery Advisory Board. Broadly stated, the provisions are geared to establishing a sharper boundary between banking institutions' investment and wholesale banking activities. It is a barrier erected in considerable measure by the Glass-Steagall Act, enacted in the throes of the Depression. That barrier has been progressively weakened over the years. What was left was largely demolished by legislation (the Financial Services Act of 1999) supported by the Clinton administration in the decade prior to the meltdown.

The Dodd-Frank Act's provisions in the area of boundaries are twofold. One set constrains bank holding and financial services holding companies from engaging in proprietary trading. The other limits the extent to which such companies may own, invest in, or sponsor private equity funds or hedge funds. The latter provisions are discussed below, in the section on private investment pools.

Proprietary trading is trading for a firm's own account, not for or on behalf of its customers. The notion is that this kind of trading is more speculative and driven by the pursuit of making as much money as possible. The issue is not that such activity is necessarily seen as bad. Rather, it is that the special, critical role banks play in the financial system might be undermined by such activity. As discussed Part I, among other things, banks provide credit to small and large businesses and to consumers. They are central to how individuals and businesses make payments. Harm to either role would damage the financial system and economy. Accordingly, government has taken special steps to protect those roles, one of which is deposit insurance. Such insurance is, of course, a critical benefit to individual depositors. But the confidence it gives depositors is even more important in stemming runs on banks in the face of distress. Banks gain from that confidence and in other ways as insured depository institutions. For example, they have access to lending by the Fed that other financial companies do not. These protections and benefits to banks help them get capital more cheaply than non-bank competitors.

The concern about proprietary trading, then, is several-fold. When banks engage in proprietary trading, according to some critics, they abuse the benefits and privileges they receive by virtue of their special status. Proprietary trading is also potentially very risky. Some contend that it is fraught with conflicts of interest, which poses other risks. In effect, proprietary trading imposes risks on a system that was not designed to handle or absorb it. It places the system more at risk and adds potential significant costs to those who work

with that system, to those who rely on it, and perhaps ultimately to taxpayers.

DISCUSSION

The Act's proprietary trading restrictions bar insured depository institutions from proprietary trading in a wide range of financial instruments, specifically any securities, derivatives, commodity futures contracts, and options on those financial instruments. The restrictions extend to such other instruments as relevant federal banking regulators, the SEC, or the CFTC might specify. In the language of the Act, proprietary trading means acting as the principal for the affected institutions in the purchase, sale, or other acquisition or disposition of one or more of the specified kinds of instruments.

However, the language of the Act substantially limits the reach of the restrictions. Some argue that the originally strict definition of proprietary trading was diluted in the final legislation. They contend that the restrictions reach only "near-term" transactions entered into principally to make a profit from a sale in the near future in light of short-term price changes, although regulators can widen the definition. Moreover, the Act affirmatively authorizes certain trading transactions, among them ones made in connection with underwriting or market-making purposes so long as the activity is commensurate with the demand for those services. A company "makes a market" when it makes a commitment to buy or sell a security at publicly quoted prices in order to maintain a firm bid and ask price in that security. A company acts as an underwriter for a new security offered to the public when it guarantees to the issuer of the security that the issuer will receive at least a certain price for a specified number of the securities. The underwriter is paid a fee for this service that reflects, among other things, the risk that the public will not buy the minimum number of securities at the minimum required price and the underwriter will have to make up the difference. Among the other exceptions are provisions that allow certain risk-hedging activities that relate to the institutions' holdings. In addition, regulators are authorized to allow further exceptions insofar as they promote the safety and soundness of the institutions and the financial stability of the United States.

In sum, the Act does not seem to re-establish a barrier between banking institutions' investment and wholesale banking activities. Rather, it creates obstacles to linking these activities, which vary according to the company affected. On one hand, the Act does seemingly prevent large (previously only) investment banks such as Goldman Sachs from engaging in proprietary trading and having large stakes in hedge funds and private equity funds. However, there is doubt about what those banks might do under the cover of what

would otherwise be termed non-proprietary trading. There is concern even about the ostensibly more modest stake that these banks might have in arguably riskier financial activities. Indeed, within a matter of days after passage of the Act two senators wrote to the chairs of the Fed, SEC, CFTC, and FDIC, and to the Comptroller of the Currency, expressing concern that firms might evade the proprietary trading restrictions under the cover of market-making activities and perhaps through relationships with hedge funds and private equity funds (as nominally limited by the Act and described below). Others have expressed concern that the Volcker Rule provisions are not a priority for the Secretary of the Treasury, who in is in a strong position to influence, though not supplant, the judgments of those regulators.



PART IV. DERIVATIVES

BACKGROUND

Considerable attention has been devoted to the role of derivatives, which is said to have been important in the recent financial crisis. Derivatives have also been associated with other crisis or near-crisis events in the past, including the failure of the Barings Bank in 1995, the collapse of the hedge fund Long-Term Capital Management in 1998, and the Enron bankruptcy in 2001. However, there are divergent views about the precise significance of the role played by derivatives.

Derivatives span innumerable, widely varied, and sometimes very complex instruments. As a general matter, a derivative is a financial instrument whose value is linked to or "derived" from an asset, index, event, value, or condition (commonly referred to as the "underlying"). The agreement on which the derivative is based involves an exchange of cash or assets based on the behavior of or a change in connection with the underlying. It might involve a promise to buy the underlying at a specified price (a "future"). It might afford the opportunity but no obligation to do so (an "option"). It might involve an agreement to exchange in the future cash flows from two different underlyings (a "swap"). Underlyings, which are potentially almost innumerable, can include assets such as stocks, commodities (from wheat to hog bellies to oil), and currencies as well as the condition of the credit of a variety of instruments.

Financial companies (including banks and hedge funds) have created an enormous and sophisticated market for derivatives. But to a considerable degree the transactions for deriv-

atives are not arranged through public exchanges (like stock exchanges) or fully completed (“cleared”) through those exchanges or other intermediaries. Rather, deals are privately worked out directly between two private parties. As a result, relatively little is known about these derivatives – termed over-the-counter (OTC) derivatives. Also, the kind of publicly available information that traders get from public exchanges to accurately or fairly set prices is not available for those who buy and sell OTC derivatives. Correspondingly, data on the size of individual buyer and seller positions in those derivatives is skimpy. There is uncertainty about the level of outstanding contracts overall. As discussed below, stresses in financial markets can be exacerbated by such lack of knowledge or uncertainty.

For example, according to the Bank for International Settlements, as of December 2007 there were \$595 trillion in OTC derivatives outstanding. To be sure, many of the deals for derivatives are interlocking. So, for example, Firm 2 may sell protection to Firm 1 against the risk of failure to pay on the debt of a particular company. But then Firm 2 may buy from Firm 3 protection against that same risk. There may be many such links. The links may even result in a circle of relationships. Roughly speaking, when netted out, the “market” or “economic value” of all of these transactions was still enormous – about \$15.8 trillion – large even in relation to existing financial assets. By far the bulk of such derivatives have been interest rate contracts – mainly interest rate swaps, in which parties exchange the right to interest payments from different interest-bearing securities. These had a notional value of \$458 trillion and a gross market value of \$7.2 trillion.

The potential impact of derivative markets on financial markets is even greater for several other reasons. Derivatives are often leveraged. A small movement in the underlying value can cause a large difference in the value of the derivative. As suggested, derivatives can be used by investors to hedge risks in connection with stocks, commodities, or other underlyings in which they have a financial stake. But even investors who have no such financial stake can still employ derivatives to speculate and to make a profit from changes in value of the underlying. Also, the nature of the transaction and the relationship between the parties may require that derivatives sellers post collateral to give buyers protection against sellers’ failing to meet their obligations.

Insofar as reports about the financial crisis have implicated derivatives, they appear to have focused overwhelmingly on credit default swaps (CDSs). In the case of CDSs, typically the seller promises to pay the buyer a certain sum if payment due on a credit instrument, like a bond or loan, is not made. However, in some cases the CDS seller’s obligation might be triggered by a bankruptcy, the downgrade of a credit rating,

or some other event related to the quality of credit. In December 2007, credit default swaps were the third largest category of derivatives with \$58 trillion in notional value and, after netting out, \$2 trillion in gross market value.

Evidence strongly suggests that CDSs played a harmful role the crisis in a number of respects. In other cases, their role is not entirely clear or definitive. CDSs are frequently associated with events that led up to the federal government bailout of a global company and major insurer, American International Group, Inc. (AIG) as a result of the CDSs it sold. In that situation, the swaps seem to have been written on subprime residential mortgage-backed securities (RMBSs). RMBSs

Evidence strongly suggests that CDSs played a harmful role the crisis in a number of respects.

are securities whose cash flow was backed by payments on home mortgages, home-equity loans, subprime mortgages, or other residential debt. AIG is reported to have issued \$440 billion worth of contracts of this sort. (More specifically and importantly, AIG’s small, United Kingdom-based Financial Products Corporation appears to have written most of those swaps.) According to one estimate, \$52 billion of \$173.3 billion in commitments by AIG were associated with CDSs written on subprime RMBSs.

When the perceived credit quality of RMBSs dropped in connection with deterioration in the housing market, this triggered the right on the part of CDS purchasers to demand capital from AIG to support its promises. These were demands that AIG had simply not equipped itself to meet. It had not set aside reserves to meet the contingencies as it would have been required to and did for its property, casualty, and other lines of insurance. Unlike other major players in the CDS market, AIG had not bought CDSs as a hedge against problems with the CDSs it had sold. Moreover, those who had bought AIG CDSs demanded that AIG post more collateral, which further undermined AIG’s financial position. The collapse of AIG, a firm with consolidated assets in excess of a trillion dollars, was a huge problem in itself for stakeholders in the company. But at the time of its impending collapse, the prospect for severe losses appeared to extend far beyond AIG. AIG was perceived to have been linked in significant but opaque ways with many of the world’s largest banks, investment funds, and insurance companies, who were purchasers of the CDSs sold by AIG. The result was greatly increased uncertainty among key financial market players that those firms might be at risk if AIG were to go bankrupt. There was also tremendous pressure for a government bailout.

Similar behavior by the so-called monoline insurance companies – which over the years migrated from, among other things, their major role in providing insurance guarantees for municipal securities – created analogous problems, though on a smaller scale. It also caused serious disruptions to the municipal securities market.

Central to the crisis were, of course, the cataclysmic failures of investment banks Bear Stearns and Lehman, which were among the major dealers in derivatives. For example, as of November 30, 2007, Bear's position in derivatives contracts was reported to be in excess of \$13 trillion. (They had an economic value of less than \$300 billion.) By contrast, Bear had assets in the range of only \$80 billion. Bear's problems had their immediate origins in the failure of two of its hedge funds as a result of losses from its investments in mortgage-backed securities and CDOs. But the U.S. Treasury's frantic, last-minute action (along with the Federal Reserve) to avert a Bear bankruptcy by engineering and supporting its sale to JPMorgan arose from other concerns, among which was the fear that banks and other institutions that had bought credit protection from Bear would, given the uncertainty of the strength of that protection, have to report large losses. According to current Secretary of the Treasury Timothy Geithner, there was the prospect of such institutions rushing to liquidate the collateral they held and buy substitute protection in already fragile markets. The Treasury also feared that it would take years to figure out what risk various players bore and the losses they might have to take.

By virtue of its size and derivatives book, Lehman would seem to have posed comparable if not greater risks. However, the Fed and Treasury chose not to head off its bankruptcy, the largest in U.S. history. Some commentators say that Lehman's derivatives book was not a cause of its failure and replacement of Lehman by other dealers as counterparties went smoothly. However, according to one report, Lehman's derivatives book of \$730 billion near the time of bankruptcy involved about 900,000 derivatives contracts, over which there have been major and extended legal disputes. More important, it is essential to distinguish between the CDSs Lehman wrote and sold (or bought) from those that were written on Lehman and, for that matter, on Bear Stearns. Thus, there has been some suggestion that Lehman's failure was caused in part by traders who held CDS positions calculated to enable them to profit from their short positions in the company's

stock held in the event of a sharp drop in the price.

Moreover, it appears that CDSs played a different kind of role in the financial crisis by virtue of collateralized debt obligations (CDOs) that were issued. While CDSs were bought to hedge risks associated with CDOs (and AIG sold many for that purpose), it has been suggested that such CDSs were not a large portion of the overall CDS market. However, CDSs were important to expansion of the CDO market and, more particularly, of the market for so-called synthetic CDOs. By definition, synthetic CDOs do not involve purchase of or direct exposure to the debt securities that the CDOs represent. Rather, they entail entering into purchases of a combination of derivatives, most frequently CDSs, which ostensibly create identical but synthetic exposure to those securities. Unlike with traditional (sometimes termed "cash flow") CDOs, the notional amount of synthetic CDOs is not limited by the size of any particular pool of reference securities. It appears that hundreds of billions of synthetic CDOs were issued in 2007, far more than in 2004. Moreover, it seems that CDSs have been used as a means to circumvent concerns about and limits on short sales, concerns that were acute during the crisis.

In sum, then, derivatives were heavily implicated in the origins and playing out of the financial crisis. However, so far it is only CDSs that have been singled out as being significant to the way events unfolded. This is not to say that there are not other concerns about CDSs, other derivatives, or derivatives markets more generally. For example, there were already long-running problems with the adequacy of the clearing and settlement of derivatives trades that were of relevance to the unfolding of the financial crisis. There are suggestions



about the complexity of valuation of derivatives and financial instruments reliant on them (like synthetic CDOs) that have import for how derivative and related markets operate, the ability to fairly represent and evaluate companies' balance sheets, and so on. There is the reality that markets in which derivatives are sold were and are highly concentrated and dominated by a small group of players. Some players, among them JPMorgan Chase, Goldman Sachs, Citigroup, and Bank of America, have so far survived the crisis by virtue of direct or indirect federal largesse. At least two others, Bear Stearns and Lehman, collapsed in the crisis. There are concerns

that while the use of derivatives to transfer the risk that stakeholders bear in relation to the underlying is a virtue, it has serious vices as well. More particularly, stakeholders' having hedged their risks with respect to, for example, under-

lying corporate stock has or may create perverse incentives that may deter them from acting to ensure the vitality and success of the corporation. In turn, and more generally, there are fears that whatever the claimed value of derivatives for improving price formation or increasing market liquidity, the harm caused by their being used as a means for speculation – especially insofar as that speculation might be associated with the use of leverage – might be significant.

The preceding paragraphs seem to suggest a relatively narrow regulatory agenda, one focused on CDSs. However, the larger historical and contextual factors cited at the outset of this section and the lack of a systematic and deep federal inquiry into the origins and playing out of the financial crisis, along with one other major consideration, point to a broader regulatory agenda. That other consideration is the inability of government and private players at all, but especially at critical times, to have or gain information that might, in and of itself, have dampened the downward spiral and might perhaps have made possible more timely and effective action. The fact that there was such a gap was tied to earlier political and other failures, among them the associated strong opposition of then Fed Chairman Alan Greenspan, then Secretary of the Treasury Lawrence Summers, and then Senator Phil Gramm to the effort by then Commodity Futures Trading Commission Chair Brooksley Born to bring derivatives within the jurisdiction of her agency. This opposition was followed by the congressionally mandated bar, championed by Gramm but supported by many others, to federal regulation of OTC derivatives, followed in turn by legislation that overturned decades of prior law which had barred enforcement of “naked” derivatives.

In light of the foregoing, the goals for regulatory reform concerning these issues are several-fold. First, the government must have information about OTC market activity, risk concentrations, and connections among firms, which is essential to understanding the operation and impact of the market as the basis for setting standards, enforcing rules, and taking other timely and effective action. To the extent practicable, derivatives must be traded in trading venues and information be available to market participants to spur price formation, increase liquidity, reduce unwarranted information asymmetries, and avert or minimize oligopolistic control of the market. Reforms have to ensure that by virtue of the size and nature of the market positions they hold, or seek, and their financial and other attributes, individual market makers and buyers and sellers of protection, or groups of the same, do not cause unwarranted harm to other individual market participants, the market as a whole, or other financial markets and institutions that are linked to or rely on OTC markets. Reforms have to ensure that unsophisticated parties are not harmed by inappropriate marketing practices. They should restrict or bar the use of derivatives if their ostensible benefits

to individual market participants and others are outweighed by harm they may cause to financial markets, financial institutions, and those dependent on them.

WHAT THE ACT DOES

The Act addresses these issues or concerns in a number of ways but falls short in others.

First, The CFTC and SEC are given authority to regulate a broad range of, though not all, OTC derivatives, referred to as “swaps” and “security-based swaps” respectively, where previously these bodies had little authority (having been legislatively stripped of such authority in 2000).

Second, many though not all OTC derivatives will be subject to new rules. In earlier drafts of the legislation so-called standardized swaps were subject to clearing because those were arguably ones for which clearing requirements were most appropriate. The Act contains no reference to standardized swaps. Along the same lines, earlier versions provided that if an organization accepted a swap for clearing, then it had to be cleared. Such a requirement is not obvious on the face of the Act. Rather, it is left to the CFTC and SEC to determine which OTC derivatives should be cleared, based on a set of specified criteria. These range from the notional amount of such derivatives that are outstanding, their liquidity, and the availability of price information, to the institutional framework available for clearing them to effects on competition and systemic risk.

So when all is said and done, not all OTC derivatives will have to be cleared for this reason alone. But in addition, the Act also makes an exception for “end-users,” freeing them from clearing requirements. Would-be end-users range from airlines concerned about fluctuating oil prices to farmers worried about sharp changes in the price at which wheat is sold. There appears to be some uncertainty as to whether they are also exempt from margin requirements applicable to other uncleared swaps. The end-user exception is supposed to be geared to not imposing undue burdens on those who use derivatives to hedge risks rather than for speculative purposes. Some critics are fearful that the end-user exception will become a loophole that frees many more transactions from clearing and margin requirements (even though the legislation accords the CFTC and SEC power to avert such abuse). In addition, regulators have the authority to exempt foreign exchange swaps and forwards from trading and clearing requirements (though they are subject to certain conduct and reporting requirements).

Third, derivatives subject to clearing requirements must be traded on either an exchange or a “swap execution facility”

(namely, a vehicle by which multiple participants can make offers to buy or sell bids from others and the transactions can be executed).

Fourth, data, including pricing information on both cleared and uncleared derivative transactions, must be collected through clearinghouses or “swap repositories” registered with the CFTC and SEC, and made available to those agencies. If a repository does not accept the information, it must be reported directly to the agencies and made publicly available on a real-time basis.

Fifth, certain key derivative market players – termed “swap dealers” and “major swap participants” – must satisfy a range of requirements. The definitions of both are complicated and the Act provides for exceptions. Broadly speaking, swap dealers are those who hold themselves out as such, make markets in swaps, regularly enter into swap transactions, or are now in the trade as dealers or market makers. A major swap participant is defined in terms of the extent to which it holds non-hedging derivative positions, how leveraged it is, or how much risk its counterparty exposure poses for the U.S. financial system. (Hedge funds and even public companies with large swap portfolios appear to fall within this definition.) Swap dealers and participants must register with the CFTC or SEC, as the case may be.

Further, pursuant to regulation, dealers and participants must meet capital and margin (as well as record keeping) requirements. For some these requirements are important because they reduce the risks associated with affected transactions. For others they are beneficial because the requirements are likely to increase the cost of the derivatives transactions upon which certain risky investment deals rely. As a result, fewer such deals will be entered into. Dealers and major swap participants are also required to meet prescribed business conduct standards, including ones relating to disclosure and conflicts of interest.

Dealers and participants must assume a special responsibility to exercise care when they provide advice to or enter into transactions with employee benefit or governmental plans as defined in the Employee Retirement Income Security Act (ERISA), endowments, and state and local governments. For example, if they act as advisors to such a plan, those entities must have a reasonable basis to believe that they have an independent representative advising them who meets certain requirements. If they act as non-advisor counterparties, they must determine that the plan is advised by an ERISA fiduciary.

Sixth, the Act requires the CFTC to set position limits on individuals or groups of individuals for the overall number or amount of derivative contracts based on an underlying com-

modity. It must establish similar limits on options or futures related to particular commodities or equivalent instruments not held for hedging purposes. The SEC is authorized to set position limits for derivatives within its purview.

Margin and capital requirements will be set by regulators. Moreover, regulators have the authority to allow non-cash collateral to meet margin requirements.

DISCUSSION

While the Act offers some prospect of reining in the risks derivatives may pose, the devil may be in both the details and the exceptions of its provisions.

For example, there is concern about the strength of capital and margin requirements for swap dealers and major swap participants because those requirements are to be set by regulations of the CFTC, SEC, or other agencies, depending upon who the dealers and participants are. Again, the Act authorizes, though it does not require, the CFTC and the SEC to limit total swaps to reduce speculation, avert market manipulation, and prevent liquidity squeezes in the derivatives market, among other things.

As noted earlier, the Act embodies something like the Volcker Rule, barring insured depository institutions (and their affiliates) from engaging in “proprietary trading,” subject to certain exceptions. There are fears that affected institutions might change their practice to effectively trade for their own

While the Act offers some prospect of reining in the risks derivatives may pose, the devil may be in both the details and the exceptions of its provisions.

account yet avoid falling under the proprietary trading definition. Moreover, there are similar worries that the exceptions – that relate to trading those institutions do in connection with making markets or underwriting the sale of securities – might end up swallowing the rule. Moreover, a number of the described requirements do not go into effect immediately. Not only is implementation delayed until after a specified period of study but the Fed has authority to delay it further. Thus, the process might stretch out years and the requirements be diluted. The delay, of course, offers the occasion for intensive lobbying for legislation, further hobbling implementation or barring it completely.

Legislative efforts to force commercial banks to move out their derivatives units failed in not inconsiderable measure.

Banks were allowed to retain most of their derivatives business, while what remains has to be placed in separate subsidiaries with higher capital requirements. What impact that will have is not clear. So it appears that large banks will still dominate the derivatives markets. The CFTC and SEC must, within a matter of months, decide the extent to which information on historical (as contrasted with post-enactment) trades must be reported. While standardized swaps are subject to the regime of clearing and trading on exchanges, it is not clear how many will escape as non-standardized. Moreover, while non-standardized ones might well be subject to higher capital charges, what they will be and what their effect will be is not evident.



Despite great concern about naked swaps, the Act does not bar or limit them; indeed, it does not bar or limit any kind of derivative. In some quarters there is a strongly held view that derivatives are important to better price discovery and markets that are more liquid. However, as noted above, others see them as a means to greatly increase speculation and as a tool to evade regulations and tax laws. Indeed, these concerns warranted the barring by law of certain derivative-type transactions in the absence of a party's having a real, pre-existing risk against which protection was needed. At minimum, before staying their hand constraining the use of derivatives, legislators should have heard substantial and convincing evidence that the putative benefits of such swaps significantly outweigh the harm they may directly or indirectly cause.

The Act addresses in several different ways the need for information about the functioning of derivatives markets. Provision is made for record keeping and reporting to the CFTC and/or the SEC on transactions by derivatives clearing organizations and by so-called "swap depositories" (which must also be registered) where swaps are traded through those organizations, or by the counterparties themselves where those organizations are not used. It also requires release to the public by the CFTC, clearing organizations, or swap repositories, as the case may be, of "aggregate data on swap trading volumes and positions" (though without "disclos[ing]

Whether the clearinghouses and facilities Congress has mandated for the trading of many derivatives achieve the goal of price transparency depends on critical decisions about how these entities are to be structured.

the business transactions or market positions of any person").

The legislation further addresses the need for information and, importantly, concerns about risk, by requiring swap dealers and major swap participants to be registered and subjecting them (through regulation) to requirements pertaining to, among other things, reporting and record keeping, minimum capital and margin, business conduct, position limits, disclosure, and conflicts of interest.

In addition, the Act addresses conflicts over the reach of CFTC and SEC jurisdiction and concerns about inconsistent regulation across agencies and/or products by clarifying that reach and spurring joint agency action to promulgate regulations that are uniform and treat functionally or economically equivalent products similarly.

Moreover, it has been suggested that the complexity of some OTC derivatives (and the inability to correctly price them), combined with the lack of sufficient transaction flow for others, makes it impracticable or economically unfeasible for them to be traded through clearinghouses. (Indeed, one commentator argues that although probably "extinct" now, the CDSs on subprime RMBSs that played an important role in the crisis were probably not unsuitable for such clearing.)

Earlier versions of the Act compelled banks to spin off their derivatives business to a separately capitalized subsidiary. However, amendments allowed them stay in the business for certain kinds of arguably less volatile derivatives, for example, those involving foreign currencies, interest rates, government securities, and the like.

As noted, various key players, including bank holding companies, certain non-bank financial companies, swap dealers, and major swap participants, have substantial financial stakes in clearing and trading facilities, a fact that raises concerns about conflicts of interest. The Act addresses these concerns only to the extent that the CFTC and SEC are left to address them.

Whether the clearinghouses and facilities Congress has mandated for the trading of many derivatives achieve the goal of price transparency depends on critical de-

cisions about how these entities are to be structured. It also depends upon the role of those who own and participate in the clearinghouses and facilities. Currently these entities are dominated by a small number of large companies. While earlier versions of the legislation specified limits on that role, the Act leaves it to the CFTC to determine what should be done.

Lastly, the “What the Act Does” part of this section noted what might be the only one of the Act’s provisions that has a specific application to employee benefit plans. It pertains to swap dealers’ and major swap participants’ obligations to assure that in transactions with such parties, the parties have independent representatives. Some have expressed concern that such a requirement might be unnecessarily burdensome for dealers and participants, resulting in making it more costly and perhaps more difficult to make appropriate and effective use of derivatives. The arguments on that score cannot be canvassed here. Suffice it to say that the concerns that animate the provisions are legitimate but with informed pension fund vigilance a workable interpretation and application of the law can be found. In this regard, it should be observed that both the SEC and the CFTC have general authority to establish standards and requirements for the protection of investment in furtherance of the purposes of the Act.



PART V. PRIVATE INVESTMENT POOLS: HEDGE FUNDS AND PRIVATE EQUITY FUNDS

BACKGROUND

Privately owned investment funds – especially private equity funds and hedge funds – have grown enormously in recent years. (Some writers include venture capital funds under the term private equity funds; others do not. For purposes of this discussion, they are included unless otherwise indicated.)

As a general matter, supporters view hedge funds as being able to deliver outsize returns. Or they contend that the funds’ returns are not correlated with those of other asset classes. In the past, such exceptional performance would have served what were originally wealthy individual investors. In recent years, such would-be rewards have come within the reach of the ultimate beneficiaries of endowments and pension funds, among other institutional investors. Institutional investors have therefore become, in the aggregate, major investors in hedge funds. Proponents also make other claims about hedge funds’ promoting market efficiency and

increasing liquidity. It is also said that in some instances, hedge funds play a constructive or positive role in struggles over the governance and management of corporations in which they have invested.

At the same time, though, a number of issues about hedge funds have been raised. Some are broad-gauge. Others predate or are immediately linked to the financial meltdown. Yet others are more narrowly focused and tied to critical events during the financial crisis.

In recent months hedge funds have had roughly \$1.5 trillion under management. Before the meltdown they have managed nearly \$2 trillion in assets. Thus, they are major financial market players for that reason alone. Hedge funds engage in strategies that typically involve active management of a liquid portfolio. The funds often utilize short selling and leverage. Because hedge funds often are leading-edge investors, their influence on others may be great. Hence, their impact—perhaps positive but also potentially negative—can be that much greater. Many hedge funds are very active (and often leveraged) traders. For example, they are reported to engage in a substantial fraction of the trading on the New York Stock Exchange. They may play an important role in fixed-income markets and derivatives markets. Again, they may carry out most of the trading for derivatives with high-yield ratings and for distressed debt. They are said to have been major players in the market for the kinds of mortgage-backed securities, asset-backed securities, and CDOs that were central to the financial meltdown. In all events, investment banks and brokers appear to earn very large commissions and fees from lending to and trading for hedge funds. So the relationships between them and hedge funds are important to each.

It has been suggested that hedge funds were among the primary buyers and sellers of CDSs, which, as discussed, were important to how the financial crisis unfolded. They also built up large positions in derivatives at little expense. Hedge funds’ use of those positions and their impact is uncertain. There are mixed claims or reports about hedge funds as shareholders. There are concerns about their use of short positions and other strategies to exercise great influence over corporate management. There are thought to be problems with hedge funds’ practice of both buying shares and selling them short, giving them incentives different from those of other shareholders. As noted in the section on corporate governance, depending upon the conflicting positions they hold in companies, hedge funds have been criticized as acting as “empty voters.” That is, they become voters who have no real economic stake in the company and use their votes to achieve their narrow aims possibly to the detriment of the company and other shareholders. There have been more dramatic

contentions about a link between hedge funds and insider trading in mergers and acquisitions (M&A) and other transactions. However, it is not clear the extent to which those contentions should be credited. More generally, questions about conflicts of interest have been raised in connection with the fact that, as noted, investment banks and brokers earn large sums from activities for or on behalf of hedge funds. These activities include the activities referred to but also the provision of appropriately structured derivatives, stock lending to enable short sales, clearing and settlement, and so on. In the case of individual firms, these activities appear to have produced a substantial fraction of those firms' profits.

As a general matter, hedge funds are said to be distinct from other investment vehicles by reason of their use of leverage, their taking of short positions, and their capacity to move quickly. These attributes may be seen as virtues by those rewarded by hedge fund investments. But they may, as well, be thought to be vices not only from the perspective of other investors but, especially important for this discussion, from the perspective of financial markets overall.

There are real concerns that those vices were manifest in the financial crisis. For example, critics have contended that hedge fund deleveraging imposed stress on financial markets during the crisis. Some might suggest that excessive hedge fund leverage might be constrained by the markets, namely by the general and prime brokers who lend to them and others who trade with them, rather than by regulation. But it is not clear whether such constraints are effective. That is, the effectiveness requires that relevant market players have the necessary information and expertise. It is also not obvious whether, under current circumstances, those players are in fact in a position to obtain needed information. Similarly, it is not evident that investors necessarily have the sophistication that is one important justification for weak hedge fund regulation. In this regard, note has been taken of the dramatic 1998 failure of the Long-Term Capital Management (LCTM) hedge fund, in which many ostensibly knowledgeable people and institutions had invested. LCTM was leveraged in the neighborhood of 25 to 1 and reportedly had a notional off-balance sheet position in interest rate derivatives of over \$1 trillion. (In fairness, it should be noted that according to one estimate, average hedge fund leverage ratio has been 3 to 1, and there are industry contentions that most recently it has declined. However, averages are averages: Leverage ratios seem to vary quite markedly according to investment strategy.) The impending collapse of the LCTM fund, which held well over \$100 billion in assets, was soon seen as such a threat to the financial system that the Fed had to intervene and corral Wall Street players to ensure that the threat wasn't realized.

Leading up to the current crisis, hedge funds invested in the

equity tranches of the CDOs and also used CDOs as collateral to borrow from prime brokers and others to make acquisitions. The collapse of two Bear Stearns hedge funds was a financial stressor that contributed to the demise of Bear Stearns. Hedge funds are in a position to move large amounts of assets very quickly. Such movements might be voluntary and in some cases are harmful. For example, it appears that the rapid withdrawal of assets held at prime brokers such as Bear Stearns and Lehman helped accelerate the failure of both. In other cases, asset movements may be involuntary. That is, during the crisis, adverse developments in the markets may have forced liquidation of assets at dramatically reduced prices. This is said to have harmed not only parties with which hedge funds dealt directly but also participants in the markets in which those assets were dumped. Hedge funds were significant players in the market for CDSs.

Hedge funds often hold concentrated and large positions. Here, too, they can move in and out quickly and thus disproportionately influence share prices. Hedge fund managers are paid not only by flat fee on assets managed – typically two percent – but also a percentage of increases in the value of assets – typically 20 percent. Thus, inflation of housing prices was a boon to hedge fund managers because the increases helped inflate securitized assets owned by the funds. The story of the meltdown is in part one of firms that used high leverage to ramp up returns and relied on short-term borrowing to finance their operations, characteristics hardly atypical of hedge funds. The meltdown is also associated with corporate executives' earning outside returns derived from overly risky investments but suffering relatively little if those investments don't pan out or even fail, as has been noted. It appears that the then current compensation structure yielded earnings for leading hedge fund managers far in excess of the amounts corporate executives received. The compensation structure for hedge fund asset managers may contain incentives that are at least as problematic if not more so than those for executives.

In a number of respects the foregoing narrative is sketchy. It is hardly definitive as to hedge funds' specific role in crises and what risks they may pose for the future. Such lack of knowledge had specific and serious implications for the crisis as well as general ones. During the crisis, regulators did not have sufficient data of quality about private pools of capital like hedge funds by which they could assess the actual or potential impact of funds' actions. There are several reasons for this lack of opacity. By their nature, hedge funds' use of leverage and short positions creates great incentives to be less than transparent about what they are doing (or perhaps even what they have done, at least recently.) In some measure hedge fund strategies are complex and hence not readily accessible. Further, to date, hedge funds have avoided

disclosures required of other investment vehicles, such as investment companies. Unlike investment companies, by far the majority of hedge funds were not obliged to register with the SEC. (It does appear, though, that a substantial number voluntarily registered after the industry successfully beat back the SEC's efforts at mandatory regulation.) It is said that the lack of such knowledge on regulators' and market participants' parts contributed to market uncertainty and instability during the crisis. Certainly, at this stage, the lack of information continues to make it difficult for policy makers and others to meaningfully assess the role of the funds in the crisis and determine what reforms are required.

Similarly, private equity funds have raised large pools of equity capital here and abroad. Private equity funds are reported to have brought in over a quarter of a trillion dollars in 2008. According to some reports, pension funds may currently have as much as a trillion dollars on call to invest, with perhaps half of that for leveraged buyout funds. At the peak of the buyout cycle they may have relied on 60 to 90 percent in debt – a leverage ratio of up to 10 to 1 – to finance the deals. So the financial market values of the corporations were much larger than the amounts of equity investments that private equity funds had made in them. Although individual venture capital funds are far smaller than private equity funds, they have been estimated to manage upwards of a quarter of a trillion dollars in assets in start-up or relatively early stage companies. Certainly there are arguments to suggest that private equity funds have been important in reviving, revitalizing, or even rescuing failing firms. It is also suggested that they make possible more efficient and productive reorganization of corporations or segments or subsidiaries thereof. And certainly, venture capital investments are linked to the emergence of new and important technologies, products, and services as well as enterprises that can grow to be among the largest of corporations, with a tremendous impact on the economy.

At the same time there are serious concerns about the behaviors of private equity funds, though it would appear that many of these funds are less immediately connected with the financial meltdown than are hedge funds. For example, as noted, the leveraged buyout segment of the private equity industry has been heavily reliant on debt. Questions have been raised about the detriment caused by burdening companies that were objects of investments with that debt. Indeed, in some cases that burden has threatened the very existence of

enterprises. The use of debt has also been tied to issues of funds' stripping companies of valuable or productive assets to cover debt payments. It has been associated with their extracting value through special bonus dividends despite the strain those dividends put on the companies' ability to repay their debts. Some of the problems with fund management incentives for private equity funds are not unlike those with hedge funds. Moreover, there are repeated contentions that cannot be ignored about the destructive impact wrought by some private equity funds on major portfolio companies, their workers and customers, and the communities in which they operate. The adverse effects on employee rights, while not immediately tied to the financial crisis or financial aspects of private equity transactions, are important and still need to be addressed.

In and of themselves, these major concerns have pointed to the need for serious legislative attention to private equity funds. Yet additional issues relate to what some see as unwarranted and even harmful tax subsidies for the use of the debt relied on in leveraged buyout deals and the favored (capital gains) tax treatment accorded earnings on funds' (ultimate) sale of companies. At the same time, for the most part, private equity funds do not appear to pose the same kind of harms experienced in connection with the financial crisis that hedge funds do. Private equity fund debt is accumulated at the company portfolio level, not at the fund level. It is typically not short-term debt. So runs on private funds and liquidity issues do not seem to be a great problem. Private equity funds' investment horizon is nominally much longer – in the area of five years – than that of hedge funds. Fears about heavy market trading in large amounts over short time periods seem largely irrelevant. Private equity funds appear to be far less connected than are hedge funds with major market players that are linked to the financial crisis. While private equity funds, for some of the reasons noted above, may pose serious challenges for the American economy, it is not clear under what circumstances they would pose systemic risks for the financial system.

Under current law and practice pursuant to it, the SEC has had limited access to information about private equity funds and their advisers. Moreover, it has been suggested that such information as has been drawn from industry sources has been unreliable and inconsistent. The SEC's contacts with such funds and advisers may be only in connection with currently allowable enforcement actions or, in the case of hedge funds, those that have chosen to register voluntarily.



WHAT THE ACT DOES

The Act affects private equity and hedge funds in a variety of ways. First, such funds are subject to provisions for new registration, reporting, and other requirements relating to advisors to what the legislation refers to “private funds.” For example, previously, advisors to such funds with fewer than 15 clients and under \$25 million in assets under management were not subject to requirements of the sort envisioned. (In part, this prescription assumed that wealthier investors were more sophisticated investors.) Now, but for certain exceptions, they apply to advisors to all funds (regardless of the number of clients) with at least \$150 million in assets under management. (There are exemptions for advisors to “venture capital funds, certain foreign advisers, investment advisers for ‘family offices.’”) This expansion of registration and registration-related requirements has multiple rationales. One is to enable regulators to gain critical insights about the behavior of such advisers. Another is to expose and deter abusive behaviors. A third is to afford needed protections to investors, even ostensibly sophisticated investors like pension funds.

For example, such funds will be required to maintain records covering a variety of subjects, including the amounts and kinds of assets they manage, the extent to which they use on- and off-balance sheet leverage, their trading and investment positions, their valuation and trading practices, and information pertaining to other matters as determined by the SEC. The SEC has the authority to inspect – and does carry out routine and “for cause” inspections of – such records and books of affected firms. It can require advisers to file reports on sought-for information. In addition, while the SEC was previously barred from doing so, it now has authority to compel advisers to disclose the identity, investments, or affairs of its clients “for purposes of assessment of potential systemic risk.” By virtue of being deemed private fund advisers, firms will have to comply with the SEC’s recently promulgated pay-to-play rules regarding political contributions to certain government officials and using unregistered solicitors or placement agents.

Second, should the FSOC designate a private fund as posing a threat to the financial stability of the United States, it would now be subject to the regulatory authority of the Fed described above. Certainly, it is conceivable that a highly leveraged hedge fund could be so designated.

Third, as described above, pursuant to the provisions of the Act’s Volcker(-like) Rule(s), banking entities are limited in their ability to sponsor or invest in a hedge fund or private equity fund. Nonbank financial companies supervised by the Fed are also so limited in somewhat different ways. In the first in-

stance, Fed-supervised nonbanking financial companies are not subject to any of these limitations, but if they choose not to comply with them, those companies are subject to certain capital and other requirements. In addition, banking entities cannot have investments in a fund they organize or in which they invest in excess of three percent of the total ownership interests of the fund, and they may not have more than three percent of their core (so-called tier 1) capital invested in the fund. The Act adds additional restrictions on banking entities’ transactions with any fund it sponsors or for which it serves as an investment manager or adviser.

DISCUSSION

As a general matter, the registration and related requirements serve, as they have for other investment advisers, as a valuable tool to track the behavior of the funds and gather information about abusive behaviors. They can help keep people with dubious records out of the fund business. They can help ensure accurate reporting and safekeeping of assets. They can be used to expose and deter conflicts of interest. They may spur an internal fund culture and practice in accord with the goals of reform. The other reporting requirements relating to systemic risk are well enough justified given the magnitude of the assets managed by these funds and the critical roles they might play in financial markets.

Legitimate concerns have been raised that various requirements may be unwarranted and costly burdens on smaller funds. However, the legislation appears to acknowledge that some of these requirements ought to vary across the different types of private pools. Objections have also been raised about public disclosure of information. Here, too, the Act seems to provide that the regulatory reporting should be on a confidential basis.

However, the Act does not give the SEC any direct authority over the private equity and hedge funds themselves. To accomplish that, funds would have to be required to register with the SEC or the SEC given authority to regulate unregistered funds. Arguably, such authority could allow the SEC to impose investment restrictions on the funds. These could include limiting their use of leverage or derivatives, mandating liquidity requirements, prescribing valuation practices, prohibiting self-dealing, regulating the governance structures of the funds, and perhaps regulating even more broadly the relation between investors and the funds. There are those who would argue that such a step is justified now.

Coming to a judgment about which argument should prevail is greatly hampered by serious gaps in knowledge about fund behavior that were the result of weak disclosure require-

ments in the past. It may be that if the proposed requirements take effect, the information gathered and analyzed by the SEC would make the case for fund regulation. At that point, perhaps many months later, however, gaining legislative attention for such action might be difficult. At minimum, perhaps, the SEC should be mandated to gather necessary and relevant information and report to Congress by a certain time about whether, in light of that information, fund regulation is required. Such regulation might be important apart from concerns about whether funds individually or in the aggregate pose systemic risk. It would appear that these funds are subject to more rigorous requirements only if they are deemed by the FSOC to be a designated company.

Prior to late-in-the-game amendments of the draft Act, banking entities were completely barred from sponsoring and investing in hedge funds and private equity funds. The three percent cap on banks' investment of tier 1 capital may not operate as a meaningful limit for most, if not all, of the major banks. The cap of three percent on bank ownership of a private equity or hedge fund arguably places the bank less at risk. But it may also mean that others who invest in such funds may think they have the bank as a significant co-investor, which it will not be.

Given the differences between hedge funds and private equity funds, it is not obvious whether there is a need for the latter to be subject to further regulation. Certainly, in principle, registration and related disclosure requirements should apply to both. But differences between the funds suggest possible differences in application of regulations. The proposed framework for regulation appears to allow for that. It may be that an explicit exemption for, say, venture capital funds, both because of their size and the nature of their activities, might be warranted. However, it might suffice that those concerns could be addressed by congressionally mandated guidance to the SEC in how it implements the provisions for regulation.

Given the differences between hedge funds and private equity funds, it is not obvious whether there is a need for the latter to be subject to further regulation.

Lastly, here, as it is with other aspects of the legislation, there are fears that requirements might drive certain funds offshore, particularly hedge funds. Arguably this would harm not only hedge funds but perhaps also American-based financial institutions that have a great financial stake in servicing them. Some opposite fears – that regulations would ex-

clude offshore competitors – have given rise to objections to proposed regulation of hedge funds and private equity funds within the European Union. The Act does not specify how its requirements or their implementation might be harmonized with foreign regulation of non-U.S. advisors or funds. Clearly there needs to be action to deal with these problems, action spurred, guided, and supported by legislation. But while these problems are real, they are no warrant for ineffective regulation but rather one for thoughtful and carefully targeted reforms that take proper account of them.



PART VI. CORPORATE GOVERNANCE

BACKGROUND

Not surprisingly, attention has turned to whether and how failures of corporate governance helped to precipitate and exacerbate the financial crisis. Certain of those problems and the remedies to address them have been the subject of considerable debate since well before the crisis. Those debates were often triggered by corporate scandals of considerable magnitude and impact, though they did not necessarily involve financial corporations. Clearly there are common concerns about the governance of financial and non-financial corporations. However, the focus here will be on the former, because it is their role in events that is of immediate concern. In turn, the discussion will have an eye to the different problems that might be posed by each and the different responses that might be appropriate. These differences may arise from the particular importance of certain risks that are of special concern in connection with financial corporations. Some relate to liquidity and reputational risk and the greater complexity in assessing risk that they confront. Others pertain to the distinctive character of their position in the financial system and the larger economy, and the already heightened role of supervision and regulation (apart from matters of corporate governance). Still others involve the presence (in the case of banking institutions) of additional stakeholders, namely depositors, and the potential for government liability (and corresponding taxpayer responsibility) for certain harms caused by those corporations. Further, the governance problems and remedies may differ insofar as commercial banking, investment banking, or other kinds of activities are concerned.

Failures of risk management at financial corporations are frequently seen as central to the financial crisis story. It has been said that corporate executives were, for a variety of reasons, ignorant of certain important risks. This may have been a result of the insufficiency of even the best available informa-

tion to properly assess those risks. It may have been because executives did not obtain the information required make such an assessment. Or perhaps they were not sufficiently aware of or did not understand critical activities within key segments of the very (perhaps too) large and complex institutions they led. Ignorance of risks could have been caused by executives' failure to hire effective risk managers, whose duty is to inform and give advice on issues of risk. Or maybe the risk managers were, for formal or social organizational reasons, segregated from key superior decision makers or not within a reporting chain of command. Moreover, it has also been suggested that corporate executives may have had some, or even sufficient, knowledge of those risks but willfully ignored them. This behavior is thought by some to be linked to arrangements that incorrectly or inadequately linked their pay to the risks they allowed the corporation to take. Some commentators contend that notwithstanding what might be adequately linked arrangements, the problems were spurred by a problematic corporate culture, perhaps combined with the executives' personal failings. On a related point, others have drawn attention to the failure of corporate leaders to correctly or adequately link the pay of subordinates in key parts of the organization to activities that were risky and potentially highly damaging to the enterprise as a whole. Certainly there is evidence of each of the foregoing. However, at this point convincing generalizations about patterns and practices and their impact are not always easy to sustain.

Other critics point to corporate directors' failure to spur adequate risk assessment and appropriate action based on it as a root of the financial crisis. One possible reason for this failure is that they did not have sufficient access to relevant information about risk exposure, either because they did not ask for it or because executives did not provide it. Another is that although they had the relevant information, they did not sufficiently understand its import, either because of the inherent complexity of the subject or because they lacked the necessary knowledge or expertise. Perhaps board-mandated policies and procedures or other actions for reporting by and dialogue with executives on the subject were inadequate. Finally, even ostensibly independent directors were too compromised by their relationships with corporate executives or too affected by the social and psychological factors that bear upon board functioning.

Some critics have argued that single-minded pursuit of return in the name of "shareholder values" places some onus on shareholders. Others claim that shareholders were not aggressive enough in monitoring corporate behavior. As noted below, in discussions of this sort, closer attention needs to be paid to who the shareholders are, for certain major shareholders like pension funds are seen as more part of the solution and less part of the problem.

In essence, then, the narrative has focused on each of the following (and in some cases, the interrelationships among them): senior corporate executives' role in risk management, executive and other corporate employee pay, board behavior or practice, and the role of shareholders.

Corporate executive pay (in all its components, including basic salaries, bonuses, stock options, pensions and other benefits, a variety of perks, and severance packages) has long been discussed, raising hotly contested issues. Among them has been the link between pay and measures of company performance. There are disputes about how to measure performance, what constitutes pay (and, in some cases, what, in fact, has been paid), and the empirical evidence bearing upon the relationship between the two. In these debates performance has tended to be viewed in terms of achieving one or another positive outcome. But the financial crisis has highlighted the importance of executive behavior that may create risks, especially risk of negative outcomes that, at the extreme, may threaten the very viability of an enterprise. As noted, the financial crisis has also brought to the fore problems of pay (and performance) at lower levels in corporate organizations—for example, traders at investment banks and mortgage brokers at mortgage companies—which have had devastating consequences for companies. Suffice it to say that debate still rages about the best formulas for linking pay with performance, what the proper measures of performance are, or, one step removed, prescriptions for the process of establishing those formulas.

These matters are tied to and nested within a broader set of questions about board behavior or practice at all corporations. Among these questions, the financial crisis has highlighted ones about risk management in general, the role of the board in risk management more specifically, and as noted above, yet more specifically, how the board takes account of risk in establishing the link between pay and performance. As already suggested, how risk is effectively addressed by key players in financial companies is of special concern. For corporate executives and board members, among others, the perceived nature and level of risk would understandably be evaluated at the level of their own corporation, with the risk to other financial institutions and to the financial system viewed as an externality.

Lastly, as noted, there has been an ongoing debate over the proper role of shareholders in all corporations in the selection and pay of directors (the latter referred to as "say on pay"). Not surprisingly, the financial crisis has heightened attention to that role, especially when it is seen as positive in enhancing internal corporate (as opposed to externally imposed regulatory) mechanisms to spur better corporate behavior, for example, more considered and effective management of risk.

Certainly pressures to generate high returns, particularly to deliver such returns over the short term, are part of the calculus within which corporate executives have operated. Other factors being equal, extreme pressure of that sort may help occasion unwarrantedly risky behavior and perhaps unethical conduct and even unlawful actions. Those pressures may arise from certain shareholders who are bent on achieving high returns over the short term. They may both spur and be spurred by media and a culture that focus on short-term share prices. Clearly, there is considerable portfolio turnover among key stock market players, suggestive of such a short-term focus.

WHAT THE ACT DOES

Before discussing the Act, it should be noted that prior to its enactment the primary legislative focus on corporate governance as it pertained to financial corporations and the crisis had been the proposed Corporate and Financial Institution Compensation Fairness Act in the context of the TARP.

Few provisions of the Dodd-Frank Act relate specifically and uniquely to the governance of financial companies. The most prominent among those few are discussed above: that publicly traded non-bank financial companies and bank holding companies with total consolidated assets of \$10 billion or more must establish a risk committee and that such a committee must have independent directors (as specified by the Fed) and have at least one risk management expert with the requisite expertise. Also, “any issuer or reporting company that wishes to use the clearing exemption is required to have a board committee that reviews and approves the use of swaps.” Of course, as detailed in the sections above, when certain financial companies are in serious distress and pose systemic risks, the Fed may and the FDIC is required to remove from their positions corporate executives deemed responsible for the company’s problems in the event of resolution of such a failing company.

Rather than specifically regulate governance of financial companies, the Act has provisions relating to executive compensation and proxy access that broadly apply to all corporations. With regard to executive compensation, certain disclosures are mandated:

1. The SEC must require companies to disclose the total compensation of (just) their CEOs, the median compensation of their other employees, and the ratio of that median to the CEO’s compensation.
2. They must describe, in accordance with an SEC prescription, the link between the pay they give to executives and the financial performance of the company. They must do so in a way that reflects changes in the value of the company’s

shares, the dividends it pays, and the distributions it makes.

3. Companies must include in their proxy disclosure the extent to which certain employers or directors make hedges with regard to their equity securities.

4. Shareholders are entitled to two different votes relating to executive pay. One vote, non-binding, is on whether the shareholders approve of executive compensation as disclosed in the proxy statement. The other, binding, is on how infrequently – up to once every six years – shareholders may vote to express their non-binding view on executive pay.

5. In the event there is a proposed transaction involving the disposition of substantially all the assets of a company, there must be disclosure of compensation arrangements with company executives that are based on or relate to that transaction. Unless those arrangements have been the subject of a previous say-on-pay vote at a previous annual meeting, shareholders have the right to a non-binding vote on the arrangements.

6. The Act requires that compensation committees of listed companies be composed entirely of independent directors (independent being determined on the basis of a variety of factors). In making their decisions, those committees must also take account of how independent any would-be independent outside advisor on compensation is.

7. The Act includes provisions for clawing back from any executive of “erroneously awarded” compensation – compensation awarded based on material noncompliance with financial reporting requirements.

In connection with proxy access, the Act confirms the SEC’s authority to establish a system that enables shareholders have the names of their nominees for election to the board of directors included in the proxy statement and card. Note that this is authorization. The question of the SEC’s authority to mandate such a system has been disputed and precisely what it should mandate has been fiercely contested. In recent weeks, the SEC has exercised that authority by issuing draft regulations for public comment.

The Act extends recent New York Stock Exchange restrictions on broker voting, barring such voting on a range of significant matters unless brokers are given specific instructions to do so by beneficial owners.

DISCUSSION

The provisions of the Act discussed appear to be closely linked to ones that were included in a proposed Corporate

and Financial Institution Compensation Fairness Act, which was pending in Congress along with other financial markets reform legislation. Although that bill included sections applicable to all corporations, some sections related only to the financial companies covered by the bill. One set of provisions would have required regulators to specify information those institutions would have to submit that had a bearing upon the relationship between “the structures of the[ir] incentive-based compensation for officers and employees” and not only the management of risk at the institutions but also potential harm to the economy or to financial stability. Another set would have given regulators the power to bar compensation structures and arrangements that encourage risk taking that endangers financial institutions, the economy, or financial stability.

It is difficult to give credence to strong objections to the say-on-pay provisions. Shareholders have a legitimate interest in pay as a general matter. That interest is even more important in relation to the issues raised here, attending to the relationship between pay and corporate performance, especially risk. Practically speaking, because the votes would be non-binding, they would primarily serve the function of promoting a productive dialogue among shareholders, board, and executives. They avoid what some critics argue would be a harmful shareholder role in actual decision making. Indeed, a number of U.S. corporations have already been challenged by purely advisory shareholder resolutions (in which pension funds have been actively involved) urging adoption of say on pay. An increasing number have made changes responsive to those requests. Moreover, the experience with say on pay – which is a legislatively mandated practice in the United Kingdom – is generally supportive of enactment here. All that being said, it is more than plausible that senior executives’ having sufficient financial “skin in the game” contingent on relevant corporate outcomes may be a necessary condition for risk management, but hardly a sufficient one. For example, critics point out that a number of senior executives at major financial corporations that failed or stumbled greatly during the crisis lost a great deal of money (though they may have earned vast sums over the length of their tenure, outweighing the losses at the end). Moreover, while there is thoughtful academic research that points to the need for changes, say on pay has not been without challenge.

The other provisions relating to covered financial institutions are potentially wider ranging and potentially much more powerful and transformative. This is because they specifically authorize regulators to assess compensation practices, not only for executives but also for lower-level employees, and to bar those deemed to pose a serious enough risk. However, given the special status and importance of financial companies, there is greater warrant for government over-

sight of not merely the methods by which compensation is set but the very terms established. To be sure, there needs to be attention to what expertise, resources, and process regulators would bring to bear to ensure that the constraints they would impose would be neither toothless nor harmful, however well-intentioned. Pursuant to the provisions of the Administration’s proposed legislation (see discussion above), there would arguably seem to be some authority for the Federal Reserve in its proposed oversight of “systemically risky” financial companies to address compensation practices as they relate to that risk and perhaps to tie required practices to capital, monitoring, or other requirements. The relationship between that seeming authority and the provisions under discussion are not clear. In any case, it seems that relevant federal authorities might not bar certain compensation practices but might instead impose higher capital, monitoring, or other requirements on corporations that choose to use them. Alternatively, requirements might be tailored to capitalization of the corporation, the quantity of (particular) financial instrument(s) they offer, the extent of trading in those instruments, and so forth.

With regard to board directors, there are a number of concerns, some of which have broad relevance while others may be of special import for financial companies beyond those noted above. In the first instance, shareholder election mechanisms would seem well suited to effectively weed out directors who have performed poorly. However, there are major obstacles to performing that function directly and indirectly. Where shareholders believe specific individuals would be better qualified to serve, the expense and difficulty of running their own nominees are considerable. Where running such a nominee is not practicable or otherwise desirable, barring the re-election of an objectionable sitting director is the alternative. But such an approach is currently rendered ineffective by the practice of plurality voting, even when there is no other candidate running in opposition to the incumbent. About the first point, the Act specifically authorizes the SEC to enable shareholders to have their nominees placed on the company’s ballot list. Indeed, having already done much work on the subject, within slightly more than a month of the Act’s taking effect the SEC took action on this matter. It exercised the authority to issue a regulation making shareholders eligible to have their nominees included in the proxy materials if they own at least three percent of the company’s shares continuously for at least the three years prior to the election. Thus, at first blush, the rule addresses concerns about the risk of too easy access cluttering the ballot with too many and perhaps frivolous candidates. Nonetheless, the regulation has not only been the subject of harsh criticism in some quarters but also been challenged in court. In the face of that challenge the SEC backed off, suspending the regulation until the legal dispute is resolved. With respect to the problems

of plurality voting, action still needs to be taken to require majority voting for directors in uncontested elections. It is encouraging that some corporations have already voluntarily acted and that legislation to mandate it broadly is pending before Congress.

There are other issues relating to directors, only some of which might be implicitly addressed by election mechanisms by which director performance is assessed and accountability enforced. Some pertain to directors themselves, others to board processes. In relation to the processes, some see the financial crisis as highlighting the need to enhance audit committee capacity. More particularly, they cite the need to better ensure transparent reporting on the complex financial assets and liabilities that are part of corporate balance sheets and the concomitant need for effective oversight by board directors. Others take note of the links between compensation and risk taking, suggesting that there should be closer working relationships between those who, on one hand, oversee compensation and auditing, and on the other, those who are concerned with risk management. With regard to the latter, yet others propose establishing a position for a high-level, independent risk officer, someone who might even serve on the board.

Given the many boards on which directors may serve, it is an open question whether they do or are able to spend the time necessary to fully meet their responsibilities.

Again, there are doubts about whether non-executive board members have the expertise or resources to understand issues well enough to fulfill their role. (Indeed, in light of such concerns, it has been suggested that for sufficiently large financial corporations, board members have staffs to support them in that task.) There are also matters that go beyond competence and resources and relate to conflicts of interest. For example, it is not clear whether the criteria for the “independence” of independent board members are sufficient or appropriate to ensure the distance and objectivity necessary for truly independent board oversight. More dramatic proposed changes range from imposing formal competence or educational requirements to mandating public company monitors for boards. A variant proposal has been to create mechanisms to develop a cadre of “professional” trustees as a pool of potential board candidates. At first, the cadre might be created on a voluntary basis. Indeed, it appears

that certain pension funds are making moves in that direction. Certainly the potential value of these approaches merits serious legislative attention. To be sure, moves to embody any proposals of that sort in legislation or regulation would be hotly contested as being unduly interventionist or unproductive. Whatever the potential strength of those criticisms, as a general matter, the question is whether the arguments for these ideas have greater force as they apply to financial corporations.

To the foregoing should be added what might best be phrased as a cautionary note. Assessments of the role of corporate governance in the financial crisis have tended to be cast in terms of how behaviors and relationships have been structured by formal rules, both those imposed from outside and those established by and within corporations. In turn, recommendations for change have been put in similar terms. In many respects that is entirely appropriate. However, the behaviors and relationships under scrutiny are nested within the complex social and organizational reality of how corporations function. That reality encompasses social, educational, and other relationships that not infrequently link corporate executives and board members to one another within and across corporations into networks that influence norms, expectations, decision making, and behavior. It also includes social and psychological factors that, among other things, can lead to the formation of groups within corporate (and other) organizations.

Such groups can exhibit dysfunctional and even pathological behavior at variance with the interests of the corporation (or other organization). Naming that reality and appreciating its potential impact still does not easily or readily translate into meaningful prescriptions. Nonetheless, legislative and certainly regulatory processes, or formulating such prescriptions, would be well served by attending to insights of that kind.

In all events, for these and other reasons, some have pointed to the need for the insights and influence of outsiders who seem to stand apart from what may be self-contained, self-perpetuating, and perhaps too self-interested structures of corporate governance. Those outsiders are the gatekeepers, outside auditors, investment analysts, lawyers, or credit rating agencies who are supposed to provide independent, objective evaluations. Where relationships of such gatekeepers



are clearly arm's-length, their assessments are valuable. But there is a risk of clouded judgments if they rely on corporate payment for their services or if their relationships are nested in the company's social-psychological context.

Curiously and perhaps ironically, if debates over corporate governance in recent years are any indication, shareholders have been cast by some as interested or self-interested, by others as outsiders; by some negatively, by others positively. But, as suggested above, there is a need for stronger shareholder voice in the selection of directors – especially for the voice of institutional investors like pension funds that have a long-term view of corporate performance – along the lines of the proposal currently pending before the SEC, referred to above. Conversely, there is a need to address concerns about those who, through a variety of financial and other devices, exercise shareholder voice yet effectively have no economic stake in the corporations; among these are some hedge funds. In this regard, the Act's provision extending the bar on broker voting was a step forward.

There are, of course, other stakeholders in corporations. Questions remain, for example, as to the most meaningful and appropriate ways for worker voice to be better heard, whether through unionization and collective bargaining, a greater role in governance, or otherwise. Yet other suggestions point to the need to protect so-called whistleblowers (insiders who may be seen to become outsiders) for their valuable role in shedding light on corporate behavior.



PART VII. CREDIT RATING AGENCIES

BACKGROUND

To assess the impact of the Act's provisions relating to credit rating agencies (CRAs) requires not only an understanding of the role that CRAs played in the financial crisis but also the historical context for that role.

With regard to the latter, there are several important background facts. First, the ratings industry is highly concentrated. Key to that concentration is the SEC's designation of ratings firms as so-called nationally recognized statistical rating organizations (NRSROs). NRSRO firms exercise enormous, government-like power because certain regulatory requirements applicable to investments in securities can be satisfied only if the securities have sufficiently high NRSRO-issued ratings. Such requirements have their origin in Depression-era legislation barring bank investment in other than investment-

grade securities as determined by "recognized rating manuals." They were more broadly institutionalized in the 1970s when certain investors' purchases of highly rated bonds were tied to lower capital requirements; in some cases, investors were limited to purchasing highly rated bonds. Even today, most institutional investors, among them pension funds, are constrained by rules that allow them to purchase only investment-grade assets, as judged by the NRSROs' ratings. So pervasive and seemingly indispensable are such ratings that well into and through the crisis the Federal Reserve and other government officials have relied on those ratings in designing and implementing their rescue packages.

Currently, there are 10 NRSROs. But the field is almost completely dominated by three – Moody's Investors Service, Standard & Poor's, and Fitch Ratings Ltd. – with the first two being larger by far. So from a practical perspective, debate about financial markets reform as it relates to CRAs is largely about the behaviors of that very small group of firms, the considerable stakes those firms have in the outcome of that debate, and the ways that any proposed legislation will impact them in particular. (In light of the foregoing, for the purposes of this discussion, we use the acronyms CRAs and NRSROs interchangeably.)

There are substantial arguments that CRAs played a central role in the financial crisis. First, and as a general matter, they are said to have made possible the sale of trillions of dollars of structured financial securities – asset-backed securities (ABSs) such as mortgage-backed securities (MBSs), collateralized debt obligations (CDOs), and the like – in 2005, 2006, and 2007.

Second, and again as a general matter, a sufficiently high credit rating was the last step in enabling issuers to sell these products to investors. Third and more particularly, it was mortgage-backed securities, and especially secondary securitized products like CDOs and structured investment vehicles (SIVs) backed by synthetic products, that were linked to the demise or near-demise of Bear Stearns, Fannie Mae, Freddie Mac, and AIG. CRA ratings were especially important to the successful marketing of those products. Fourth, the severe damage suffered by those firms and others who used or relied on those ratings was closely linked to the fact that the ratings were highly erroneous.

The reasons why CRAs are seen as culpable for those errors and their consequences are several-fold. Some observers relate the problem to the CRAs' internal operations, saying they relied on faulty or inadequate data pertaining to default rates for and the underlying default rates of mortgages and CDOs. It has been suggested that they ignored the possibility of a housing bust and its impact, and failed to do adequate stress

testing about the effects of stock market-wide declines. Indeed, one strong critic of the CRAs has contended that this record of failure is not new. This critic's suggestion is that the CRAs failed to properly alert investors prior to the bursting of the dot-com bubble and the collapse of Enron and World-Com, and made numerous errors in rating many companies that deteriorated or collapsed during the current crisis. Some attribute faulty ratings simply to greed and the pursuit of profit, or to the allocation of CRA resources not keeping up with the number of ratings being issued. Others view CRAs' success in averting legal liability for issuing faulty ratings – on the grounds that the ratings are expressions of “opinion” protected by the First Amendment – as contributing to their having exercised less than the necessary level of care. It has also been argued that investors were misled or confused about the nature and level of risks they were running because the CRAs rated structured finance securities with the same symbols they employed to rate traditional corporate bonds.

In addition, CRAs have also faced twofold criticism for their behavior after the onset of the crisis. The CRAs downgraded what might have been nearly \$2 trillion in mortgage-backed securities in the months after the Bear Stearns collapse. But it is said that they failed to change their ratings quickly enough in light of ongoing credit deterioration. Further, and perhaps more precisely, because of this delay, it is asserted that when the rating downgrades did come, they were too wide-ranging and deep, sapping market confidence.

CRAs are also thought to be culpable because of their business practices. For some years they have worked under an “issuer pays” model. That is, issuers pay CRAs to rate the securities they want to sell. Under the earlier “investor pays” model, would-be purchasers would pay CRAs for a rating for the offered securities. The concern with the current model is that CRA revenues and profits are tied to issuers' demand for their services, and CRAs feel pressured to curry favor by issuing fewer negative or harsh ratings. Arguably this problem is more severe for specialized securitized products, for which there are far fewer issuers than, say, conventional corporate or municipal bonds. The incentives for misbehavior would seem that much greater for at least two reasons. First, it is reported that credit rating agencies collected higher fees for structured products than for other products such as corporate bonds. Second, while there are thousands upon thousands of corporate and municipal bond issuers, there are relatively few structured product issuers, so the latter arguably have much greater leverage. These concerns are exacerbated by a more recent practice, one commonly engaged in, in connection with CDOs. That is, CRAs were paid by issuers to advise them on how to structure CDOs to ensure that the CRAs would rate the CDOs highly enough to permit and spur their

sale to key investors. In turn, this may have allowed issuers to “CRA shop” in pursuit of the firm most open to giving the security a higher rating.

Even if these contentions about CRAs are warranted, an assessment of the precise role and impact of CRAs depends upon looking at the interplay of their actions with those of others. For example, it has been suggested that certain investors were less aware than they should have been and inquired less than they should have about the kinds of assets that were or even might have been included in the CDOs they purchased. Moreover, some say that such investor omissions were the result of their unwarranted excessive or perhaps exclusive reliance on CRA rating of the securities. Such reliance arguably was driven by several considerations. First, as noted, certain investors could purchase securities only if they were highly enough rated. The precise level of the required rating was specified by a government agency (such as the SEC). And the entity with the sole authority to give a rating – an NRSRO – was accorded that authority by the SEC. While this double government role might have been viewed as just one of the minimum conditions for the investment, it was instead often thought to be a government blessing and a sufficient condition for the investment. Also, accepting that blessing, so to speak, offered an easy out for investors either unwilling or unable to independently scrutinize the investment.

Commentators suggest that related considerations may have come into play with the issuers themselves. First, recognizing the importance of the government-required ratings, issuers fixed their sights on just gaining that rating. As noted above, they may have overstepped boundaries in the pursuit of profits from sales of the rated product. Second, in some cases, issuers may have been spurred by sloth, opportunism, overconfidence, or corner-cutting to view those ratings – and, more important, the methodologies and data upon which they were based – as all that was needed to gauge the risks of the products they were marketing. Third, some argue that some issuers may have been conscientious but held an unjustified belief in the validity of the ratings – and the methodologies and data that supposedly supported them – formulated by the CRAs; indeed, that the CRAs may have given unwarranted credence to the merits of their own work. Finally, it would appear that regulators, whether through lack of attention, unwarranted deference to the CRAs or the issuers, or inadequate resources, were not aware of the risks of these products.

WHAT THE ACT DOES

The Act includes provisions relating to credit rating agencies geared to conflicts of interest; transparency of the procedures and methodologies they use to establish ratings; penalties,

punishment, or both for wrongful conduct; and disclosure of information gathered in connection with the formulation of credit ratings. It also limits the degree to which institutional investors are allowed to rely on credit ratings.

The conflict-of-interest provisions include directions to the SEC to establish rules aimed at assuring that CRAs comply with their own policies and procedures. Other provisions require that they not be influenced by marketing and sales considerations in setting ratings. Still others require CRAs to report on whether those involved in rating an issuer company were or have become employed by those companies. The SEC is also encouraged to adopt rules to limit CRAs' ability to provide other than credit rating services. CRAs are required have boards at least half of whose members must be independent. No matter its size, any board must have at least two independent members.

To assure greater transparency and reliability, CRAs are required to describe the information upon which they base their ratings. This includes the assumptions that underlie their procedures and methodologies and the data from the issuer upon which they rely. If CRAs receive credible and potentially significant information from other than the issuer, they must consider it in their rating decision. (In the case of asset-backed securities, they must make publicly available any third-party due diligence reports they have obtained.) CRAs must use rating procedures and methodologies that accord with what is prescribed by the SEC. They must ensure that those procedures and methods are applied consistently. They must notify users of material changes or significant errors and any effect these have on ratings. They have to communicate the meaning of the rating symbols they use and apply those symbols consistently. CRAs must, again in accord with SEC rules, have policies and procedures by which they estimate the probability that an issuer will fail to comply with the terms of the instrument issued—that is, default, fail to make timely payments, and so on. Further, CRAs must publicly disclose in standardized ways how their initial rating is performed, report on changes to those ratings, and in various ways attest that the changes were not improperly motivated. Finally, CRA employees who perform ratings must meet SEC-set standards of training, experience, and competence.

The Act (prospectively) removes the prescriptions in law referred to above that require use of credit ratings as a means for assessing the creditworthiness of certain investments. Statutory prescriptions are to be removed within two years.

Within one year, regulators must remove those prescriptions and substitute other standardized means for characterizing creditworthiness.

CRAs will now be subject to oversight and compliance audits by a new Office of Credit Ratings. They are subject to disciplinary action should they fail to comply with certain requirements. In addition, enforcement and penalty provisions are applied to them for statements they make in the same way they are already applied to statements by registered public accounting firms and securities analysts. However, as a practical matter, the Act sets up some significant hurdles for private lawsuits for fraud against CRAs.

DISCUSSION

The complicated, interdependent nature of the decisions behind the Act is highlighted by certain of the CRA provisions. For example, the Act limits the use of private credit ratings in determining what the capital standards for banks must be, that is, how much of a capital cushion against loss banks should have. Such a limit means that a different way to set those standards must be found, but that perhaps will

To assure greater transparency and reliability, CRAs are required to describe the information upon which they base their ratings.

not be easily or quickly done. In that regard it should be noted that the CRAs, whether in a calculated move or otherwise, recently barred issuers of billions of ABSs from using CRAs' ratings to induce prospective buyers to purchase them. The CRAs contended that under the Act they were exposed

to liability for harm resulting from such use. The issuance of the ABSs had to be scuttled until the SEC agreed that temporarily such ABSs could be issued without a credit rating.

As noted, the Act does not itself articulate an alternative standard to agency reliance on ratings to avert the kinds of problems described above. Rather, it leaves it to the vagaries of a study and report two years off. This is not to say that agencies should not rely on such ratings in limiting certain investors' choices of particular investments. For example, the extent of reliance might depend upon the capacities of the investors involved and what burdens and responsibilities it is warranted to place on them.

At first blush, the Act's provisions offer no response or solution to the oligopolistic nature of the industry. In principle, public disclosure of methodologies, models, and assumptions of historical ratings along with ratings histories offers a basis for comparison of ratings and rating agencies and might arguably spur competition. But more generally, consideration

needs to be given to whether and how to encourage the entry of alternative providers of opinions. As shown above, reliance on other than ratings might open up greater competition by companies offering risk assessments of investments. Consideration also needs to be given to whether and under what circumstances more CRAs might be recognized.

Alternatively, some would argue that other operating models for CRAs need to be considered. One such model would be to establish a public CRA. In certain respects, this model would create the financial equivalent of the Food and Drug Administration (FDA). Such a financial FDA would assess claims about the value of financial products and countervailing contentions about the risks of harm from use of those products to decide whether the products could be marketed. Products that survive the process would have an implicit stamp of approval. A public CRA might be seen as providing a stamp of approval for certain kinds of securities. So while a public CRA merits some attention, a clear and convincing description of how such a public agency would actually operate and, realistically, how effective it would be is needed. Another proposal would have the SEC, pursuant to its current authority, spur the creation of one or more (debt market) investor-owned and -controlled rating agencies. Such agencies would not be without their own problems, but they could serve to counterbalance the current issuer model. For that reason they should be considered.

Other issues that the Act shunts aside for “study” include the process, incentive structures, and conflicts of interest that relate to the rating of structured finance products; a possible system for assigning ratings of such products to CRAs; alternative means for compensating CRAs to spur more accurate ratings; better ways to manage or perhaps prohibit conflicts of interest that arise when CRAs provide consulting services as well as rating services; whether and how professional standards for credit rating analysts should be set and overseen by a professional body; whether there are standardized means for rating terminology; and whether, and if so how, there should be standardized means for stress testing of such ratings linked to default and loss outcomes.

As described, the Act assigns continued oversight of CRAs to the SEC. However, there have been contentions that historically the SEC has failed to perform that role effectively. It is not clear how much attention was given to suggestion that a new agency was needed to carry out the task.

The Act, quite appropriately, gives great attention to CRA behaviors and individual impacts. But it does not focus on other legitimate concerns about the systemic impact of those behaviors. For example, sudden ratings downgrades can un-

dermine confidence in particular firms or the securities they issue or insure. The loss of confidence may undermine securities prices and result in investment losses for yet other financial market players. Indeed, banks, CDS issuers, or other financial market players may have contractual obligations to raise additional capital or post more collateral, which are triggered automatically by ratings drops. Those players may be unable to fulfill these obligations or perhaps able to do so only by hurriedly and even dramatically selling other securities, driving the markets for those securities down, threatening further ratings drops, and so on.



PART VIII. THE CONSUMER FINANCIAL SERVICES MARKET

BACKGROUND

Debate over the need for financial markets reform as it pertains to consumer financial products is twofold. The first group of considerations relates to the failure of consumer financial products markets as a general matter. The second concerns how that failure played out in the financial crisis and its aftermath.

With respect to the former, the contention is that well-informed and rational consumers are the condition for an appropriate and effective functioning of markets for those products. If so, that condition is not currently satisfied. According to that view, as a general matter, consumer purchasers of products do not have the financial and other resources they need to make sufficiently informed purchasing decisions. More particularly, they are said not to understand basic financial concepts. They are thought not to really grasp the terms of the contracts they sign. They are seen as confused in their choices of products. Moreover, it is argued that certain features of consumer financial products currently sold do not square with what well-informed and thoughtful consumers would want. This problem may be worse for consumer financial products as compared to, for example, tangible products. It is argued that it is easy for providers, in the pursuit of sales, to change what are often unessential characteristics and corresponding terms of offer of the products. In turn, it may be more difficult for those providing information and advice to keep up with the changes. Perceived consumer ignorance may, as well, deter others from selling better or higher quality but costlier products because they would largely bear the expense of having to educate consumers about them.

With respect to the financial crisis (and in considerable measure the preceding considerations as well), the fact that the market has not been functioning properly was recognized long ago. But efforts to remedy the problem through regulation have hardly been effective enough. Critics offer several reasons for this result. For example, different kinds of products are regulated by different agencies of government, with certain products falling into the gaps between regulators. There are at least 10 agencies that have responsibilities for consumer protection pertaining to financial services. State regulators have authority as well. Moreover, many argue that where there has been regulatory authority, particular federal agencies have not been up to the task of meeting their responsibilities. In this respect, several contentions stand out. One is that certain federal agencies had the legal authority to protect consumers for decades but did not. For example, even though the Fed had authority to deal with predatory mortgage lending, it failed to enact rules to do so. Another contention is that the Office of the Comptroller of the Currency was aggressive in preventing states from going after such predatory lenders in the name of the comptroller's own authority to regulate, but then failed to exercise that authority. Analogous assertions have been made about agencies' responses to credit card, prepaid card, payday lender, bank overdraft fee, student loan, and other abuses. Others note that even the existing extended and complex regulatory scheme has significant gaps, for example, in relation to non-bank mortgage originators.

According to many observers, ineffective or nonexistent protection of home mortgage borrowers resulted in their being persuaded to take on mortgages they could not afford. This not only harmed them but also enhanced major financial companies' ability to market and reliance on selling such harmful products. Such reliance, it is said, helped undermine the safety and soundness of the institutions themselves, contributing to the financial crisis. This view has been hotly contested. Some contend that consumers and speculators gave false or misleading information, both knowing full well what (they thought) they would gain by it. There is, no doubt, some truth to this argument. But it is not clear whether in some cases there was an extended devil's pact in which mortgage originators and others may have known full well or turned a blind eye to the deceptions because it was in their financial interest to do so. In all events, it has been suggested that similar abuses and lack of protection relating to credit cards contributed to and may well extend or even worsen the financial and economic downturn. In addition, several key reasons have been offered for why regulators may not have provided the necessary protection to consumers. Some are structural. Many financial companies were allowed to organize themselves as a whole (in the

case of bank holding companies, they could shift business among their differently organized subsidiaries) – for example, as federally chartered banks, as federally chartered thrift institutions, or as state banks – which allowed them to choose which agency regulated them. This enabled them to shop for the most favorable regulators. Correspondingly, regulators relied on revenues from the companies they regulated to support their budgets, creating incentives for regulators to weaken regulation in order to gain oversight over more companies. Third, for those federal agencies in which regulatory authority has been lodged, consumer protection has played second fiddle to other, higher agency priorities, for example, monetary policy at the Fed. Fourth, the plethora of regulators has resulted in an inefficient and costly system of multiple, overlapping, and perhaps conflicting regulations. As such, it is a system that, because of its expense, is likely to favor larger financial institutions better able to bear the cost over smaller ones, and hence, has been less competitive than it ought to be. Fifth, fragmented and uneven regulation (in some cases no regulation) has created an uneven playing field and placed pressure on those regulated to evade standards that are set for them.

WHAT THE ACT DOES

The Act consolidates much of the regulatory authority relating to consumer protection laws within a new Bureau of Consumer Financial Protection (BCFP). Although from a formal organization chart perspective the BCFP is located within the Fed, the bureau is termed an "independent" entity. The president, with the advice and consent of the Senate, approves its director. Even though, as noted below, the Fed funds the BCFP, there appear to be far-ranging restrictions on the Fed's interfering with the bureau's operations. No loopholes in the Act by which the Fed can exercise any meaningful authority over the BCFP are evident.

As noted, the BCFP's reach is broad. It covers those offering or providing consumer financial services. It extends but is not limited to the provision of financial advisory services to individuals, such services relating to proprietary financial products or services, the provision of a variety of real estate-related transaction services, and the provision of bank-like services such as the taking of deposits. It also covers transmitting or exchanging funds; being the custodian of financial instruments; extension of credit and servicing of loans; and provision of check cashing, collection, and guaranty services. In addition, the BCFP has authority to expand its reach by regulation to products and services it deems fashioned to avoid federal consumer financial laws and even ones provided by bank or financial holding companies insofar as they have "a material impact on consumers."

Despite its broad reach, the BCFP has no authority over certain persons except insofar as they offer consumer financial products or services or are otherwise subject to certain consumer laws specified in the Act. Such persons include those who by law are regulated by certain agencies. Among the agencies are the SEC (with respect to registered broker-dealers and investment advisers, national securities exchanges, credit rating agencies, etc.), the CFTC, and state insurance regulators. Also exempted are people in certain professions, among them those engaged in the real estate brokerage business, accountants, and lawyers. There was a heavily lobbied, very specific carve-out for auto dealers.

However, the BCFP's authority does reach large – with over \$10 billion in total assets – insured depository institutions and insured credit unions and their affiliates through exclusive rulemaking and examination authority and primary enforcement authority relating to any federal consumer financial laws. Its authority over smaller such institutions is limited to exclusive rulemaking authority and participation in examinations conducted by prudential regulators. The BCFP has exclusive rulemaking and examination authority over non-depository persons covered under the Act and exclusive enforcement authority, subject to coordination with the Federal Trade Commission in relevant cases.

The BCFP's powers over the matters within its purview are substantial. Not only does it have authority to issue rules, but

Despite its broad reach, the BCFP has no authority over certain persons except insofar as they offer consumer financial products or services or are otherwise subject to certain consumer laws specified in the Act.

the federal courts must give deference to the BCFP's interpretation of the laws it is implementing, and the BCFP's rulemaking authority is to the exclusion of other federal agencies with any overlapping responsibility. Further, it can formulate not only rules that identify unfair, deceptive acts or practices but also ones that regulate characterization of product or service features conducive to full, accurate, and effective disclosure to consumers.

One potential check on the BCFP's regulatory power is the authority of the FSOC, by a two-thirds vote, to bar implementation of a BCFP regulation.

A number of provisions of the Act relate to specific kinds of consumer transactions – for example, those concerned with

credit card fees – that are of importance to consumers but do not particularly bear on concerns of pension funds.

The BCFP has a fair measure of independence based on funding. Moneys for the bureau are to be paid by the Fed based on a determination by the BCFP director, though the amount is capped at a fixed percentage of the Fed's operating expenses (set at 112 percent for 2013 and adjustable thereafter). However, the BCFP director may seek additional appropriations from Congress if she or he believes funding is inadequate.

DISCUSSION

Consolidation of regulation with the BCFP has been criticized on a number of grounds. Clearly, some of the BCFP's authority would supplant that of a number of other agencies. With respect to the Fed and the Office of Thrift Supervision, this has been justified by what has been characterized as these agencies' poor record of consumer protection. Some argue that it would have been beneficial for those agencies to retain both oversight of the safety and soundness of the banks and thrifts, respectively, that they oversee, and protection of consumers that those institutions ostensibly serve. But it does not necessarily follow that oversight of consumer protection needs to remain with those agencies in order for them to stay abreast of and address concerns raised by the link between that and prudential oversight. So for example, it appears that the bureau would have to consult with federal banking agencies on prudential market and systemic objectives and with the SEC and CFTC on securities and derivatives markets.

In relation to the latter point, some are critical of the carve-outs for the SEC and CFTC in the first instance. They assert that such exclusion creates opportunities for regulatory arbitrage. There might very well be merit to that contention. However, there are several countervailing factors. One relates to a judgment about the seriousness of failures on the part of those agencies to exercise or apply existing authority to protect investors. Another would be how readily that problem could be remedied by reforms at those agencies. In addition, the need for comprehensive and sufficiently uniform authority over (and avoiding regulatory arbitrage in connection with) consumer financial services, as a formal matter, has no obviously logical stopping point. As a practical matter, though, the following paragraph suggests that limits might be drawn based on judgment that is as realistic as possible when the scope of the BCFP's authority would be so large as to likely render it ineffective in exercising that authority.

More particularly, agencies that currently have regulatory roles to be assumed by the BCFP have staff with experience and significant, perhaps unique, expertise, as well as other resources critical to fulfilling those roles. Moreover, it might well be that any consolidation of authority could engender an exodus of such staff from the federal government entirely. It is essential that the BCFP not have to build its operation from scratch and, hence, that it be able to draw fully upon all of the foregoing. And even if the BCFP were able to do so, it would still need to be able to integrate the previously diverse, separate operations into one agency. That would appear to be a challenging task. Certainly the choice of the best leadership and sufficient resources would be important to fulfilling it. However, a better solution might be a scheme in which at least some agencies retain much of their current authority. In such cases, the BCFP's role might be one primarily of oversight to ensure the appropriateness and consistency of those agencies' actions, with authority to overturn or compel actions by them under specified circumstances.

Of necessity, the Act had to resolve thorny issues concerning the allocation of authority between federal regulators and state regulators. The Act comes out on the side of giving a fair amount of leeway for state protection of consumers. More particularly, states would be preempted only if it would be impossible for the affected party to comply with both federal and state law or if the state law is an obstacle to achieving the objective of some federal law. The Act makes clear that a state law affording greater protection than federal law is not necessarily inconsistent with that federal law. In essence, then, federal standards would be viewed as minimum or baseline protections, with states being allowed to impose greater ones. Such state power, though, would be subject to a check by the BCFP at least in the sense of deciding whether the protection accorded by the state was, in fact, greater.

Those who pressed for greater preemption of state law appear to have been driven by a number of factors, including the desire to have to deal with only a single regulator and a single regulatory standard, thereby avoiding the uncertainty, trouble, and expense of dealing with more than one. There may also be a belief that a single federal regulator may, under these particular circumstances, be more amenable to the influence of one or another sector or segment of the financial services industry. Clearly the existence and outcomes of state regulation of one or another segment or sector may weigh heavily as well.

On the other hand, proponents of state regulation contend that in those areas where states have been able to regulate, they have been effective. Indeed, advocates suggest that had not state regulators been thwarted by federal agency actions and judicial interpretations, consumers would have been better protected and the risks of the financial meltdown would

have been reduced. Also, they argue that states are frequently the source of innovative ideas and regulatory schemes that later inform or may even be models for federal regulation. Further, state regulation and enforcement may provide valuable information and insights about current practices that merit serious attention at the federal level. Finally, in some instances, local circumstances might be sufficiently distinctive as to warrant standards specially crafted to the situation, standards that states are best equipped to fashion.

Finally, there was much controversy over a provision present in earlier versions of the Act that authorized the BCFP to mandate "plain vanilla" or standardized versions of financial products, which consumer advocates vigorously contended would greatly benefit consumers. Opponents attacked the idea of the agency being accorded this power, calling it an unwarranted and potentially heavy-handed government intrusion in the market. The language was stripped out of the bill. Some suggest, however, that the BCFP ostensibly has broad powers to do what proponents advocate. Whether it might try and how contested the effort would be remain to be seen.



FINAL OBSERVATIONS AND COMMENTS

The Act takes a pass on many key questions, leaving federal agencies to come up with analyses and recommendations for action by Congress at some near or distant time. (More specifically, The Act requires nearly 100 one-time reports and over 40 periodic ones as well as nearly 300 rulemaking processes.)

The Act largely leaves the federal agency players virtually unchanged. (It does dismantle the Office of Thrift Supervision [OTS], which was the primary regulator of all federal and many state-chartered thrift institutions, but whose regulatory record had been the subject of harsh criticism. The OTS's duties were transferred to other agencies.) By the harshest reading, one of the only two new agencies, the FSOC, is mainly a glorified cross-agency committee, the establishment of which required no legislation and which might operate under the thumb of the Secretary of the Treasury. Ironically perhaps, the Treasury and for now its current head—which played a key, and in many quarters heavily criticized, role in the events leading up to and during the financial crisis—has been accorded greatly expanded powers.

Perhaps even more ironically, the Fed, which was vigorously attacked by critics for failures on its part that contributed to the crisis and mismanagement of the response to it, has been

accorded greatly expanded power. The loss of jurisdiction over consumer financial services was not much of a loss because Fed interest in it appears to have paled in comparison with its attention to other matters within its purview; indeed, for some, its neglect of consumer financial issues was significant and harmful. Moreover, there was concern about lack of transparency about what actions the Fed has taken and why. There was dismay over its governing structure, heavily weighted to private banking interests, and lack of public accountability. All of that criticism seems to have evaporated. It is not clear why. Meanwhile, the Fed's increased authority will make it a more important target of political influence. And that expanded power will be exercised through a larger and more complex organization, making the task of effective management more of a challenge.

By contrast, on its face, the new Bureau of Consumer Financial Protection, even though stripped of certain important authority in the course of the legislative process, can be an important means to stem significant abuses. Even so, the important practical questions remain. Will a director for it be nominated and approved in a timely fashion? Will he or she be a person who is strongly committed to its goals? Will he or she be up to the very difficult task of merging and integrating activities that before the Act were housed in diverse federal agencies focusing on disparate activities? Will the new director have the vision and stamina to advance a proactive agenda for the bureau in the face of what likely will be strong and sustained opposition? Many are encouraged in this regard by the appointment of Harvard Law School professor Elizabeth Warren – a strong consumer advocate and critic of the financial services industry – to a senior position with the Obama administration to play a key role in the establishment of the bureau, though not as its first director.

In all events, Congress left to the secretary and agency regulators extensive power to interpret what the Act's specific mandates mean and require. In numerous cases it has failed to address certain important questions. Instead, it has left it to one or another agency to study and report back to Congress some months or even many months in the future as to what legislative form, if any, the answers should take. In most respects that is understandable given the vast scope and complexity of the issues addressed by the Act and the practical lack of time, focus, and expertise of legislators for the task. At the same time, as we have seen, members of congress can address matters that are hard and with respect to which they should be decision makers and should be held accountable. Some might view the shift from legislative to administrative decision making as a shift from more to less influence by political or vested interest group considerations. Perhaps it would be more apt to say that the shift is from the

influence of one kind of political or vested interest group to that of another.

In many respects, the Act leaves the landscape of financial companies largely unchanged. This is not to say that the landscape is unchanged, but if it in many respects has changed, that has been by virtue of the play of forces in financial and other markets. Considerable power remains concentrated in relatively few financial companies. Indeed, government actions prior to passage of the Act will have led, at least in the near term, to a further concentration of power as a result of the disappearance of players from the market. The Act, on its face, would seem to have little power to stem or reduce that concentration. (Prior to the Act, starting in 1994, any given bank or bank holding company was barred from holding more than 10 percent of the deposits held by all banks. It would appear that the Act restricts any given bank or systemically important financial company from having consolidated liabilities of more than 10 percent of the consolidated liabilities of all such companies.)

As suggested above, there is a concentration of power not merely in markets but also in politics. Well-resourced financial companies, including ones bailed out by the taxpayer, expended enormous sums in an effort to shape the Act to their liking. They will no doubt be ever present in all the critical follow-on interpretation and implementation. The Supreme Court's recent Citizens United decision, giving greater play to corporate political contributions will likely further enhance their presence. To be sure, in various ways – whether through its Volcker Rule-type provisions or those relating to derivatives or, arguably, in extreme situations by virtue of authority exercised by the FSOC, the Fed, and the FDIC – the Act seeks to clip the wings of these companies in needed ways. But whether within the compass of such provisions meaningful action will be taken, the tale told will depend on how the provisions are implemented and the ingenuity of those subject to the requirements in successfully evading them.

It should be added that there is one important subject that the Act does not address at all: the role of the GSEs, Fannie Mae and Freddie Mac, in causing the financial crisis and the harm which resulted from it. Although much ink has been spilled on the matter, it does not appear that they were the primary cause of the home mortgage fiasco central to the meltdown. Moreover, despite further print to the contrary, such mandate or incentives as each had to spur home ownership among lower-income households was also not a cause. Nonetheless, both engaged in risky practices. Both, notwithstanding their seeming government imprimatur, in a shareholder-driven pursuit of profit, strove to regain their large share of the home mortgage market in the face of inroads by

other players who had greatly expanded their shares through subprime and Alt-A loans, dubious underwriting, and other practices. That combination, in the face of deteriorating conditions in housing and other markets, combined with their massive portfolios and committees for guarantees, was a recipe for financial disaster. The upshot has been conservatism for both and taxpayer bailouts on the order of \$200 billion with perhaps more on the way. Congress is only now turning to what long-term solutions are required.

Apart from the merits of particular provisions of the Act (or lack thereof) there remain serious issues that will bear heavily on their practical effect or perhaps even whether they survive over time.

There is the matter of ideological and social inbreeding and insularity. Of overconfidence if not arrogance on the part of many—from corporate executives to those given the task of crafting models for them—about their ability to understand and manage risks. Of unwarranted political influence played out one way in the legislative process and another in the regulatory one. Of limited agency capabilities and resources, driven by hostility to or lack of confidence in government. Of revolving doors for those who work for agencies at one time and for companies those agencies regulate at another time. (The Act only asks the comptroller general to study and report on this issue.) Of a political culture in which agencies are far more likely to be criticized for problems they are said not to have solved than praised for solving or preventing problems. Of the seeming frequent assumption that the occurrence of the financial crisis can be understood solely in terms of the behaviors of financial actors and of government actors who regulate those behaviors. Of lack of attention to, among other things, trade policy and its impact, on both the flow of capital across borders and on domestic employment and income, changes in social welfare and labor policies and practices, related shifts of financial and other risks onto workers, income inequality more generally, and a host of others.

In addition, there are concerns about competing agency agendas and turf wars within Congress. Of a money-driven electoral process that reduces even further the limited time legislators have to focus on important issues in a serious and informed way. Of media that, at best, have not been well equipped or had incentive to alert citizens to and inform them in a timely and meaningful way on critical matters; and that, at worst, may have contributed to the crisis by their coverage. Of diffuse claims about the merits of size and scale in financial companies. Of similar diffuse claims about the nature and merits of financial innovation. Of all-too-many shareholders or investors who all-too-readily looked for and demanded short-term returns. Of others who have not been

attentive to what is required to create long-term value, not only for them and other direct stakeholders but also for the larger economy and community.

At first blush, the Financial Crisis Inquiry Commission so far appears to be a pale replay of the so-called Pecora Commission (named after Ferdinand Pecora, who became its chief counsel), created by the U.S. Senate, which for two years had the task of investigating the cause of the crash of 1929. It is argued that the Pecora Commission's work informed and spurred popular support for major New Deal legislation for financial markets reform, including passage of the Glass-Steagall Act and creation of the SEC.

The FCIC's report was due on December 15, 2010 (although the FCIC deferred its submission to January 15, 2011). So clearly its work had little bearing on the formulation and passage of the Act. Perhaps at that late date it might offer a more definitive or at least a strongly suggestive analysis of what occasioned the financial crisis and what lessons must be learned. And perhaps if the past is any guide – for example, Glass-Steagall was passed in 1933, the Securities and Exchange Act in 1934 – the process of reform may continue, aided by what the FCIC has to say.

In all events, several things should be clear. It is essential that pension funds individually, and especially collectively, need to stay abreast of how the Act is being implemented, track the results of mandated studies and their recommendations, and be aware of what actions are taken (or not taken) in light of those recommendations. It is also essential that pension funds, so alerted and informed, speak with a forceful voice on what has been done and needs be done. The stakes are simply too high, not only for pension fund members and beneficiaries but also for many others with retirement plan investments, for pension funds not to make themselves heard.



GLOSSARY

ALT-A LOAN. Defined variously, such as a home mortgage loan to a borrower who has a less than grade A credit score, a below grade A borrower (who might be referred to as an “Alt-minus borrower”), a borrower who has provided less than full documentation in support of the loan application, or a borrower who in other ways does not meet normal underwriting criteria.

ASSET-BACKED COMMERCIAL PAPER. Commercial paper, the proceeds from which are used to acquire various kinds of assets, among them trade or consumer debt receivables that may be issued by a special purpose vehicle conduit typically sponsored by commercial banks, which might provide guarantees for that debt.

ASSET-BACKED SECURITIES. Securities, payments from which are derived from the cash flow from receivables – payments owed companies by their creditors and debtors – and other financial assets, such as loans, for example, student and automobile loans, credit card debt, and leases.

BANK HOLDING COMPANY. As described by the Fed, a company “that owns and/or controls one or more U.S. banks or one that owns, or has controlling interest in, one or more banks.”

BROKER-DEALER. For the purposes of the Securities and Exchange Act of 1933, a broker is “any person engaged in the business of effecting transactions in securities for the account of others”; a dealer is “any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise.”

BUREAU OF CONSUMER FINANCIAL PROTECTION. A new agency created by Dodd-Frank under which much of the regulatory authority relating to consumer protection laws has been consolidated. From a formal organization chart perspective, it is located within the Fed but is supposed to operate largely independently of it.

COLLATERALIZED DEBT OBLIGATION (CDO). A type of asset-backed security, the value of and payments from which are based on portfolio of fixed-income underlying assets. CDOs are split into classes, or tranches. “Senior” tranches are considered the safest securities because owners have first claim on the interest and principal payments from the underlying assets; the lowest “junior” tranche, having the last claim, is the least safe one. Prices are correspondingly higher and expected returns lower the more senior the tranches are.

COLLATERALIZED DEBT OBLIGATION—SQUARED (CDO-SQUARED). A security structured like a CDO but for which the assets themselves are CDO tranches.

COMMERCIAL BANK. An institution that accepts deposits from and makes loans primarily to businesses and that offers related services, including ones pertaining to international banking.

COMMERCIAL PAPER. A senior unsecured obligation generally issued by a corporation to provide work capital funding, for example, to finance accounts receivable and inventories and meet short-term liabilities, with maturity as short as 1 day but of no more than 270 days, so as to avoid application of certain Securities and Exchange Commission registration requirements. Commodity Futures Trading Commission. The federal agency with authority to regulate commodity futures and option markets in the United States.

CREDIT DEFAULT SWAP (CDS). A CDS, or swap contract, is an agreement by which a buyer makes payments to a seller who agrees, in turn, to make specified payments to the buyer in the event of a default or default-related event with respect to a credit instrument. Typically the instrument is a form of corporate debt, a mortgage security, or a municipal bond. The buyer need not necessarily own the instrument with respect to which the agreement is made; if that is the case, it is referred to as a “naked CDS.” A CDS is a particular example of a derivative.

DERIVATIVE. Generally speaking, a financial instrument whose value is linked to or derived from an asset, index, event, value, or condition (commonly referred to as the “underlying”).

FANNIE MAE. Also known as the Federal National Mortgage Association, formerly a wholly owned federal corporation established in 1938 to buy federally insured home mortgages, it was transformed into a federally chartered, publicly traded corporation that purchases home mortgages and issues and insures mortgage-backed securities.

FED. Sometimes referred to as the Federal Reserve; here, shorthand for the Board of Governors of the Federal Reserve – whose members are appointed by the president – though it also encompasses Federal Reserve Banks and the Federal Open Markets Committee (FOMC). The Fed’s responsibilities include using various tools to influence monetary and credit conditions, supervising and regulating banking institutions, acting to maintain stability in the financial system and limit systemic risk in financial markets, and providing financial services, including payment services, to depository institutions, the U.S. government, and foreign official institutions. The FOMC, which has a special role in decisions relating to the availability of money and the cost of credit, is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York, and the presidents of four other Reserve banks. Some of the board members of the 12 (geographic)–district Federal Reserve banks are chosen by member banks; others are chosen by the Board of Governors.

FEDERAL DEPOSIT INSURANCE CORPORATION. In its own words, this is “an independent agency created by the Congress to maintain stability and public confidence in the nation’s financial system by ... insuring deposits [in U.S. banks and thrift institutions,] examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships [of failing institutions].”

FINANCIAL HOLDING COMPANY. As described by the Fed, a financial entity “engaged in a broad range of banking-related activities, created by the Gramm-Leach-Bliley Act, [including] insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, issuing or selling securitized interests in bank-eligible assets, and generally engaging in any non-banking activity authorized by the Bank Holding Company Act.”

FINANCIAL STABILITY OVERSIGHT COUNCIL. Federal agency created by Dodd-Frank to identify systemic risk.

FREDDIE MAC. Also known as the Federal Home Mortgage Corporation, a federally chartered, publicly traded corporation established to be a competitor to Fannie Mae.

GINNIE MAE. Also known as the Government National Mortgage Association, a government-owned corporation within the federal Department of Housing and Urban Development that “guarantees timely payment of principal and interest on [residential mortgage-backed securities] backed by federally insured or guaranteed loans.”

GLASS-STEAGALL ACT. Also known as the Banking Act of 1933, enacted during the Depression in response to bank failures that were attributed to banks’ involvement in the sale of securities (associated with investment bank activities). The law sharply restricted banks’ involvement in such sales. Among its other important provisions was the establishment of the Federal Deposit Insurance Corporation to insure bank deposits. The act was weakened over the years. In 1999, important provisions relating to the separation of commercial and investment banking (as well as insurance) activities were repealed by the Gramm-Leach-Bliley Act.

GOVERNMENT-SPONSORED ENTERPRISES (GSEs). Federally chartered financial corporations that are privately owned and controlled and that have specified lending and other powers geared to achieving specified federal objectives, such as spurring home ownership, supporting farming enterprises, and enabling access to colleges and universities, and that are seen

to enjoy special federal benefits such as an implicit federal guarantee of the obligations incurred by those corporations. In these terms, Fannie Mae and Freddie Mac are GSEs.

GRAMM-LEACH-BLILEY ACT. Enacted in 1999, among other things it repealed portions of the Glass-Steagall Act to permit the consolidation of commercial bank, investment bank, securities firm, and insurance company activities within a single firm.

INVESTMENT BANK. Unlike a commercial bank, such an institution does not accept deposits or make loans to individuals. Among other things, it earns income from the role it plays in the issuance of equities and debt securities by companies and debt securities by municipalities, from the sale and purchase of securities for others as well as for itself, and from advising investors and helping to effect the sale, merger, acquisition, or restructuring of companies.

MONEY MARKET MUTUAL FUND. As described by the Securities and Exchange Commission, a mutual fund is required “to invest in low-risk securities” and “typically invest[s] in government securities, certificates of deposit, commercial paper of companies, or other highly liquid and low-risk securities.” Investors “tendering mutual fund shares, including shares of money market funds, for redemption generally must be paid within seven days of tender.” However, the sums invested are not federally insured, as are deposits in commercial banks and thrift institutions.

MORTGAGE-BACKED SECURITIES. Asset-backed securities payments which derive from the principal and interest due from a specified pool of mortgage loans which serve as collateral.

OFFICE OF FINANCIAL RESEARCH. An office established by Dodd-Frank located in the U.S. Department of the Treasury to, among other things, collect financial information, develop risk management tools, and perform other work in support of the Financial Stability Oversight Council and other financial regulatory agencies.

PRIME BROKER. A firm that provides services to hedge funds and other professional investors, which include executing, clearing and settling trades, lending money, lending securities, and acting as a counter party to derivative contracts.

PROPRIETARY TRADING. Trading for a firm’s own account, not for or on behalf of its customers.

REPO. Shorthand for “repurchase agreement,” a contract by which one party sells a security to another but agrees to buy back that security at a specified price and time. Typically the buyback time is short, 1 day, although it could be much longer.

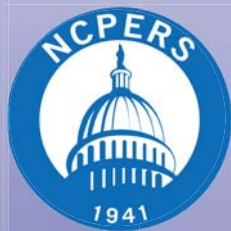
SAVINGS INSTITUTIONS. Institutions that primarily engage in accepting time deposits – savings accounts or certificates of deposit (CDs) – from consumers, making mortgage and real estate loans, and investing in high-grade securities. They include savings banks and savings and loan associations.

SECURITIES AND EXCHANGE COMMISSION. The primary federal regulator of securities markets including key participants such as securities exchanges, securities brokers and dealers, investment advisors, and mutual funds.

SPECIAL PURPOSE VEHICLE. A limited-purpose corporate or trust entity created as a conduit for the sale of asset-backed securities, frequently administered by a commercial bank sponsor of the asset-backed commercial paper program.

SUB-PRIME LOAN. A loan to a borrower who is deemed to be an above-average risk and hence does not qualify for the prime interest rate but who might be offered a loan at a higher interest rate, termed the “sub-prime rate.”

THRIFT INSTITUTIONS. In popular terms, institutions, which include savings banks, savings and loan associations, and credit unions, that mainly take deposits in the form of savings accounts and lend primarily for home mortgages. In technical legal terms as they relate to the Federal Deposit Insurance Corporation, “domestic building and loan or savings and loan association[s],” “cooperative bank[s] without capital stock organized and operated for mutual purposes and without profit,” “Federal savings banks,” and certain “State-chartered savings banks.”



NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS.
444 N. CAPITOL ST., NW SUITE 630, WASHINGTON, D.C. 20001
TEL: 1-877-202-5706 FAX: 202-624-1439