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# Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street

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## TURNING A BLIND EYE: WHY WASHINGTON KEEPS GIVING IN TO WALL STREET

*Arthur E. Wilmarth, Jr.\**

*As the Dodd–Frank Act approaches its third anniversary in mid-2013, federal regulators have missed deadlines for more than 60% of the required implementing rules. The financial industry has undermined Dodd–Frank by lobbying regulators to delay or weaken rules, by suing to overturn completed rules, and by pushing for legislation to freeze agency budgets and repeal Dodd–Frank’s key mandates. The financial industry did not succeed in its efforts to prevent President Obama’s re-election in 2012. Even so, the Obama Administration has continued to court Wall Street’s leaders and has not given a high priority to implementing Dodd–Frank.*

*At first glance, Wall Street’s ability to block Dodd–Frank’s implementation seems surprising. After all, public outrage over Wall Street’s role in the global financial crisis impelled Congress to pass Dodd–Frank in 2010 despite the financial industry’s intense opposition. Moreover, scandals at systemically important financial institutions (SIFIs) have continued to tarnish Wall Street’s reputation since Dodd–Frank’s enactment. However, as the general public’s focus on the financial crisis has waned—due in large part to massive governmental support that saved Wall Street—the momentum for meaningful financial reform has faded.*

*Wall Street’s political and regulatory victories since 2010 shed new light on the financial industry’s remarkable success in gaining broader powers and more lenient regulation during the 1990s and 2000s. Four principal factors account for Wall Street’s continued dominance in the corridors of Washington. First, the financial industry has spent massive sums on lobbying and campaign contributions, and its political*

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*influence has expanded along with the growing significance of the financial sector in the U.S. economy. Second, financial regulators have aggressively competed within and across national boundaries to attract the allegiance of large financial institutions. Wall Street has skillfully exploited the resulting opportunities for regulatory arbitrage*

*Third, Wall Street's political clout discourages regulators from imposing restraints on the financial industry. Politicians and regulators encounter significant "pushback" whenever they oppose Wall Street's agenda, and they also lose opportunities for lucrative "revolving door" employment from the industry and its service providers. Fourth, the financial industry has achieved "cognitive capture" through the "revolving door" and other close connections between Wall Street and Washington. A widely-shared "conventional wisdom" persists in Washington—notwithstanding abundant evidence to the contrary—that (i) giant SIFIs are safer than smaller, more specialized institutions, (ii) SIFIs are essential to meet the demands of large multinational corporations in a globalized economy, and (iii) requiring U.S. SIFIs to comply with stronger rules will impair their ability to compete with foreign financial conglomerates and reduce the availability of credit to U.S. firms and consumers.*

*Despite Wall Street's continued mastery over Washington, two recent events could lead to a renewed public focus on the need for stronger restraints on SIFIs. In March 2013, Attorney General Eric Holder admitted that global SIFIs are "too big to jail," and a Senate subcommittee issued a stunning report on pervasive managerial failures and regulatory shortcomings surrounding JPMorgan Chase's "London Whale" trading scandal. In response to those events, Senators Sherrod Brown and David Vitter introduced a bill that would require SIFIs to satisfy much higher capital requirements and would also limit their access to federal safety net subsidies. The Brown-Vitter bill could prove to be a milestone because it demonstrates Dodd-Frank's inadequacy and also focuses the "too big to fail" debate on issues where Wall Street is most vulnerable, including dangerously low levels of capital at the largest banks and extensive public subsidies exploited by those banks.*

*"Turn a blind eye": "To knowingly refuse to acknowledge something which you know to be real";<sup>1</sup> "to refuse to see: be oblivious"<sup>2</sup>*

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1. *Turn a Blind Eye*, PHRASE FINDER, <http://www.phrases.org.uk/meanings/turn-a-blind-eye.html> (last visited Oct. 29, 2012). Admiral Horatio Nelson reportedly inspired this saying at the Battle of Copenhagen in 1801, when he ignored a superior's signal to disengage from the enemy fleet.

“I remind people, we do have the best capital markets in the world.”  
(Jamie Dimon, chairman of JPMorgan Chase, June 19, 2012)<sup>3</sup>

“[T]he size of some of these [financial] institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, . . . it will have a negative impact on the national economy, perhaps even the world economy.” (Attorney General Eric Holder, March 6, 2013)<sup>4</sup>

“[D]on’t you see? Too big to fail isn’t a problem with the system. It is the system . . . . The bigger [global corporations] get, the bigger financial institutions will have to get.” (Robert Rubin, former Treasury Secretary and former senior executive at Goldman Sachs and Citigroup)<sup>5</sup>

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Instead, he put his spyglass to his blind eye and said, “I have only one eye, I have a right to be blind sometimes . . . I really do not see the signal.” JAMES STANIER CLARKE & JOHN M’ARTHUR, 2 THE LIFE OF ADMIRAL LORD NELSON, K.B. FROM HIS LORDSHIP’S MANUSCRIPTS 270 (1809).

2. MERRIAM WEBSTER’S COLLEGIATE DICTIONARY 1349 (11th Ed. 2004). Kathleen Engel and Patricia McCoy have previously used this phrase to characterize the manner in which Wall Street investment banks “securitize[d] subprime home loans without determining if loan pools contain[ed] predatory loans” and thereby “actively facilitated abusive lending.” Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2040 (2007).

3. William D. Cohan, *Wall Street Forgets its Job Is to Create Jobs*, BLOOMBERG (June 24, 2012 6:05 PM), <http://www.bloomberg.com/news/2012-06-24/wall-street-forgets-its-job-is-to-create-jobs.html> (quoting testimony by Mr. Dimon during a hearing on the “London Whale” trading scandal before the House Financial Services Committee on June 19, 2012); *see also infra* Part IV(C)(2) (describing that scandal and Mr. Dimon’s role in it).

4. *Transcript: Attorney General Eric Holder on ‘Too Big to Jail’*, AM. BANKER (Mar. 7, 2013) (quoting testimony by Mr. Holder before the Senate Judiciary Committee on Mar. 6, 2013) (available on Lexis).

5. DAVID ROTHKOPF, *POWER, INC.: THE EPIC RIVALRY BETWEEN BIG BUSINESS AND GOVERNMENT—AND THE RECKONING THAT LIES AHEAD* 266 (2012) (quoting from undated recent interview with Mr. Rubin). Mr. Rubin served as co-chairman of Goldman Sachs before serving as Treasury Secretary during the Clinton Administration, and he then served as senior counselor, chairman of the executive committee, and a director of Citigroup from 1999 to 2009. During his tenure at Citigroup, Rubin encouraged the bank to engage in high-risk securitization and trading activities. Those activities inflicted massive losses on Citigroup and led to the bank’s near-failure and bailout by the U.S. government in 2008. CHARLES GASPARINO, *THE SELLOUT: HOW THREE DECADES OF WALL STREET GREED AND GOVERNMENT MISMANGEMENT DESTROYED THE GLOBAL FINANCIAL SYSTEM* 145-47, 190-91, 304-08, 317-20, 482-83 (2009); Eric Dash & Louise Story, *Rubin Leaving Citigroup; Smith Barney for Sale*, N.Y. TIMES, Jan. 10, 2009, at B1; Ken Brown & David Enrich, *Rubin Under Fire, Defends His Role at Citi*, WALL ST. J., Nov. 29, 2008, at A1; Eric Dash & Julie Creswell, *Citigroup Pays for a Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at A1.

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## I. INTRODUCTION

Almost three years have gone by since Congress passed the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank)<sup>6</sup> in July 2010, but Dodd–Frank’s reform program still remains largely unfinished. During the past year, advocates of financial reform have expressed growing dismay as federal regulators missed deadlines for more than three-fifths of the rulemakings mandated by Dodd–Frank.<sup>7</sup>

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6. Pub. L. No. 111-203, 124 Stat. 1376 (enacted July 21, 2010).

7. For recent expressions of this dismay, see Haley Sweetland Edwards, *He who makes the rules*, WASH. MONTHLY, Mar. 1, 2013, 2013 WLNR 6615176 (“As of now, roughly two-thirds of the 400-odd rules expected to come from Dodd–Frank have yet to be finalized.”); Barbara Rehm, *Regulators’ Reputation Sinks Along with Industry’s*, AM. BANKER, Mar. 28, 2013, 2013 WLNR 7543392 (“[I]n the 32 months since [Dodd–Frank’s] enactment, regulators have done little to restore the public’s confidence in the government’s ability to police the financial system.”); Gary Rivlin, *How Wall Street Defanged Dodd–Frank*, THE NATION, May 20, 2013 (arguing that the failed implementation of Dodd–Frank provides “a perfect case study of the ways an industry with nearly unlimited resources can avoid a set of tough-minded reforms it doesn’t like”); see also *supra* note 29 and accompanying text (showing that regulators missed 175 of the 279 rulemaking deadlines that expired by June 2013). For earlier expressions of similar views, see Donna Borak, *After Year of Progress, Dodd–Frank Rule Phase*

As explained in Part II of this article, the financial industry has pursued a three-front campaign that has blocked the fulfillment of many of Dodd–Frank core reforms. First, the industry’s aggressive lobbying efforts have persuaded regulatory agencies to delay or water down regulations mandated by Dodd–Frank. Second, industry trade groups have filed lawsuits to strike down completed rules. Third, the industry helped to elect a Republican majority in the House of Representatives in 2010 and again in 2012, and Republican leaders have introduced numerous bills to repeal or weaken key provisions of Dodd–Frank. Although Wall Street failed to defeat President Obama in the 2012 election, President Obama has continued to court Wall Street executives and has not spent meaningful political capital in pushing for a robust implementation of Dodd–Frank’s reforms.<sup>8</sup>

In response to the financial industry’s efforts to undermine Dodd–Frank, a group of former senior government officials, private-sector leaders and financial experts launched a new nonprofit group known as the Systemic Risk Council (SRC) in 2012.<sup>9</sup> SRC member and former Commodity Futures Trading Commission (CFTC) chairman Brooksley Born declared that Dodd–Frank’s reforms “are under attack by many of the firms who brought us the financial crisis.”<sup>10</sup> SRC chair and former Federal Deposit Insurance Corporation (FDIC) chairman Sheila Bair similarly warned that “[t]he public is becoming cynical about whether the regulators can do anything right, which is undermining support for reforms.”<sup>11</sup>

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*Hits Roadblocks*, AM. BANKER, July 16, 2012 (quoting Cornelius Hurley’s warning that “every day we are realizing more that reform efforts are inadequate”); William D. Cohan, *Does Congress Want Another Economic Meltdown?*, BLOOMBERG, June 10, 2012 (“Wall Street’s well-paid army of lawyers and lobbyists continues to make a mockery of the whole re-regulation process.”); Roger Lowenstein, *Derivatives Lobby Has U.S. Regulators on the Run*, BLOOMBERG, Apr. 17, 2012 (“The derivatives industry is squeezing Washington like a python.”); Matt Taibbi, *How Wall Street Killed Financial Reform*, ROLLING STONE, June 24, 2012 (“The fate of Dodd–Frank over the past two years is an object lesson in the government’s inability to institute even the simplest and most obvious reforms, especially if those reforms happen to clash with powerful financial interests.”); Neil Barofsky, *Bungled Bank Bailout Leaves Behind Righteous Anger*, BLOOMBERG, July 22, 2012 (“Dodd–Frank hasn’t solved the problem it was meant to address—the power and influence of banks deemed too big to fail . . . . The banks have also been gaming and watering down the [implementing] rules and regulations.”).

8. See *infra* notes 183–85, 401–403 and accompanying text.

9. Joe Adler, *Bair’s Systemic Risk Council to Highlight ‘What’s Not Happening,’* AM. BANKER, June 19, 2012. SRC’s mission “includes counteracting efforts by the [financial services] industry to undercut reforms established by Dodd–Frank.” *Id.*; see also *Former FDIC Chair to Lead Systemic Risk Council, Monitor Financial Regulation*, BUSINESS WIRE, June 6, 2012 (quoting John Rogers, an SRC member, who explained that the SRC “will serve as an essential sounding board for systemic risk reforms focused on strong investor protection, and offer a critical voice to promote the enforcement of regulations, financial disclosure and transparency”).

10. Adler, *supra* note 9 (quoting Ms. Born).

11. Floyd Norris, *Group Forms to Urge Strict Oversight of Wall St.*, N.Y. TIMES, June 6, 2012, at B4 (quoting Ms. Bair).



The financial industry's ability to delay and weaken the implementation of Dodd–Frank seems surprising at first glance. Intense popular anger at Wall Street for its central role in causing the financial crisis provided the political impetus for Dodd–Frank's enactment.<sup>12</sup> Public confidence in banks and bankers has fallen to very low levels since the outbreak of the global financial crisis in 2007.<sup>13</sup> In a survey taken at the end of 2011, 56% of respondents agreed that “the power and influence of banks and other financial institutions represented a major threat to the country.”<sup>14</sup>

The public has directed much of its outrage at the largest banks. Consumers have condemned big banks for their role in triggering the financial crisis, for opposing the adoption and implementation of Dodd–Frank after receiving huge government bailouts, and for engaging in abusive foreclosure, debt collection and fee-setting practices.<sup>15</sup> As

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12. See, e.g., John C. Coffee, *The Political Economy of Dodd–Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020 (2012) (stating that Dodd–Frank's enactment followed a “financial collapse . . . that threatened financial institutions on a global scale and brought the problem of systemic risk to the attention of a public already infuriated at financial institutions (and their highly compensated investment bankers) [for] being bailed out at taxpayer expense”); Kimberly D. Krawiec, *Don't 'Screw Joe the Plummer': The Sausage-Making of Financial Reform*, (Mar. 26, 2012), at 13 (“The public detested the 2008 bailouts and, as economic and employment fears lingered into 2010, popular backlash increased, reaching a crescendo as news of lavish bonuses and compensation packages at bailed-out financial firms hit the press.”), available at <http://ssrn.com/abstract=1925431>; Arthur E. Wilmarth, Jr., *The Dodd–Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 962 (2011) (“The severity and duration of the financial crisis, along with rising costs of governmental support for troubled [large banks], produced public outrage and created a strong consensus in favor of reforming financial regulation.”).

13. See, e.g., Remarks by FDIC Chairman Sheila C. Bair to the ABA Government Relations Summit, Mar. 16, 2011 (stating that “[i]n April 2010, a Pew Research poll found that just 22 percent of respondents rated banks and other financial institutions as having a ‘positive effect on the way things are going in the country’”), available at <http://www.fdic.gov/news/news/speeches/archives/2011/spmar1611.html>; Andrew Edgecliffe-Johnson & Francesco Guerrera, *US public loses faith in business*, FT.COM, Jan. 25, 2011 (reporting on “a backlash against bankers and their bonuses, with the number of Americans who trust US banks dropping to a low of 25 per cent, down from 33 per cent a year ago and 71 per cent before the financial crisis”); Dawn Kopecki, *Wall Street Leaderless in Rules Fight as Dimon Diminished*, BLOOMBERG, Aug. 20, 2012 (reporting on a Gallup poll in June 2012, which found that only 21% of Americans had a “great deal” or “quite a lot” of confidence in U.S. banks, compare with 41% in 2007, representing “the lowest level of consumer confidence in U.S. banks since Gallup Inc. began polling on the question in 1979”); see also Barbara A. Rehm, *Reputation Remains Industry's No. 1 Problem*, AM. BANKER, June 7, 2012 (stating that “[t]he banking industry's image is about as awful as it's ever been. Polls prove it and popular culture reflects it.”).

14. Maurice E. Stucke, *Occupy Wall Street and Antitrust*, Univ. of Tenn. Coll. of Law Res. Paper No. 179, Mar. 2012, at 4 (quoting results of a December 2011 survey by Pew Research Center for the People & the Press), available at <http://ssrn.com/abstract=.2002234>.

15. See, e.g., Carter Dougherty, *Major Banks Largest Source of Consumer Bureau Complaints*, BLOOMBERG, June 19, 2012 (reporting that Bank of America, JPMorgan Chase and Citigroup “were the subjects of the largest number of [consumer] complaints to the U.S. Consumer Financial Protection Bureau in 2011”); Joe Nocera, *Why People Hate the Banks*, N.Y. TIMES, April 3, 2012, at A27

explained in Part II(C)(2), a series of recent scandals further eroded Wall Street's reputation. MF Global, a large commodities broker, collapsed in late 2011. JPMorgan Chase (JPMorgan), the largest U.S. bank, disclosed a huge loss from its "London Whale" trading debacle in May 2012. Barclays, UBS and RBS paid large fines in 2012 and early 2013 to settle charges that they colluded with other major international banks to manipulate the London interbank offered rate (Libor), an overnight bank lending rate that determines interest rates for more than \$300 trillion of worldwide debt obligations. Finally, HSBC and Standard Chartered, two of the five largest U.K. banks, paid similarly large penalties in 2012 to resolve charges that they violated federal laws prohibiting money laundering, terrorist financing and financial transactions with Iranian businesses.

Notwithstanding these new scandals—which resembled the abuses that led to the financial crisis—the financial industry has shown a continuing ability to influence politicians and regulators.<sup>16</sup> The industry's persistent clout is due to the public's inability to maintain a long-term focus on financial reform, as well as the industry's overwhelming advantages in lobbying and other forms of political and regulatory influence. As John Coffee has shown, financial regulatory reform typically follows a "regulatory sine curve," in which (i) a financial crisis provokes widespread outrage and public demands for reform, which cause Congress and regulators to impose more stringent

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(declaring that "the country . . . hates the banks these days" due to the abusive foreclosure and debt collection practices of the largest banks); Robin Sidel, *Customers to Banks: It's You, Not Me*, WALL ST. J., Dec. 2, 2011, at C1 (reporting on customers' anger caused by "rising fees" and "a flood of foreclosures" at big banks); Richard Burnett, *Consumers unhappy with banks*, ORLANDO SENTINEL (FL), Dec. 23, 2010, at B5 (reporting that most consumer complaints "involve large banks, while community banks and credit unions, though far more numerous, draw far fewer complaints") (available on Lexis); *Americans' anger not easing over banks' practices*, CHARLESTON GAZETTE (WV), Dec. 10, 2010, at P3D (available on Lexis) (reporting on customers' anger over "excessive fees" and "foreclosure practices they view as unfair," and quoting the view of bank analyst Paul Miller that "[t]he culture at banks has been to chase profits at all costs, even if it hurts their customers"); see also Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1046 (2009) (stating that large financial institutions "were the primary private-sector catalysts for the destructive credit boom that led to the subprime financial crisis, and they have become the epicenter of the current global financial mess"). For discussions of efforts by large financial institutions to defeat Dodd-Frank or, in the alternative, to weaken its key provisions, see SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 191–92, 205–07, 213–14 (2010); Wilmarth, *supra* note 12, at 1025–34; John Cassidy, *The Volcker Rule: Obama's economic adviser and his battles over the financial-reform bill*, NEW YORKER, July 26, 2010, at 25.

16. See, e.g., Phil Mattingly, *Wall Street Supporters in Congress Unmoved by Libor Probe*, BLOOMBERG, July 3, 2012 (reporting that "Wall Street's defenders in Congress are sticking by the [financial] industry, undaunted by the Barclays fine or trading losses of more than \$2 billion at JP Morgan Chase"); John Kemp, *Wall St and Republicans team up to curb CFTC*, REUTERS, June 7, 2012 (contending that Wall Street's Republican allies in Congress were "deeply cynical" in voting to cut the CFTC's operating budget while attacking the CFTC for not having adequately regulated MF Global).

rules on the financial industry, and (ii) after the crisis has passed and conditions seem to return to “normal,” the public loses interest in the financial sector and the industry pushes Congress and regulators to repeal or soften the new rules.<sup>17</sup> Thus, as the financial crisis recedes in the public’s memory, the financial industry can weaken previously enacted reforms by exerting direct political influence through campaign contributions and lobbying, as well as indirect influence through “revolving door” employment opportunities offered to legislators and regulators.<sup>18</sup>

The financial industry’s success in obstructing Dodd–Frank’s reforms—despite recent blows to Wall Street’s already tarnished reputation—sheds new light on an enduring mystery from the financial crisis. Commentators have repeatedly asked why financial regulators “adopted policies that induced financiers to take excessive risks” during the period leading up to the crisis, even though regulators “often knew their policies were destabilizing the financial system many years before the crisis.”<sup>19</sup> Part III of this article provides an overview of legislative and regulatory mistakes that helped to inflate the enormous and unsustainable credit boom which triggered the crisis. From the early 1990s until the crisis broke out in 2007, Congress and federal regulators repeatedly ignored warning signs and implemented policies that encouraged reckless lending and securitization practices by banks, savings associations (thrifts) and nonbank mortgage companies. Those ill-fated policies included repealing restrictions on affiliations between banks and securities firms, watering down capital requirements, preempting state consumer protection laws, removing regulation of over-the-counter derivatives, and giving “superpriority” treatment in bankruptcy to derivatives and repurchase agreements for mortgage-related securities. After the financial crisis began, federal officials gave enormous amounts of financial assistance to threatened megabanks and also provided extensive forbearance by suspending mark-to-market

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17. Coffee, *supra* note 12, at 1029–31.

18. *Id.* at 1029–31, 1076–81; *see also* JOHNSON & KWAK, *supra* note 15, at 88–100, 133–37, 147–49, 175–88 (providing a similar explanation for why financial scandals often do not produce effective reforms); *infra* Part IV (describing the sources of the financial industry’s political and regulatory influence).

19. JAMES R. BARTH, GERARD CAPRIO JR., AND ROSS LEVINE, GUARDIANS OF FINANCE: MAKING REGULATORS WORK FOR US 5 (2012); *see also* KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS 149 (2011) (“Federal regulators acted in time to stop a complete collapse of the world economy, but where were they when consumers and their advocates, researchers, cities, and states were warning about the growing abuses in the subprime market?”); Arthur E. Wilmarth, Jr., *The Financial Services Industry’s Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FINANCIAL L. 881, 932 (2012) (“Why didn’t federal regulators stop financial institutions from generating huge volumes of high-risk credit that exploited consumers, risked their own soundness and undermined the stability of the financial markets?”).

accounting rules and by allowing the largest banks to defer losses on extensive portfolios of impaired second-lien housing loans.

Politicians, regulators and bankers subsequently asserted that the financial crisis was caused by “an unforeseeable confluence of events” that created a “perfect storm . . . no one could anticipate.”<sup>20</sup> However, those claims are demonstrably false.<sup>21</sup> A recent study of regulatory failures during the credit boom concluded that “financial regulators . . . repeatedly designed, implemented, and maintained policies that helped precipitate the global financial crisis . . . . [T]hey recklessly endangered the global economy.”<sup>22</sup> Part III of this article provides additional support for that conclusion.

Part IV offers four principal reasons for the pervasive legislative and regulatory mistakes that led to the financial crisis, as well as the financial industry’s success in undermining the implementation of Dodd–Frank. First, the financial industry wields enormous influence due to its massive spending on political campaigns and lobbying and its outsized share of the U.S. economy. The industry spent more than \$8.6 billion on political contributions and lobbying between 1998 and 2012 and earned very favorable returns on those investments. The industry achieved a series of major legislative victories between 1994 and 2005 and defeated several bills that attempted to restrict subprime lending. While the industry could not prevent Dodd–Frank’s passage, it did succeed in weakening several of Dodd–Frank’s key provisions and in subsequently obstructing the statute’s implementation.

Second, regulators have strong incentives to compete within and across national borders to attract the allegiance of major financial institutions. Competition among domestic and foreign regulators encourages officials to follow policies that please their existing

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20. BARTH, CAPRIO & LEVINE, *supra* note 19, at 1; *see also* ENGEL & MCCOY, *supra* note 19, at 11 (“Some people like to call the subprime crisis a perfect storm. That’s not what it was . . . Had anyone in Washington cared, the virus could have been checked.”); *compare* Nelson D. Schwartz & Eric Dash, *Where Was The Wise Man?*, N.Y. TIMES, April 27, 2008, § BU, at 1 (quoting Citigroup executive committee chairman and former Treasury Secretary Robert Rubin, who stated, “I don’t know of anyone who foresaw a perfect storm, and that’s what we’ve had here.”).

21. BARTH, CAPRIO & LEVINE, *supra* note 19, at 1–5, 85–86, 118–20, 204–06; *see also id.* at 205 (“[T]his crisis is not essentially about unforeseeable shocks . . . . Rather, many regulators made many mistakes, problems grew ever worse over years, regulators learned of or should have recognized the cumulating problems arising from their policies and from the obvious changes in the financial landscape, and yet the regulators chose not to respond until it was too late.”); ENGEL & MCCOY, *supra* note 19, at 10, 204 (“[T]he federal government witnessed what was happening [with abusive subprime lending] and made a deliberate decision to desist from any meaningful action . . . . [T]he federal government bears strong collective responsibility for the subprime crisis and the enormous financial harm it inflicted on ordinary Americans.”).

22. BARTH, CAPRIO & LEVINE, *supra* note 19, at 4–5; *see also* ENGEL & MCCOY, *supra* note 19, at 11 (“This book is born of frustration: frustration that Congress and federal regulators refused to heed warnings about the subprime market and let subprime loans spiral out of control.”).

regulated constituents and attract new ones. Similarly, legislators fear that restrictive policies might cause global financial firms to move large segments of their operations to foreign jurisdictions. During the two decades leading up to the financial crisis, large financial institutions skillfully exploited these opportunities for regulatory arbitrage and secured legislative and regulatory concessions that enabled those institutions to expand their operations and assume greater risks. Since Dodd–Frank’s enactment, the financial industry has continued to assert the need for international “competitiveness” as a rationale for not adopting strong new safeguards for megabanks.

Third, the financial industry’s political clout discourages regulators from imposing tougher restraints on financial institutions. Regulators who dare to challenge the industry encounter intense “pushback” from industry trade groups and their political and regulatory allies. In addition, the “revolving door” between government service and financial-sector jobs encourages regulators to accommodate industry demands for deregulation and supervisory “flexibility.” The most egregious form of regulatory accommodation has occurred in the area of law enforcement. Regulators and law enforcement agencies have repeatedly invoked the need to preserve financial stability as a reason not to impose criminal sanctions (or even harsh civil sanctions) on large financial firms or their top executives. As a result, not a single major financial firm, or a single senior executive of such a firm, has been criminally prosecuted despite widespread evidence of serious misconduct at many large financial institutions.

Fourth, over the past three decades politicians, regulators and industry leaders have developed a common “mindset” that promotes deregulation and opposes effective supervision of large financial institutions. Prior to the outbreak of the crisis in 2007, the “conventional wisdom” in Washington and on Wall Street strongly supported “financial innovation and deregulation” and opposed “governmental interference in the economy.”<sup>23</sup> Officials who disagreed with this consensus “were marginalized as people who simply did not understand the bright new world of modern finance.”<sup>24</sup>

Since Dodd–Frank’s passage, the largest banks and their political and regulatory supporters have continued to advance many of the same arguments that were widely accepted as “conventional wisdom” before the crisis. As explained in Part IV(B), those arguments include claims that (i) large financial conglomerates are essential to meet the demands of a globalized economy, and (ii) requiring megabanks to satisfy

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23. JOHNSON & KWAK, *supra* note 15, at 89–90, 97–101 (quotes at 89, 101).

24. *Id.* at 97.

stronger prudential regulations will impair their ability to compete with foreign universal banks and reduce the availability of credit for businesses and consumers. The continued repetition of these shopworn arguments by industry representatives and their political and regulatory allies—despite the greatest financial crisis since the Great Depression—speaks volumes about Wall Street’s continuing political clout. In addition, the industry contends that the “costs” of new financial reforms will outweigh their likely “benefits.” However, the industry refuses to acknowledge the enormous costs that our nation and many other countries have incurred due to weak or nonexistent regulation during the pre-crisis boom.<sup>25</sup>

As explained in Part IV(C), two events in March 2013 demonstrated that megabanks remain too big to fail (TBTF) as well as too big to manage or discipline effectively. First, Attorney General Eric Holder acknowledged during a Senate committee hearing that the Department of Justice was very reluctant to pursue criminal charges against the largest financial institutions because of the potentially destabilizing impact of such prosecutions on domestic and global financial systems. Second, a Senate investigative report on JPMorgan’s “London Whale” trading scandal revealed systemic failures in risk management and oversight by both the bank’s management and the bank’s primary regulator, the Office of the Comptroller of the Currency (OCC).

The analysis set forth in this article might lead to the discouraging conclusion that the battle for financial reform is over, because Wall Street’s political influence is just too strong and too pervasive for reform advocates to overcome. However, Part V suggests that Attorney General Holder’s “too big to jail” admission and the Senate investigative report on JPMorgan’s “London Whale” trades could prove to be watershed events. Shortly after those events occurred, a national survey found that half of American adults supported a mandatory breakup of the largest banks, and the Senate voted 99–0 in favor of a non-binding resolution calling for an end to government subsidies for megabanks.

In April 2013, Senators Sherrod Brown (D-OH) and David Vitter (R-LA) introduced a bill that would require banks larger than \$50 billion to maintain significantly higher levels of equity capital, with the most stringent capital mandate imposed on banks larger than \$500 billion. The bill was hailed by some senior regulators and by many policy analysts and journalists as a strong challenge to the TBTF subsidies enjoyed by megabanks. Wall Street institutions and their lobbyists fiercely attacked the bill, and the Obama Administration indicated its

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25. See *infra* Part II(B)(2) (providing a summary of some of the principal costs of the financial crisis).

lack of support by claiming that Dodd–Frank had already solved the TBTF problem. Notwithstanding that opposition, the Brown–Vitter bill could significantly alter the TBTF debate by (i) highlighting the inadequacy of Dodd–Frank’s reforms, as implemented to date, and (ii) focusing the TBTF debate on issues where Wall Street is highly vulnerable, including the largest banks’ dangerously low levels of equity capital and the extensive subsidies those banks receive from the federal government. It remains to be seen whether continued revelations of excessive risk-taking and other abuses on Wall Street will finally mobilize the American people to demand fundamental legislative reforms, like Brown–Vitter, which could finally break Wall Street’s stranglehold over financial policy.

## II. THE FINANCIAL INDUSTRY’S CAMPAIGN TO BLOCK DODD–FRANK’S IMPLEMENTATION

Financial institutions and their trade associations have pursued a campaign on three fronts to undermine Dodd–Frank’s reforms. First, they have lobbied extensively to delay and weaken rulemakings mandated by Dodd–Frank. Second, they have filed lawsuits to overturn final rules that the industry opposes. Third, they helped to elect a Republican majority in the House of Representatives in 2010 and again in 2012, and House Republican leaders have pushed bills to repeal key reforms or to hamstring the ability of federal agencies to carry out those reforms.<sup>26</sup> In mid-2012, former CFTC chairman Brooksley Born publicly warned that the financial industry was succeeding in its efforts to block Dodd–Frank’s reforms by “lobbying for the dismantling of protections in the Act, delay[ing] rulemaking procedures, challenging the rules in the courts, trying to defund regulatory agencies and preventing appointment of key regulators.”<sup>27</sup>

### A. *The Industry’s Lobbying Efforts to Impede Dodd–Frank’s Reforms*

As soon as Congress passed Dodd–Frank, the financial industry unleashed a massive lobbying campaign to undermine the ability of federal agencies to issue rules to implement the statute.<sup>28</sup> Due in large

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26. See, e.g., Edwards, *supra* note 7; Rivlin, *supra* note 7; Taibbi, *supra* note 7.

27. Adler, *supra* note 9 (quoting Ms. Born).

28. See, e.g., Binyamin Appelbaum, *On Finance Bill, Lobbying Shifts to Regulations*, N.Y. TIMES, June 27, 2010, at A1; Gretchen Morgenson, *It’s Not Over Until it’s in the Rules*, N.Y. TIMES, Aug. 29, 2010, at BU1; Stacy Kaper, *Now for the Hard Part: Writing All the Rules*, AM. BANKER, July 22, 2010, at 1; Cheyenne Hopkins, *Bankers Seek Ways to Gut Prop-Trading Ban*, AM. BANKER, Nov. 19, 2010, at 1; Asjlynn Loder & Phil Mattingly, *Wall Street Lobbyists Besiege CFTC to Shape Derivatives Rules*, BLOOMBERG (Oct. 14, 2010, 12:20 AM), <http://www.bloomberg.com/news/2010-10->

part to the success of that campaign, federal agencies failed to adopt more than three-fifths of the 279 rules whose issuance was required by June 2013.<sup>29</sup> Prominent examples of the financial industry's lobbying prowess include the industry's ability to delay adoption of final rules governing systemically important financial institutions (SIFIs) as well as implementation of the Volcker Rule and Dodd–Frank's new regulatory regime for over-the-counter (OTC) derivatives.

### 1. Enhanced Regulatory Requirements for SIFIs

After encountering heavy industry resistance, the Financial Stability Oversight Council (FSOC) moved at a snail's pace toward Dodd–Frank's goal of identifying nonbank financial companies that should be designated and regulated as SIFIs.<sup>30</sup> Dodd–Frank authorizes FSOC to designate nonbank SIFIs in order to place those companies under the systemic risk oversight regime administered by the Federal Reserve Board (FRB).<sup>31</sup> However, almost three years elapsed before FSOC finally proposed to designate the first group of nonbank SIFIs in June 2013.<sup>32</sup>

After withdrawing proposed rules that were strongly opposed by the

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14/wall-street-lobbyists-besiege-cftc-to-influence-regulations-on-derivatives.html.

29. Frank Pompa & Denny Gainer, *Who Killed Financial Reform: After three years, key parts of the plan to avert another Wall Street crisis remain undone*, USA TODAY, June 4, 2013, at 1A (available on Lexis) (reporting that federal regulators missed 175 (about 63%) of the 279 Dodd–Frank rulemaking deadlines that had passed by June 3, 2013, and regulators failed to issue proposed rules for 64 of the 175 missed deadlines); see also DAVIS POLK, DODD–FRANK PROGRESS REPORT 2 (June 2013), available at [http://www.davispolk.com/files/Publication/3bafb045-659b-40f0-be66-00c49ba3bffd/Presentation/PublicationAttachment/c5d1116c-35b9-46db-8ed1-055523d30e9f/Jun2013\\_Dodd.Frank.Progress.Report.pdf](http://www.davispolk.com/files/Publication/3bafb045-659b-40f0-be66-00c49ba3bffd/Presentation/PublicationAttachment/c5d1116c-35b9-46db-8ed1-055523d30e9f/Jun2013_Dodd.Frank.Progress.Report.pdf) (providing same information) [hereinafter Dodd–Frank Progress Report].

30. Wilmarth, *supra* note 12, at 993–94 (discussing Dodd–Frank's creation of FSOC and FSOC's responsibility for designating nonbank financial companies as SIFIs if "material financial distress" at such companies "could pose a threat to the financial stability of the United States") (quoting Dodd–Frank § 113(a)(1)).

31. See Wilmarth, *supra* note 12, at 993–95, 1006–08 (discussing FSOC's authority to designate nonbank SIFIs, and explaining that the FRB may impose a range of prudential regulations, including capital and liquidity requirements, to mitigate the systemic risk posed by nonbank SIFIs).

32. On June 3, 2013, FSOC "voted to make proposed determinations regarding an initial set of nonbank financial companies [that would be designated as nonbank SIFIs] under section 113 of the Dodd–Frank Act." Jeff Bater, *Systemic Risk: Council Votes on Proposed Determinations Of Nonbank SIFIs; Doesn't Name Firms*, 100 BNA'S BANKING REP. 1027 (2013) (quoting Treasury Department spokesperson Suzanne Elio). FSOC did not name the firms that were subject to the proposed determinations, but American International Group (AIG), GE Capital and Prudential disclosed that they received notices of proposed designation from FSOC. *Update 3-U.S. regulators propose scrutiny of AIG, Prudential, GE Capital*, REUTERS, June 3, 2013. Each of the firms receiving the proposed designations would have the right to request a hearing within 30 days thereafter. If any of those firms did request a hearing, FSOC would be required to hold a nonpublic hearing to decide whether to issue a final order designating that firm as a nonbank SIFI. *Id.*



financial industry,<sup>33</sup> FSOC did not issue final rules governing the process for designating nonbank SIFIs until April 2012. Those rules establish a lengthy procedure—including three stages of FSOC evaluation, followed by the right of an identified nonbank financial company to demand a hearing and seek judicial review—before FSOC can make a final designation.<sup>34</sup> Due to FSOC’s long delay in issuing even its first set of proposed designations, major nonbank financial firms—including leading insurance companies and large asset managers—have remained outside Dodd–Frank’s systemic risk oversight regime, even though “[t]he ability to keep a closer eye on financial giants other than banks is a major aspect of [Dodd–Frank].”<sup>35</sup>

Dodd–Frank authorized FSOC to designate nonbank SIFIs in order to “prevent the chaos that occurred” when federal regulators were forced to bail out American International Group (AIG), the nation’s largest insurance company, in the fall of 2008.<sup>36</sup> By identifying nonbank SIFIs, FSOC would bring those companies “within the perimeter of prudential rules” and would enable the FRB to exercise the types of supervisory powers that it needed but did not possess over large securities firms and insurance companies during the financial crisis.<sup>37</sup> FSOC’s painfully slow progress toward designating nonbank SIFIs has clearly undermined one of Dodd–Frank’s primary objectives.<sup>38</sup>

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33. R. Christian Bruce, *Systemic Risk: FSOC Plans Three-Stage Analysis to Tag Systemically Risky Nonbanks*, 97 BNA’S BANKING REP. 634 (2011) (reporting that FSOC scrapped its original proposal for rules governing the designation of nonbank SIFIs after that proposal “sparked a chorus of protests from critics”); see also Dave Clarke, *Financial Risk Council Readies Systemic Tag*, REUTERS (Apr. 3, 2012, 6:00 PM), <http://www.reuters.com/article/2012/04/03/us-financial-regulation-sifi-idUSBRE83211A20120403> (reporting that “[l]arge insurers, hedge funds and other [nonbank] financial firms are hoping to avoid the systemic designation and have been trying to convince regulators to leave them alone”).

34. Mike Ferrulo, *Systemic Risk: Officials Say Selection, Supervision of SIFIs Will Be Tailored to Each Firm’s Risks*, 98 BNA’S BANKING REP. 891 (May 22, 2012) (describing FSOC’s issuance on April 3, 2012, of final regulations governing the process for designating of nonbank SIFIs).

35. Clarke, *supra* note 33; see also S. REP. NO. 111-176, at 2–3 (2010) (explaining that Dodd–Frank authorizes FSOC to “require nonbank financial companies to be supervised by the Federal Reserve if their failure would pose a risk to U.S. financial stability,” in order to prevent “the harm that could be inflicted on the financial system and economy by the failure of . . . [systemically important] nonbank financial firms operated with inadequate government oversight”).

36. Clarke, *supra* note 33; see also FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 139–42, 200–02, 344–51 (2011) [hereinafter FCIC Report], available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (describing the factors contributing to the federal government’s emergency bailout of AIG, including the lack of effective regulation of AIG and the failure by federal officials to identify the systemic risks created by AIG’s massive issuances of credit default swaps).

37. Daniel K. Tarullo, FRB Governor, Speech at the Council on Foreign Relations (May 2, 2012), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20120502a.pdf> [hereinafter Tarullo, May 2, 2012 Speech].

38. Barbara A. Rehm, *Editor at Large: Dodd–Frank’s Big Misses: Systemic Risk, Reg Reform*,

The financial industry's opposition has also bogged down the FRB's efforts to establish enhanced prudential requirements for both nonbank SIFIs and bank SIFIs (banking organizations with assets over \$50 billion), as required by Sections 165 and 166 of Dodd Frank.<sup>39</sup> The FRB did not issue proposed rules under Sections 165 and 166 until the end of 2011, nearly eighteen months after Dodd-Frank's enactment.<sup>40</sup> The FRB's proposed rules included heightened capital and liquidity requirements, counterparty credit exposure limits, risk management standards, periodic stress test requirements and early remediation sanctions for SIFIs that fail to comply with the FRB's enhanced prudential standards.<sup>41</sup> The FRB explained that its proposals were designed to reduce the systemic risks posed by large, complex financial institutions and to decrease the likelihood of future taxpayer bailouts of TBTF institutions.<sup>42</sup>

In response, financial industry trade groups attacked every major aspect of the proposed rules.<sup>43</sup> Five trade associations representing the

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AM. BANKER, July 21, 2011, at 1 (contending that Dodd-Frank "was supposed to prevent a repeat of the 2008 financial crisis by identifying which firms are too big to fail and then subjecting them to tighter oversight and higher capital standards," and maintaining that FSOC's delay in designating nonbank SIFIs "exposes a lack of leadership that is fueling uncertainty and anxiety"). As discussed above, FSOC did not issue proposed designations for the first group of nonbank SIFIs until June 2013. See *supra* note 32 and accompanying text. In contrast, FSOC acted more quickly in designating eight "financial market utilities" (FMUs) as "systemically important" under Title VIII of Dodd-Frank in July 2012. The eight designated FMUs operate multilateral systems for clearing, transferring and settling payments and other financial transactions (including purchases and sales of securities and other financial instruments). FINANCIAL STABILITY OVERSIGHT COUNCIL, 2012 ANNUAL REPORT 110-11, 145-87, available at <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>.

39. See Dodd-Frank, §§ 165-66.

40. Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012) [hereinafter FRB Proposed Rules for SIFIs]; see also R. Christian Bruce, *Regulatory Reform: Fed Launches New Phase in Bank Oversight with Tougher Rules for Systemic Institutions*, 98 BNA'S BANKING REP. 5 (2012).

41. See FRB Proposed Rules for SIFIs, *supra* note 40, at 594-602 (providing an overview of the FRB's proposal); Bruce, *supra* note 40 (same).

42. In the preamble to its proposed rules, the FRB stated that "[t]he recent financial crisis showed that some financial companies had grown so large, leveraged, and interconnected that their failure could pose a threat to overall financial stability." FRB Proposed Rules for SIFIs, *supra* note 40, at 595. The FRB also observed that "[t]he market perception that some companies are 'too big to fail' poses threats to the financial system" by reducing incentives for market discipline of those companies and by producing "competitive distortions" through lower funding costs for those firms. *Id.*

43. Donna Borak, *Regionals, Big Banks Raise Fears on Slew of Fed Rules*, AM. BANKER, May 8, 2012 (reporting that banks and financial trade groups filed 90 comment letters, which included claims that the FRB's proposal "went too far and needs to be significantly reworked"); Dave Clarke, *Big Isn't Bad, Banks Tell Fed*, REUTERS (Apr. 27, 2012, 6:01 PM), <http://www.reuters.com/article/2012/04/27/us-financial-regulation-fed-idUSBRE83Q19Q20120427>

(reporting that "[l]obbying groups representing the big banks are pushing back against" the FRB's proposal); Cheyenne Hopkins & Dawn Kopecki, *JPMorgan's Zubrow Says Fed Risk Rule May Hurt Markets*, BLOOMBERG (Apr. 30, 2012, 8:02 PM), <http://www.bloomberg.com/news/2012-04-30/jpmorgan-s-zubrow-says-fed-risk-rule-may-hurt-markets.html> (reporting that JPMorgan's comment letter argued that the FRB's proposal went "well beyond" Dodd-Frank's mandate and sought to impose

largest U.S. financial institutions challenged the FRB's proposals for being "premised" on the view that "big is bad" and "size inherently is a major indicator of and contributor to systemic risk."<sup>44</sup> The associations alleged that the FRB "has set a course to use Section 165 [of Dodd-Frank] to achieve . . . a reduction in the size of large banks through size-based regulation."<sup>45</sup> The associations maintained that any "approach grounded in a 'too big' or 'big is bad' concept is . . . misguided and detrimental to a sound, strong banking system and a strong economy."<sup>46</sup>

Wall Street firms and trade associations also strongly opposed the FRB's proposal to establish a single counterparty credit limit (equal to ten percent of a SIFI's capital stock and surplus), which would impose a ceiling on its aggregate net exposure to any other nonbank SIFI or bank holding company (BHC) having assets over \$500 billion.<sup>47</sup> Industry participants maintained that the credit limit proposal "would needlessly reduce liquidity in the financial system and thereby dampen economic activity,"<sup>48</sup> and "could destabilize markets" by restricting the ability of SIFIs to execute risk-hedging transactions with large counterparties.<sup>49</sup>

In May 2012, senior executives of several major banks held a "closed-door meeting" with FRB Governor Daniel Tarullo (the official who heads the FRB's bank supervision efforts). During that meeting, they criticized the FRB's efforts to establish stronger prudential standards for SIFIs and to implement the Volcker Rule.<sup>50</sup> One news

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"disruptive' standards").

44. Letter from The Clearing House Ass'n L.L.C., American Bankers Ass'n, Financial Services Forum, Financial Services Roundtable, and Securities Industry and Financial Markets Ass'n, to the FRB 16 (Apr. 27, 2012), available at [http://op.bna.com/bar.nsf/id/cbre-8tukx4/\\$File/tradegroupletter165166.pdf](http://op.bna.com/bar.nsf/id/cbre-8tukx4/$File/tradegroupletter165166.pdf) [hereinafter Big Bank Systemic Risk Comment Letter]. The five trade associations that signed the letter "collectively represent financial institutions accounting for a substantial majority of banking and financial assets in the United States." *Id.* at 1 n.1.

45. Big Bank Systemic Risk Comment Letter, *supra* note 44, at 16 (pointing out that the preamble to the FRB's proposal stated that the proposed rules "would provide incentives for [SIFIs] to reduce their systemic footprint") (quoting FRB Proposed Rules for SIFIs, *supra* note 40, at 596).

46. *Id.* at 16-17; see also *infra* notes 696-707 and accompanying text (discussing arguments presented by the largest financial institutions and their allies in support of the alleged benefits created by big banks).

47. While Section 165(e)(2) of Dodd-Frank generally limits single-party credit exposures to 25 percent of a SIFI's capital and surplus, the statute authorizes the FRB to adopt rules imposing stricter limits if the FRB determines such limits are "necessary to mitigate risks to the financial stability of the United States." Dodd-Frank, § 165 (e)(2); see also FRB Proposed Rules for SIFIs, *supra* note 40, at 600, 612-14 (discussing proposed single-counterparty credit limit exposure limits for SIFIs).

48. Big Bank Systemic Risk Comment Letter, *supra* note 44, at 4.

49. Hopkins & Kopecki, *supra* note 43 (quoting and summarizing JPMorgan's comment letter); see also Lauren Tara LaCapra, *Banks Fight Fed's Push to Make Them Less Entwined*, REUTERS (June 26, 2012, 3:05 PM), <http://www.reuters.com/article/2012/06/25/us-banks-derivatives-rules-idUSBRE85O16820120625> (reporting that "the industry is spooked by [the credit risk exposure] rules").

50. Bradley Keoun et al., Joshua Zumbun & Cheyenne Hopkins, *Dimon Cites "Give and Take" After Bank Chiefs Meet at Fed*, BLOOMBERG (May 3, 2012, 12:00 AM), <http://www.bloomberg.com/news/2012-05-03/dimon-meets-tarullo-as-banks-lobby-fed-on-softer->

report described the meeting as “highlight[ing] the magnitude of Wall Street’s campaign to blunt new regulations” because it showed the determination of “Wall Street bosses . . . to personally lobby the Federal Reserve about softening proposed reforms that might crimp their profits.”<sup>51</sup>

Mr. Tarullo did not respond directly to the bankers’ objections at the meeting.<sup>52</sup> However, in a speech given earlier on the same day, Mr. Tarullo stated that it was “sobering to recognize that, more than four years after the failure of Bear Stearns began the acute phase of the financial crisis, so much remains to be done.”<sup>53</sup> He also expressed his “concern . . . that the momentum generated during the crisis will wane or be redirected to other issues before reforms have been completed.”<sup>54</sup> He further warned that, if regulators failed to complete a “rigorous implementation” of Dodd–Frank’s reforms, “we will have lost the opportunity to reverse the pre-crisis trajectory of increasing too-big-to-fail risks.”<sup>55</sup> The content and timing of Mr. Tarullo’s speech indicated that he viewed Wall Street’s lobbying campaign as a significant and potentially dangerous obstacle to the accomplishment of Dodd–Frank’s reforms.

In mid-2013—a full year after Mr. Tarullo’s speech—the FRB’s proposals for enhanced prudential requirements for SIFIs remained unfinished business.<sup>56</sup> Indeed, the FRB and its fellow banking agencies (the FDIC and OCC) completed less than two-fifths of the regulations

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rules.html (describing Governor Tarullo’s private meeting with CEOs of JPMorgan, Bof A, Goldman, Morgan Stanley, U.S. Bancorp and State Street); *see also* Donna Borak, *Fed Discloses Details of Private Meeting with Bank CEOs*, AM. BANKER, May 3, 2012 (same); Craig Torres & Cheyenne Hopkins, *A Fed Regulator Who Actually Regulates*, BLOOMBERG BUSINESSWEEK, Mar. 26, 2012, at 13 (explaining that Mr. Tarullo is “the Fed governor in charge of bank supervisions and regulation” and “[i]n the past three years, no one has done more to strengthen the government’s grip on the financial system”).

51. Keoun et al., *supra* note 50.

52. Borak, *supra* note 50 (reporting that Mr. Tarullo listened but did not respond to comments made by the bank CEOs during the meeting).

53. Tarullo, May 2, 2012 Speech, *supra* note 37; *see also* Keoun, *supra* note 50 (reporting that Mr. Tarullo delivered his speech “earlier in the day” before he met with the bank CEOs).

54. Tarullo, May 2, 2012 Speech, *supra* note 37.

55. *Id.*

56. Barbara A. Rehm, *Regulators’ Reputation Sinks Along with Industry’s*, AM. BANKER, Mar. 28, 2013, at 1, 2013 WLNR 7543392 (reporting that the FRB had not yet adopted final rules establishing “enhanced prudential standards” for SIFIs even though those rules “are key to preventing the next crisis”); *see also* Satish M. Kini et al., *The Federal Reserve’s Proposal and the Foreign Banking Community: A Practical Guide for Foreign Banks*, 32 BANKING & FINANCIAL SERVICES POLICY REPORT No. 5 (May 2013), at 21, 21, 26 (reporting that the FRB issued proposed rules in December 2012 that would establish enhanced prudential standards for large foreign banks with significant operations in the U.S., and the proposed standards for foreign banks were “generally consistent” with the enhanced prudential standards that the FRB proposed for SIFIs in December 2011 but had not yet adopted in final form).

those agencies were required to adopt by June 2013.<sup>57</sup>

## 2. Regulations Implementing the Volcker Rule and Title VII of Dodd–Frank

Wall Street firms and financial trade associations have also waged determined wars of attrition against rulemakings designed to implement Section 619 (the Volcker Rule) and Title VII of Dodd–Frank.<sup>58</sup> By mid-2013, industry members had battled the Volcker Rule to a virtual standstill, and they had significantly delayed the implementation of Title VII.

The Volcker Rule prohibits banking organizations from engaging in “proprietary trading,” and it also limits their investments in hedge funds and private equity funds.<sup>59</sup> The financial industry has sought to undermine the Volcker Rule’s effectiveness on numerous grounds, including by persuading regulators to adopt very broad interpretations of the statute’s exemptions for “market making” and “risk-mitigating hedging.”<sup>60</sup> When federal regulators issued a proposed set of implementing regulations in October 2011, the American Bankers Association immediately condemned the “oversized nature and complexity” of the proposal and declared that the proposal was “unworkable.”<sup>61</sup> A month later, the U.S. Chamber of Commerce

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57. Dodd–Frank Progress Report, *supra* note 29, at 5 (showing that the FDIC, FRB and OCC finished only 40 of 104 rulemakings whose deadlines had passed by June 3, 2013).

58. *See* SEN. REP. NO. 111-176, at 8–9, 29–35, 90–101 (2010) (describing the Volcker Rule and the new regime for regulating derivatives under Title VII of Dodd–Frank); Pompa & Gainer, *supra* note 29 (describing the financial industry’s success in blocking the implementation of the Volcker Rule and Dodd–Frank’s provisions governing derivatives).

59. *See* Wilmarth, *supra* note 12, at 1025–30 (describing the Volcker Rule, which prohibits “proprietary trading” by banking organizations and sharply limits their investments in hedge funds and private equity funds); Krawiec, *supra* note 12, at 14–16 (same).

60. *See, e.g.,* Wilmarth, *supra* note 12, at 1028–30; Dave Clarke & Jonathan Spicer, *Regulators Split on Hedging Under Volcker Rule*, REUTERS (Sept. 21, 2011, 12:42 PM), <http://www.reuters.com/article/2011/09/21/us-financial-regulation-volcker-idUSTRE78K42R20110921>; Hopkins, *supra* note 28; Yalman Onaran, *Attack on Volcker Rule Seen Exaggerating Cost of Disruption to Bond Market*, BLOOMBERG (Jan. 18, 2012, 2:29 PM), <http://www.bloomberg.com/news/2012-01-18/attack-on-volcker-rule-seen-exaggerating-cost-of-disruption-to-bond-market.html>; Cheyenne Hopkins, Silla Brush & Phil Mattingly, *Volcker Rule Faces Critics as Effective Date Nears*, BLOOMBERG (Feb. 14, 2012, 11:13 AM), <http://www.bloomberg.com/news/2012-02-14/u-s-volcker-rule-faces-harsh-global-critics-months-before-it-takes-effect.html>.

61. Yin Wilczek, *Regulatory Reform: Banking Regulators Issue Volcker Proposal*, 97 BNA’S BANKING REP. 633 (2011) (quoting the American Bankers Association’s press release issued on Oct. 11, 2011); *see also* Phil Mattingly & Cheyenne Hopkins, *U.S. Regulators to Defend Volcker Rule Ban on Proprietary Trades*, BLOOMBERG (Jan. 18, 2012), <http://www.businessweek.com/news/2012-01-20/u-s-regulators-to-defend-volcker-rule-ban-on-proprietary-trades.html> (reporting that financial firms attacked the regulators’ proposal to implement the Volcker Rule for being “too complex and potentially damaging for financial markets,” and noting that the proposal included nearly 1,300 questions and was almost 300 pages long).

attacked the proposal as “the poster child of regulatory complexity” and demanded that federal regulators withdraw the proposal and issue a new set of proposed rules.<sup>62</sup>

The complexity of the regulators’ Volcker Rule proposal resulted in part from their decision to include highly detailed exemptions and safe harbors in response to concerns expressed by the financial industry.<sup>63</sup> Similarly, the industry persuaded regulators to include in the proposal a broad extraterritorial application of the Volcker Rule, in order to “level the playing field” between U.S. and foreign banks.<sup>64</sup> However, after regulators issued their proposal, U.S. bankers encouraged foreign banks and foreign regulators to oppose the proposal’s international scope.<sup>65</sup> American financiers also urged foreign officials to object to the regulators’ proposal because it would not permit banks to trade foreign sovereign bonds, while the statutory language of the Volcker Rule allows banks to trade U.S. government securities.<sup>66</sup> Due to the intense opposition marshaled by financial industry, federal regulators failed to issue final implementing regulations for the Volcker Rule by the statutory deadline of July 21, 2012.<sup>67</sup> A Treasury official subsequently predicted that regulators would adopt a “final version” of the Volcker

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62. *U.S. Chamber Calls for Re-Proposal and Delay of Volcker Rule*, U.S. CHAMBER OF COMMERCE (Nov. 17, 2011), <http://www.uschamber.com/press/releases/2011/november/us-chamber-calls-re-proposal-and-delay-volcker-rule>; see also *Regulatory Reform: U.S. Chamber Calls on Regulators to Withdraw, Repropose Volcker Rule*, 97 BNA’S BANKING REP. 890 (Nov. 22, 2011).

63. *Bankers’ Objections to Volcker Rule Fail on the Merits*, BLOOMBERG (Oct. 19, 2011, 8:00 PM), <http://www.bloomberg.com/news/2011-10-20/big-u-s-banks-main-objections-to-volcker-rule-fail-on-the-merits-view.html> (“The complexity [in the proposal] is largely financial-industry lobbyists’ own doing” because “many of the proposed rule’s 298 pages and 383 questions are devoted to carving out exceptions” requested by the industry); Mattingly & Hopkins, *supra* note 61 (reporting the view of Rep. Barney Frank that the proposal’s complexity resulted from efforts by regulators to “accommodate[] the concerns” of the financial industry).

64. Yalman Onaran, *Bank Lobby Widened Volcker Rule, Inciting Foreign Outrage*, BLOOMBERG (Feb. 23, 2012, 3:56 PM), <http://www.bloomberg.com/news/2012-02-23/banks-lobbied-to-widen-volcker-rule-before-inciting-foreigners-against-law.html> (quoting Douglas Landy, head of U.S. financial regulatory practice at the Allen & Overy law firm).

65. *Id.*

66. *Id.*; Cheyenne Hopkins, *U.S. Regulators Exploring Volcker Exemption for Foreign Sovereign Debt*, BLOOMBERG (Feb. 1, 2012, 12:01 AM), <http://www.bloomberg.com/news/2012-02-01/u-s-regulators-weigh-volcker-exemption-for-sovereign-debt.html>. The Volcker Rule expressly exempts trading by banking organizations in U.S. government securities but does not contain a similar exemption for securities issued by foreign governments. Dodd–Frank § 619(d)(1)(A).

67. Donna Donna Borak, *Fed’s Raskin Pushes for Tougher Volcker Rule*, AM. BANKER, July 25, 2012 (reporting that “[r]egulators have already missed the statutory deadline to finalize the Volcker Rule by July 21”); see also Donna Borak, *Fed’s Plosser: “Volcker Rule” Outcome Still Murky*, AM. BANKER, Apr. 13, 2012 [hereinafter Borak, “Fed’s Plosser”] (reporting that the Volcker Rule proposal was “opposed by many banks and even some foreign governments”). In April 2012, the FRB issued guidance confirming that banks would not be expected to comply fully with the Volcker Rule (as finally implemented) until July 21, 2014. Donna Borak, *Regulators Offer Long-Awaited Guidance on Compliance With Volcker Rule*, AM. BANKER, Apr. 20, 2012.

Rule by the end of 2012.<sup>68</sup> However, in mid-2013 the Volcker Rule remained unfinished, and final adoption was “nowhere in sight.”<sup>69</sup>

The financial industry has similarly delayed efforts by the CFTC and the Securities and Exchange Commission (SEC) to implement Title VII of Dodd–Frank, which establishes a comprehensive regulatory regime for OTC derivatives.<sup>70</sup> Prior to Dodd–Frank’s passage, the OTC derivatives business was largely unregulated and was also a leading source of profits for the largest U.S. banks.<sup>71</sup> Not surprisingly, major banks strongly opposed Title VII’s provisions that mandate centralized clearing, public reporting and collateralization of swaps trading, and that also require banks to transfer some of their derivatives trading activities to separately-incorporated affiliates.<sup>72</sup> Since Dodd–Frank’s enactment, Wall Street banks and their allies have conducted a massive lobbying campaign to weaken or delay the implementation of Title VII that is

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68. *Final Volcker Rule Expected by Year-End—Treasury Official*, REUTERS (Aug. 21, 2012, 11:50 AM), <http://www.reuters.com/article/2012/08/21/volcker-timeline-idUSL2E8JL4CB20120821>.

69. Darrell Delamaide, *Volcker rule delay shows financial reform’s flaws*, USA TODAY, April 10, 2013, available at <http://www.usatoday.com/story/money/business/2013/04/10/delamaide-column-volcker-rule/2070951/>; see also Pompa & Gainer, *supra* note 29 (reporting that the Volcker Rule “remains unfinished and long behind schedule” in June 2013).

70. Under Title VII, the SEC regulates “security-based swaps” while the CFTC regulates other types of “swaps.” The agencies are required to “consult and coordinate” in adopting rules and orders governing such instruments with the goal of “assuring regulatory consistency and comparability to the extent possible.” Dodd–Frank, § 712(a)(1), (2). For discussions of the reforms mandated by Title VII of Dodd–Frank, see Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd–Frank’s Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. BUS. & TECH. L. 127, 152–55 (2011); Adam J. Krippel, *Regulatory Overhaul of the OTC Derivatives Market: The Costs, Risks, and Politics*, 6 ENTREPREN. BUS. L.J. 269, 281–97 (2011).

71. Krippel, *supra* note 70, at 281–82 (explaining that five large U.S. banks controlled 96% of all derivatives held by U.S. banks and also controlled almost two-fifths of global derivatives markets); Kambiz Foroohar, *Gensler Evolving in Derivatives War Sees No Deed Go Unpunished*, BLOOMBERG (June 21, 2011, 7:07 PM), <http://www.bloomberg.com/news/2011-06-21/gensler-evolving-in-derivatives-war-sees-no-deed-go-unpunished.html> (reporting that the five largest U.S. banks generated \$30 billion in annual profits from trading in derivatives).

72. See Alison Vekshin & Phil Mattingly, *Lawmakers Reach Compromise on Financial Regulation*, BLOOMBERG (June 26, 2010, 12:01 AM), <http://www.bloomberg.com/news/2010-06-25/lawmakers-reach-compromise-on-financial-regulation.html> (describing lobbying battles and debates over Dodd–Frank’s provisions regulating OTC derivatives); see also Wilmarth, *supra* note 12, at 1030–34 (explaining that Section 716 of Dodd–Frank (the Lincoln Amendment) was originally designed to force banks to move most of their OTC derivatives trading activities into separate nonbank affiliates; however, the House-Senate conference committee significantly weakened Section 716 by inserting several exemptions as a result of “intense opposition” from Wall Street banks and their legislative allies); Krippel, *supra* note 70, at 284–85 (explaining that the “watered down” Lincoln Amendment applies to less than one-fifth of the OTC derivatives market); see also Jesse Hamilton, *OCC Tells Banks To Start Planning Safe Phase-out of Swaps Trades*, BLOOMBERG (June 12, 2013) (reporting that the OCC and FRB gave U.S. banks and foreign banks with U.S. operations two additional years—i.e., until July 2015—to comply with the Lincoln Amendment’s requirement to transfer equity swaps, commodity swaps and certain non-cleared derivatives to separate affiliates), <http://www.bloomberg.com/news/2013-06-12/occ-tells-banks-to-start-planning-safe-phase-out-of-swaps-trades.html>.

comparable to their epic battle against the Volcker Rule.<sup>73</sup>

For example, the financial industry persuaded the CFTC and the SEC to adopt rules defining “swap dealers” as firms conducting more than \$8 billion of swap trades each year, a much higher trading threshold than the \$100 million trading level the agencies originally proposed.<sup>74</sup> In addition, the agencies’ definition of “swap dealers”—which triggers the applicability of many of Title VII’s most demanding requirements—allows dealers to exclude hedging transactions in determining whether their annual trading volume exceeds the \$8 billion threshold.<sup>75</sup> Some advocates of financial reform viewed the much higher threshold and the broad hedging exemption as “discouraging,” and one advocate remarked that “[t]he \$8 billion exemption level . . . demonstrates the enormous lobbying effort of Wall Street and major energy and commodity companies that have been working to undermine Dodd–Frank.”<sup>76</sup>

The CFTC and SEC did not adopt final rules defining “swap” and “end-user”—terms that govern the scope of many of Title VII’s requirements—until July 2012.<sup>77</sup> The final definitions of those terms contained significant carve-outs from Title VII’s regulatory regime, including exclusions of commercial firms and smaller banks from clearing requirements as well as exemptions for insurance products, loan participations and commodity forwards from the regulatory definition of “swaps.”<sup>78</sup> The broad scope of those exemptions provoked a dissent

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73. Loder & Mattingly, *supra* note 28; Lowenstein, *supra* note 7.

74. Alexandra Alper & Sarah N. Lynch, *Update 6—U.S. Regulators Spare All But Biggest Swap Dealers*, REUTERS (Apr. 18, 2012, 6:51 PM), <http://www.reuters.com/article/2012/04/18/financial-regulation-swaps-idUSL2E8FI44Y20120418>.

75. *Id.* (describing the hedging exemption, and explaining that swap dealers “must register with regulators and back up their trades with more capital and collateral”); Steven Sloan & Jesse Hamilton, *Regulators Approve \$8 Billion Threshold for Swaps Dealers*, BLOOMBERG (Apr. 18, 2012, 4:52 PM), <http://www.bloomberg.com/news/2012-04-18/swap-regulators-set-to-approve-8-billion-threshold-for-dealers.html> (reporting on the new rules defining “swap dealers” and explaining that those dealers “will ultimately be subject to the highest capital and collateral requirements for [swap] market participants”).

76. Alper & Lynch, *supra* note 74 (quoting Tyson Slocum, director of Public Citizen’s Energy Program).

77. Richard Hill, *CFTC Adopts Definition for Swaps; Action Key to Breaking Rules Logjam*, 44 SEC. REG. & L. REP. (BNA) 1381 (July 16, 2012) (explaining that many of Title VII’s provisions “could not be implemented” until the CFTC and SEC adopted a final definition of “swap,” while a final definition of “end-user” was needed to delineate the scope of Title VII’s clearing requirements); *see also* Alexandra Alper, *U.S. Regulator Finally Defines a Swap, Starts Reform Countdown*, REUTERS (July 10, 2012, 2:06 PM), <http://www.reuters.com/article/2012/07/10/us-cftc-swap-definition-idUSBRE8690S120120710> (noting that the CFTC and SEC originally proposed rules defining “swap” in April 2011 but did not adopt final rules until July 2012).

78. Richard Hill, *CFTC Adopts Definition for Swaps; Action Key to Breaking Rules Logjam*, 44 SEC. REG. & L. REP. (BNA) 1381 (July 16, 2012); Silla Brush, *CFTC Approves Swap Definition Triggering Dodd–Frank Rules*, BLOOMBERG (July 11, 2012, 12:01 AM), <http://www.bloomberg.com/news/2012-07-10/cftc-votes-4-1-to-approve-swap-definition-starting-overhaul-1-.html> (explaining that the end-user exemption from Title VII’s clearing requirements includes banks smaller than \$10 billion of assets as well as commercial and manufacturing firms).



from Commissioner Bart Chilton as well as expressions of concern from public interest groups.<sup>79</sup>

Major U.S. and foreign banks also lobbied federal regulators to exempt all swaps traded in overseas jurisdictions from Title VII's regulatory regime.<sup>80</sup> Section 722(d) of Dodd–Frank authorizes the CFTC to apply Title VII's provisions to overseas swap activities if those activities “have a direct and significant connection with activities in, or effect on, the commerce of the United States,” or if overseas activities violate regulations adopted by the CFTC “to prevent the evasion of any provision of [Title VII].”<sup>81</sup> CFTC Chairman Gary Gensler advocated a broad application of Title VII's mandates to foreign derivatives trading by U.S. banks and by foreign banks with a significant U.S. presence. Mr. Gensler pointed out that several major financial institutions (including AIG, Bear Stearns (Bear), Citigroup, JPMorgan and Lehman Brothers (Lehman)) had suffered large losses in recent years from overseas trading.<sup>82</sup> However, Mr. Gensler failed to persuade a majority of CFTC's five commissioners to approve a proposed regulation that would reach overseas swaps trades.<sup>83</sup>

Instead, the CFTC issued proposed guidance on regulation of overseas trading in June 2012. The proposed guidance recommended a “more flexible” approach for regulating cross-border swaps trading, including allowing a limited group of overseas units of U.S. and foreign banks to rely on “substituted compliance” by following foreign rather than U.S. derivatives rules.<sup>84</sup> Notwithstanding its less ambitious scope,

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79. Alper, *supra* note 77 (reporting that Commissioner Chilton dissented because of his concern that the final rule's exclusion for forward contracts could “create loopholes for swaps masquerading as commodity forwards,” thereby opening a “new Enron loophole”); Richard Hill, *Following Key Dodd–Frank Rulemaking, Some Worry About Exclusions, Exemptions*, 44 SEC. REG. & L. REP. (BNA) 1383 (July 16, 2012) (describing Commissioner Chilton's dissent and additional concerns expressed by Public Citizen and Americans for Financial Reform about the broad scope of several exemptions in the CFTC's final rule).

80. Silla Brush, *Goldman Sachs Among Banks Fighting to Exempt Half of Swap Books*, BLOOMBERG (Jan. 30, 2012, 12:01 AM), <http://www.bloomberg.com/news/2012-01-30/goldman-sachs-among-banks-lobbying-to-exempt-half-of-swaps-from-dodd-frank.html> (reporting that more than half of the derivatives trading activities of the five largest U.S. banks took place overseas); Gregory Meyer & Aline van Duyn, *US Banks Plead to Limit Range of Swap Rules*, FT.COM (Mar. 16, 2011, 10:01 PM), <http://www.ft.com/intl/cms/s/0/fb9b1c78-500b-11e0-9ad1-00144feab49a.html#axzz2B1t80iX3> (reporting on lobbying efforts by U.S. and foreign banks).

81. Dodd–Frank § 722(d)(i)(1), (2).

82. Keynote Address by CFTC Chairman Gary Gensler on the Cross-Border Application of Swaps Market Reform at Sandler O'Neil Conference, June 6, 2013, *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-141> [hereinafter Gensler June 6, 2013 Speech]; Testimony by CFTC Chairman Gary Gensler before the U.S. House Committee on Financial Services, June 19, 2012, *available at* [www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-117](http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-117) [hereinafter Gensler June 19, 2012 Testimony].

83. Ben Protess, *A Debate Goes Behind Doors*, N.Y. TIMES, June 23, 2012, at B1.

84. *Id.*; *see also* Alexandra Alper, *CFTC Floats Overseas Treatment of Swaps Rules*, REUTERS

the proposed guidance was strongly opposed by CFTC Commissioner Scott O'Malia, by foreign regulators, by "market participants around the world" and by "dozens of members of Congress" after aggressive lobbying by major banks.<sup>85</sup>

In June 2013, Commissioner O'Malia and Wall Street trade associations urged the CFTC to postpone any further action on its proposed cross-border guidance. They also argued that the CFTC must harmonize its guidance with the SEC's issuance of a much weaker proposal on cross-border trading. In contrast to the CFTC's guidance, the SEC's cross-border proposal would give overseas units of U.S. and foreign banks much greater leeway to avoid U.S. regulation by showing "substituted compliance" with foreign derivatives rules.<sup>86</sup>

As described below, the financial industry and its Republican allies in Congress have succeeded in cutting or freezing budget appropriations for the CFTC and SEC, thereby undermining the ability of both agencies to complete dozens of rulemakings mandated by Dodd-Frank.<sup>87</sup> In June 2012, CFTC Chairman Gary Gensler condemned industry efforts to slash his agency's budget, declaring that the requested budget cuts would "effectively put the interests of Wall Street ahead of those of the American public by significantly underfunding this agency."<sup>88</sup> Due in large part to the financial industry's efforts, the CFTC and SEC failed to finish almost half of the rulemakings they were required to complete by

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(June 29, 2012, 6:11 PM), <http://www.reuters.com/article/2012/06/29/us-cftc-cross-border-idUSBRE85S15M20120629> (explaining that the CFTC's proposal was issued in the form of "proposed guidance").

85. Richard Hill, *International Developments: O'Malia Urges Fellow CFTC Commissioners To Extend Delay in Cross-Border Swap Rules*, 45 SECURITIES REG. & L. REP. (BNA) 1097 (2013); see also Eric Lipton, *Banks Resist Strict Controls of Foreign Bets*, N.Y. TIMES, May 1, 2013, at A1 (reporting that "Wall Street bankers and some of the world's top finance ministers are waging a bitter international campaign to block" the CFTC's proposed cross-border guidance, and that leading banks have lobbied heavily to persuade Democratic and Republican members of Congress to oppose the guidance); Alper, *supra* note 84 (reporting that Mr. O'Malia criticized the guidance as "overly broad" and stated that "if I were asked to vote on the proposed guidance as final, my vote would be no").

86. Hill, *supra* note 85; Dave Michaels, *Bill to Limit CFTC Cross-Border Authority Faces U.S. House Vote*, BLOOMBERG, June 12, 2013, available at <http://www.bloomberg.com/news/2013-06-12/bill-to-limit-cftc-cross-border-authority-faces-u-s-house-vote.html>; see also Yin Wilczek, *SEC's Proposed Cross-Border Approach to Swaps Includes 'Substituted Compliance*, 45 SECURITIES REG. & L. REP. (BNA) 813 (2013) (describing the SEC's cross-border swaps proposal issued on May 1, 2013, and reporting that "market participants welcomed" the proposal but "regulatory watchdog Better Markets called the proposal a 'major disappointment' that would fail to adequately protect U.S. investors").

87. See *infra* notes 160-62, 405 and accompanying text (discussing the impact of industry-backed legislative measures reducing or freezing budget appropriations for the CFTC and SEC).

88. Stephen Joyce, *Derivatives: Gensler Criticizes Vote on CFTC Budget, Says Dodd-Frank Requires More Funding*, 98 BANKING REP. (BNA) 1030 (June 12, 2012) (quoting speech by Mr. Gensler on June 7, 2012, responding to a House subcommittee's vote to reduce the CFTC's budget by more than 12% compared to the previous year).

June 2013.<sup>89</sup> As a result, Title VII's implementation fell far behind schedule, and it remained very doubtful in mid-2013 when (or if) Title VII would become fully effective.<sup>90</sup>

### *B. The Industry's Litigation Strategy to Block Financial Reforms*

The financial industry has impeded the implementation of Dodd-Frank's reforms through litigation as well as lobbying. The industry's litigation strategy has focused on attacking new regulations for not being supported by an adequate analysis of their likely costs and their potential benefits. The strategy has been successful to date, in part because neither the regulators nor the courts have properly accounted for the enormous costs of the financial crisis and the very large potential benefits of adopting reforms that could prevent or mitigate similar crises in the future.

#### 1. The Industry's Reliance on "Cost-Benefit Analysis" in Challenging Financial Reforms

In *Business Roundtable v. SEC*,<sup>91</sup> the Business Roundtable and the Chamber of Commerce attacked the SEC's proxy access rule (Rule 14a-11).<sup>92</sup> The D.C. Circuit struck down the rule, agreeing with the trade association plaintiffs that the SEC failed to conduct an adequate cost-benefit analysis (CBA) as required by the Securities Exchange Act of 1934 and the Investment Company Act of 1940.<sup>93</sup> Commentators have

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89. DODD-FRANK PROGRESS REPORT, *supra* note 29, at 5 (showing that the CFTC and SEC failed to complete 66 of 141 rulemakings whose deadlines had passed by June 3, 2013); Edwards, *supra* note 7 (explaining how the financial industry used lobbying, the courts and Congress to frustrate the CFTC's and SEC's efforts to implement Dodd-Frank); Rivlin, *supra* note 7 (same).

90. Rivlin, *supra* note 7.

91. *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

92. *See id.* at 1146-47 (explaining that Rule 14a-11 allowed qualifying shareholders to nominate and elect directors by gaining access to the proxy materials distributed by corporate management). Section 971 of Dodd-Frank gave the SEC discretionary authority to adopt its proxy access rule. *See infra* note 102 and accompanying text (discussing Section 971). In addition to its role as a plaintiff in *Business Roundtable*, the Chamber of Commerce has played a leading role in lobbying against the passage and implementation of Dodd-Frank. Wilmarth, *supra* note 19, at 886 n.14 (noting the Chamber of Commerce's determined opposition to Dodd-Frank's creation of the CFPB); Devin Leonard, *Tom Donohue: Obama's Tormentor*, BLOOMBERG BUSINESSWEEK, Nov. 2, 2010 (describing the Chamber of Commerce's implacable opposition to Dodd-Frank and its intention to lobby vigorously against implementation of the statute); Taibbi, *supra* note 7 (describing the Business Roundtable and Chamber of Commerce as "Wall Street[']s . . . two favorite lobbying arms").

93. *Business Roundtable*, *supra* note 91, at 1146, 1148 (holding that the SEC was required to "consider" the effect of its proxy access rule on "efficiency, competition, and capital formation"); *id.* at 1148-49 (concluding that the SEC "failed . . . adequately to assess the economic effects" of the proxy access rule and "inconsistently and opportunistically framed the costs and benefits of the rule"); *see also* Jonathan D. Guynn, *Note: The Political Economy of Financial Rulemaking after Business Roundtable*,

questioned whether it was proper for the court to refuse to defer to the SEC's evaluation of the potential costs and benefits of the rule, particularly as the SEC's preamble to the final rule included a lengthy economic assessment of costs and benefits that occupied "nearly twenty pages" in the *Federal Register*.<sup>94</sup>

In December 2011, the International Swaps and Derivatives Association (ISDA) and SIFMA filed a similar lawsuit challenging the validity of a CFTC regulation, which established "position limits" for commodities trading.<sup>95</sup> ISDA and SIFMA alleged that the CFTC failed to make a statutorily required finding that its position limits were "necessary" to prevent excessive speculation or to deter market manipulation.<sup>96</sup> The trade associations also charged that CFTC "failed to satisfy its independent statutory obligation to conduct a meaningful cost-benefit analysis."<sup>97</sup> Thus, the suit against the CFTC's regulation involved the "same issue—the supposed lack of sufficient cost-benefit analysis—that the Chamber of Commerce used to derail the proxy access rule."<sup>98</sup>

In September 2012, the federal district court vacated and remanded the CFTC's regulation, but the court did not address the plaintiffs' CBA

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99 VA. L. REV. 641, 659-62 (2013) (describing "five flaws with the SEC's [cost-benefit analysis] that the court found particularly vexing" in *Business Roundtable*).

94. Guynn, *supra* note 93, at 641, 643-44, 665, 658 (quote), 658n.111 (citing Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56753-71 (Sept. 18, 2010); *see also id.* at 667 ("The court's decision in *Business Roundtable* not to defer to the SEC looks much more like *de novo* review. The SEC had evidence upon which to rely, and according to a recent critique of *Business Roundtable*, the studies favored by the court were methodologically flawed as well. The SEC's CBA . . . would have been upheld as reasonable under the arbitrary and capricious standard"); Note, *Administrative Law—Corporate Governance Regulation—D.C. Circuit Finds SEC Proxy Access Rule Arbitrary and Capricious for Inadequate Economic Analysis—Business Roundtable v. SEC*, 647 F.2d 1144 (D.C. Cir. 2011), 125 HARV. L. REV. 1088, 1092-93 (2011) [hereinafter *Business Roundtable* Commentary] ("Courts hardly outperform the SEC at evaluating the imperfect science of economics . . . Not surprisingly given the complexity of economic analysis, Judge Ginsburg's opinion [in *Business Roundtable*] made missteps similar to those for which he scolded the SEC."); Edwards, *supra* note 7 ("[Judge] Ginsburg appears to ignore the precedent set by the foundational 1984 *Chevron* case, which . . . stressed that judges must afford 'deference' to an agency's interpretation of a statute, especially when it's 'evaluating scientific data within its technical expertise'").

95. Plaintiffs' Application for a Preliminary Injunction, Int'l Swaps and Derivatives Ass'n v. CFTC, No. 11-CV-2146, 2012 WL 385627 (D.D.C., Feb. 7, 2012); *see also* Stephen Joyce & Vin Wilczek, *Derivatives: Publication of Rule Sets Date of Oct. 12 For Start of Contested Position Limits Regime*, 99 BANKING REP. (BNA) 305 (Aug. 14, 2012) (discussing the filing and status of SIFMA's and ISDA's lawsuit challenging the CFTC's rule on position limits). Section 737(a) of Dodd-Frank authorizes the CFTC to establish aggregate position limits for commodities trading contracts in order to "diminish, eliminate, or prevent excessive speculation" and "to deter and prevent market manipulation" while, at the same time, ensuring "sufficient market liquidity for bona fide hedgers" and preserving "the price discovery function of the underlying market."

96. Memorandum in Support of Plaintiffs' Application for a Preliminary Injunction at 19, Int'l Swaps and Derivatives Ass'n v. CFTC, No. 11-CV-2146, 2012 WL 385627 (D.D.C., Feb. 7, 2012).

97. *Id.* at 27 (citing 7 U.S.C. § 19(a)(2) (2000)).

98. Taibbi, *supra* note 7.

claim. Instead, the court held that the CFTC wrongly interpreted the Commodities Exchange Act as requiring the CFTC to establish position limits without making any determination as to whether such limits were necessary to address excessive speculation or market manipulation. The court's decision did not resolve questions about the nature and substance of the CBA that the CFTC would be required to perform before issuing a revised position limits rule.<sup>99</sup>

The financial industry's demands for extensive CBA studies have become a highly effective weapon in the industry's fight to block or delay agency rules needed to implement Dodd-Frank.<sup>100</sup> One analyst warned that if courts support such demands with the fervor demonstrated by *Business Roundtable*, the result could be a "judicial blockade on complex financial rulemaking, which would impede regulators' ability to police the marketplace in accordance with congressional intent."<sup>101</sup> The same commentator observed that "[s]uch stringent [judicial] oversight should be especially suspect when statutes suggest proregulatory congressional intent," as Section 971 of Dodd-Frank did in granting the SEC specific authority to adopt a proxy access rule.<sup>102</sup>

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99. *Int'l Swaps & Derivatives Ass'n v. CFTC*, 887 F. Supp. 2d 259, 279-84 (D.D.C. 2012); see also Yin Wilczek, *Future Trading: Court Vacates and Remands CFTC Position Limits Regulation*, 99 BANKING REP. (BNA) 568 (Oct. 2, 2012) (discussing the impact of the court's decision on the CFTC's authority to adopt a revised position limits rule); Alexandra Alper, Jonathan Leff & Karey Wutkowski, *Analysis: After Five-Year Push, Is It RIP for Commodity Limits?*, REUTERS (Oct. 1, 2012, 1:03 AM) (same), available at <http://www.reuters.com/article/2012/10/02/us-regulation-commodities-limits-idUSBRE8901CS20121002>).

100. See, e.g., Guynn, *supra* note 93, at 669 ("The financial industry has already responded to the *Business Roundtable* decision by increasing its focus on agency compliance with applicable CBA mandates in its comment letters on proposed rulemaking and by filing lawsuits challenging various rules based on an alleged failure to conduct an adequate CBA"); Big Bank Systemic Risk Comment Letter, *supra* note 44, at 7 (declaring that "any analysis of the impact of a proposed rulemaking, even more so in the context of broad reforms, is incomplete without a cost/benefit analysis"); *The Impact of Dodd-Frank on Customers, Credit, and Job Creators: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises*, 112th Cong. 11 (2012) (Testimony of Dennis M. Kelleher, President and CEO, Better Markets, Inc.) [hereinafter Kelleher Testimony] (stating that the financial industry's "latest weapon to kill or weaken financial reform is to claim that every rule and regulation passed to implement [Dodd-Frank] must be subjected to exhaustive 'cost-benefit analysis'").

101. *Business Roundtable* Commentary, *supra* note 94, at 1092; see also Guynn, *supra* note 93, at 671 ("There is already evidence that the financial regulatory agencies have slowed down the process of issuing rules under the Dodd-Frank Act as a result of *Business Roundtable*'s rigorous scrutiny. Many agencies feel bullied by the requirement to improve their CBA apparatus."); Edwards, *supra* note 7 (stating that *Business Roundtable* has been "paralyzing for the agencies . . . . How extensive must their cost-benefit analyses be? . . . Everyone is trying to figure out how to move forward without getting sued.") (quoting an unnamed former CFTC staff member).

102. *Business Roundtable* Commentary, *supra* note 94, at 1094-95. Section 971 provides that the SEC's proxy rules "may include" a proxy access requirement. Dodd-Frank § 971(a)(2). The conference report on Dodd-Frank explained that Section 971 "authorizes the SEC to write . . . proxy access rules" but requires the SEC to consider "the burden on small [corporate] issuers" and the appropriateness of "exemptions" from such rules. H.R. REP. NO. 111-517, at 873 (2010) (Conf. Rep.),

In their joint comment letter, five leading financial industry trade groups attacked the FRB's proposal to establish enhanced prudential requirements for SIFIs because the proposal "reflects little or no attempt . . . to weigh the enormous costs to [SIFIs] and U.S. financial markets associated with the proposals against the likely benefits of the proposals for the goal of U.S. financial stability."<sup>103</sup> The groups asserted that the FRB's proposed rules would impose "excessive limitations on the ability of U.S. banks to take controlled risks" and would create the danger that "the still nascent economic recovery may likely be stalled and future economic growth will be curtailed by a reduced availability of credit."<sup>104</sup> The groups also charged that "no country has adopted . . . legislation or regulations having the scope of Dodd-Frank," and the "combined impact" the FRB's proposed rules and other rules implementing Dodd-Frank "may place U.S. banks at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach."<sup>105</sup>

As explained below, the financial industry previously used the same arguments to support deregulation and block effective supervisory controls during the unsustainable credit boom that led to the financial crisis. During that credit boom, as now, the industry and its supporters repeatedly claimed that stronger regulations would impose excessive compliance burdens on financial institutions, reduce the availability of credit to businesses and consumers, and endanger the global competitiveness of U.S. banks and financial markets.<sup>106</sup> Congress and regulators acceded to the industry's claims and failed to adopt measures that could have prevented or mitigated the worst financial crisis since the Great Depression.<sup>107</sup> Given that unfortunate history, policymakers and courts should be highly skeptical when the financial industry

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reprinted in 2010 U.S.C.C.A.N. 722, 729-30. The Senate committee report on Dodd-Frank stated that Section 971 "gives the SEC wide latitude in setting the terms of such proxy access." S. REP. NO. 111-176, at 146 (2010). The D.C. Circuit's decision in *Business Roundtable* did not include any any reference to Section 971 or any discussion of its legislative history.

103. Big Bank Systemic Risk Comment Letter, *supra* note 44, at 7-8.

104. *Id.* at 4.

105. *Id.* at 9; *see also id.* at 4 (warning that "excessive limitations on the ability of U.S. banks to take controlled risks will reduce the role of the United States as a leader in the global financial system").

106. *See infra* notes 258-65, 533-49, 696-707 and accompanying text; *see also* Kelleher Testimony, *supra* note 100, at 9-10 (noting that "[s]ince the emergence of financial market regulation, the financial services industry has argued that new regulatory requirements will have a devastating impact by imposing unbearable compliance costs" and "[o]pponents of reform under the Dodd-Frank law are following this familiar pattern").

107. *See infra* Parts III(A)-(C), (F); Kelleher Testimony, *supra* note 100, at 10 (contending that "the financial collapse and economic crisis . . . were a direct result of too little regulation. In the years leading up to the crisis, huge sectors of our financial markets (such as swaps) were completely unregulated, and other sectors (such as mortgage-backed securities) were poorly regulated") (emphasis added).

presents the same arguments as justifications for blocking Dodd–Frank’s reforms.

## 2. Any Analysis of the Costs and Benefits of Dodd–Frank’s Reforms Must Consider the Huge Costs of the Financial Crisis and the Comparable Benefits of Avoiding Future Crises

The financial industry’s cost–benefit arguments are deeply flawed because they rarely, if ever, include any detailed consideration of the enormous benefits that society would receive from avoiding a catastrophic financial crisis similar to the recent crisis.<sup>108</sup> A comprehensive analysis of the costs of the recent crisis is beyond the scope of this article. However, the following brief overview of some of the major costs inflicted on U.S. financial markets and the general economy is sufficient to demonstrate the devastating impact of the crisis as well as the huge potential benefits from reforms that could avoid or mitigate a similar disaster in the future.

The financial crisis imposed two principal categories of costs on U.S. financial markets and the general economy. First, the federal government created serious distortions in the financial markets through its dramatic interventions to rescue TBTF financial institutions and preserve market stability:

- The federal government “provided more than \$6 trillion of support to financial institutions during the financial crisis, when such support is measured by the peak amounts of outstanding assistance under the [Troubled Asset Relief Program (TARP)] capital assistance programs, [Federal Reserve (Fed) ] emergency lending programs, FDIC debt guarantees, and other asset purchase and guarantee programs.”<sup>109</sup>

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108. See Big Bank Systemic Risk Comment Letter, *supra* note 44, at 3 (stating that the five financial industry trade associations supported regulatory reform that “protects the financial system against potential systemic meltdowns of the type faced in the recent crisis,” but the associations made no effort to quantify the potential benefits of avoiding such a crisis); BETTER MARKETS, THE COST OF THE WALL-STREET CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN \$12.8 TRILLION 8 (2012), available at <http://www.corporatecrimereporter.com/wp-content/uploads/2012/09/bettermarkets.pdf> [hereinafter Financial Crisis Costs] (declaring that the financial industry “is really advocating for an incomplete and biased version of ‘cost–benefit analysis’ that . . . ignores the costs of the crisis to society and also ignores the benefits of financial reform to society”); see also Hilary J. Allen, *A New Philosophy for Financial Stability Regulation* 13 (Aug. 6, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2085336](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2085336) (observing that “[i]t is very difficult to put a dollar value” on the potential benefits of avoiding financial crises, and therefore a “strict cost–benefit approach” encourages regulators to ignore such benefits and to focus on the more easily quantifiable costs of complying with new regulations).

109. Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform That Could Solve the Too-Big-to-Fail Problem and Align US and UK Financial Regulation of Financial Conglomerates (Part 1)*,

- The federal government rescued eleven large financial institutions that were threatened with failure. Officials arranged bailouts for two of the three largest U.S. banks (Bank of America (BoFA) and Citigroup) as well as the largest U.S. insurance company (AIG). Regulators provided financial assistance for emergency acquisitions of two other major banks (Wachovia and National City), the two biggest thrifts (Washington Mutual (WaMu) and Countrywide), and two of the five largest securities firms (Bear Stearns and Merrill Lynch (Merrill)). Regulators also granted emergency approvals for conversions of two other leading securities firms (Goldman Sachs (Goldman) and Morgan Stanley) into BHCs in order to place those institutions under the Fed's protection.<sup>110</sup>
- In early 2009, federal regulators publicly announced—in connection with “stress tests” for the 19 largest BHCs (each having assets over \$100 billion)—that the federal government would provide any capital assistance needed to ensure the survival of those institutions. As a practical matter, regulators thereby certified the TBTF status of all 19 BHCs.<sup>111</sup>

Studies have shown that the TARP capital infusions, FDIC debt guarantees and Fed emergency lending programs provided “very large transfers of wealth from taxpayers to the shareholders and creditors of the largest [financial institutions]” during a period when the recipient institutions would have had great difficulty in raising funds in the capital markets.<sup>112</sup> Other studies have concluded that major banks have benefited from large subsidies—including a significantly lower cost of raising funds—by virtue of their presumed TBTF status before, during and after the crisis.<sup>113</sup> The federal government's TBTF rescues

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BANKING & FIN. SERVICES POL'Y REP., Mar. 2012, at 1, 3; *see also infra* notes 283-86 (describing the massive financial assistance provided by the federal government to large financial institutions).

110. Wilmarth, *supra* note 109, at 3.

111. *Id.* at 3; *see also* Kelleher Testimony, *supra* note 100, at 5 (quoting a joint statement issued by the federal bank regulators on Feb. 23, 2009, which declared that the federal government would “preserve the viability of systemically important financial institutions so that they are able to meet their commitments”).

112. Wilmarth, *supra* note 109, at 5, 20 nn.40–41 (citing five studies that evaluated the impact of federal assistance programs for the largest banks during the financial crisis).

113. *See, e.g.*, Wilmarth, *supra* note 109, at 4–5, 19 nn.24–29 (summarizing a study by A. Joseph Warburton and Daniz Anginer, finding that large U.S. banks enjoyed a funding cost advantage (due to an implicit TBTF subsidy) equal to \$4 billion per year before the financial crisis, rising to \$60 billion annually from 2007 to 2009, and peaking at \$88 billion in 2008); Frederic Schweikhard & Zoe Tsesmelidakis, *The Impact of Government Interventions on CDS and Equity Markets*, June, 2012, at 1–4, 32–34, available at <http://ssrn.com/abstract=1943546>; (concluding that large U.S. banks benefited from total reductions in bond funding costs (due to an implicit TBTF subsidy) of nearly \$130 billion between 2007 and 2010); Kenichi Ueda & Beatrice Weder di Mauro, *Quantifying Structural Subsidy Values for Systemically Important Financial Institutions* 3–7, 11–12 (Int'l Monetary Fund Working Paper No. WP/12/128, 2012) (finding that large banks in the U.S. and 15 other developed nations



confirmed the existence of those subsidies, thereby weakening creditor discipline over large financial institutions and encouraging those institutions to assume even larger risks.<sup>114</sup> In addition, TBTF subsidies give big banks unfair competitive advantages over smaller banks and therefore create unjustified incentives for “further consolidation and concentration in the financial system.”<sup>115</sup>

The second major category of costs from the financial crisis results from the fact that the crisis triggered the most severe economic recession since the 1940s.<sup>116</sup> The “Great Recession”<sup>117</sup> has inflicted tremendous economic losses on the U.S., as shown by the following illustrative statistics:

- The U.S. is projected to lose approximately \$7.6 trillion of gross domestic product (GDP) from 2008 to 2018, representing the cumulative difference between the actual and forecast GDP for those years and “potential GDP—what GDP would have been but for the financial and economic crises.”<sup>118</sup> In addition, government spending in response to the crises is expected to

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received average funding cost advantages (due to implicit TBTF subsidies) equal to 60 basis points in 2007 and 80 basis points in 2009); *Why Should Taxpayers Give Big Banks \$83 Billion a Year?*, BLOOMBERG, Feb. 20, 2013 (editorial) (concluding, based on the foregoing study by Ueda and di Mauro, that the ten largest U.S. banks receive “a taxpayer subsidy of \$83 billion a year” and the five largest banks—JPMorgan, BofA, Citigroup, Wells Fargo and Goldman—“account for \$64 billion of the total subsidy, an amount roughly equal to their typical annual profits”); see also Joseph Noss & Rhiannon Sowerbutts, *The Implicit Subsidy of Banks* (Bank of England Financial Stability Paper No. 15, May 28, 2012), available at <http://ssrn.com/abstract=2071720> (concluding that large U.K. banks benefited from a funding cost advantage of £40 billion in 2010, due to an implicit TBTF subsidy).

114. Wilmarth, *supra* note 109, at 4; FRB Proposed Rules for SIFIs, *supra* note 40, at 595; Noss & Sowerbutts, *supra* note 113, at 4.

115. FRB Proposed Rules for SIFIs, *supra* note 40, at 595 (stating that “[t]he market perception that some companies are ‘too big to fail’ . . . produces competitive distortions because [such] companies . . . can often fund themselves at a lower cost than other companies . . . and tends to artificially encourage further consolidation and concentration in the financial system”); accord Wilmarth, *supra* note 109, at 5–6 (“In recent years, and particularly during the present crisis, [large banks] have operated with much lower capital ratios and have benefited from a much lower cost of funds, compared with smaller banks . . . Given the major advantages conferred by TBTF status, it is not surprising that [large banks] have pursued aggressive growth strategies during the past two decades to reach a size at which they would be considered TBTF by regulators and the financial markets.”); Noss & Sowerbutts, *supra* note 113, at 4 (“[B]anks that benefit from the implicit [TBTF] subsidy have a competitive advantage over those that do not” because the expectation of governmental support results in “lowering those banks’ cost of funding” and “may enable guaranteed banks to expand at the expense of non-guaranteed banks.”).

116. Kevin J. Lansing, *Gauging the Impact of the Great Recession*, FRBSF ECONOMIC LETTER 2011–21 (July 21, 2011) (“The ‘Great Recession,’ which started in December 2007 and ended in June 2009, was the most severe economic contraction since 1947.”).

117. *Id.*; see also Paul Wiseman, *US Economic Recovery Is Weakest Since World War II*, ASSOCIATED PRESS FIN. WIRE, Aug. 15, 2012 (reporting that “[m]any economists say the agonizing recovery from the Great Recession . . . is the predictable consequence of a housing bust and a grave financial crisis”).

118. Financial Crisis Costs, *supra* note 108, at 13.

“increase the national debt by \$8 trillion as of 2018.”<sup>119</sup>

- Due to sharp declines in the prices of homes and financial assets, household net worth declined by \$19 trillion (in 2012 dollars) from July 2007 to the depths of the crisis in early 2009.<sup>120</sup> Median household net worth fell 38.8% from 2007 to 2010, and average household net worth fell 14.7% during the same period.<sup>121</sup>
- Home values dropped by one-third from the peak of the housing boom in 2006 through the end of 2011, resulting in a loss of about \$7 trillion in household wealth.<sup>122</sup>
- In March 2013, almost ten million homes (representing nearly a fifth of all residential properties with a mortgage) were worth less than the outstanding balance on their mortgages.<sup>123</sup> “About 7 million mortgage holders have had to leave their homes since 2007 because of foreclosure or a short sale, in which a property is sold for less than is owed.”<sup>124</sup> Five million additional homes were “at least 30 days delinquent or in some stage of foreclosure” in March 2013.<sup>125</sup>
- 8.5 million jobs disappeared between 2007 and 2009, and the

119. *Id.* at 41, 62; *see also* Allen, *supra* note 108, at 12 n.41 (stating that, according to the Congressional Budget Office, “the United States incurred an additional \$7 trillion in government debt as a direct result of the recession following the Financial Crisis”).

120. Financial Crisis Costs, *supra* note 108, at 33.

121. Jesse Bricker et al., *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, 98 FED. RES. BULL. No. 2, (June 2012), at 1, 16-17 (noting that median household net worth in 2010 “was close to levels not seen since the 1992 survey,” while mean household net worth in 2010 “fell to about the level of the 2001 survey”), available at <http://www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf>.

122. Financial Crisis Costs, *supra* note 108, at 36.

123. Prashant Gopal, *Homeowners With Negative Equity Below 20% of Borrowers*, BLOOMBERG, June 12, 2013 (reporting that the number of “underwater homes,” whose owners owed more than the market value of their homes, declined to “9.7 million, or 19.8 percent of all U.S. homes with mortgages . . . down from 21.7 percent at the end of [2012]”), <http://www.bloomberg.com/news/2013-06-12/homeowners-with-negative-equity-below-20-of-borrowers.html>.

124. Prashant Gopal, *Americans Seize Second Chance Mortgages Post-Foreclosure*, BLOOMBERG (April 3, 2013), <http://www.bloomberg.com/news/2013-04-03/americans-seize-second-chance-post-foreclosure-mortgages.html>; *see also* Kathleen M. Howley & Thom Weidlich, *Seizures Threatened in Massachusetts with Naked Loans Challenge: Mortgages*, BLOOMBERG (Feb. 21, 2012) (reporting that “[a]bout 5 million homes have been lost to foreclosure” between 2006 and 2011), <http://www.bloomberg.com/news/2012-02-21/seizures-threatened-in-massachusetts-with-naked-loans-challenge-mortgages.html>; Dan Levy & Heather Perlberg, *Foreclosures Jump as Banks Bet on Rising U.S. Home Prices*, BLOOMBERG (June 13, 2013) (stating that 670,000 additional homes were repossessed via foreclosures in 2012), <http://www.bloomberg.com/news/2013-06-13/foreclosures-jump-as-banks-bet-on-rising-u-s-home-prices.html>.

125. John Gittelsohn, *Housing Crash Fades as Defaults Decline to 2007 Levels*, BLOOMBERG (May 6, 2013) (also reporting that the number of homes in delinquency or foreclosure proceedings in March 2013 were “down from a peak of 7.7 million in January 2010, [but] still more than double the 2.2 million non-current mortgages in January 2005”).

unemployment rate exceeded 10% at its peak in October 2009.<sup>126</sup> The unemployment rate remained above 8% from February 2009 through August 2012, representing “the longest stretch in monthly [employment] records going back to 1948.”<sup>127</sup> In addition, the “underemployment rate” (which includes unemployed workers, part-time workers seeking full-time positions and those who stopped looking for jobs) remained above 14% during the same period.<sup>128</sup>

- A Labor Department survey revealed that problems with long-term unemployment persisted after the recession ended in mid-2009, due to the weakness of the economic recovery. The survey found that only a quarter of six million “displaced workers” who lost their jobs between 2009 and 2011 were able to find a job with equivalent pay by January 2012. Almost a third of those workers took a job that paid less, and nearly half were still unemployed or had stopped looking for work by the latter date.<sup>129</sup> The percentage of families falling below the poverty line rose from 12.5% to 15.1% between 2007 and 2010, and the number of Americans receiving food stamps increased from 33 million to 46 million between 2009 and July 2012.<sup>130</sup>

In view of the tremendous losses inflicted by the financial crisis, a prominent advocate of financial reform has aptly described as “ridiculous” the financial industry’s claims that “it cannot be re-regulated to prevent it from causing yet another crisis if the costs it must bear are too great.”<sup>131</sup> Even so, the industry will undoubtedly continue to use *Business Roundtable* as a basis for challenging the compliance costs imposed by Dodd–Frank’s reforms. Without a proper accounting of the costs of the financial crisis and the potential benefits of avoiding future crises, the industry’s legal challenges pose a very significant

126. Lansing, *supra* note 116, at 3.

127. Paul Wiseman & Christopher S. Rugaber, *US Hiring Picked Up in July; So Did Unemployment*, ASSOCIATED PRESS FINANCIAL WIRE (Aug. 3, 2012) (available on Lexis) (reporting that the unemployment rate increased to 8.3% in July 2012 from 8.2% in June); Shobhana Chandra, *Miss in U.S. Payrolls Spurs Talk of New Fed Stimulus*, BLOOMBERG (Sept. 7, 2012), <http://www.bloomberg.com/news/2012-09-07/payrolls-in-u-s-rose-96-000-in-august-jobless-rate-falls.html> (reporting that the unemployment rate fell to 8.1% in August 2012, as 368,000 Americans left the labor force, and the unemployment rate “has exceeded 8 percent since Feb. 2009, the longest stretch in monthly records going back to 1948”).

128. See Wiseman & Rugaber, *supra* note 127, at 3 (reporting an underemployment rate of 15% in July 2012); Financial Crisis Costs, *supra* note 108, at 23 & fig. 5 (showing that “the broadest measure of unemployment, the U-6 rate,” peaked at 17.5% in October 2009 and remained above 14% through July 2012).

129. Peter Whoriskey, *Laid-Off Workers Struggle to Rebound*, WASH. POST, Aug. 25, 2012, at A01 (describing a Labor Department survey of “displaced workers” who lost their jobs due to plant closings or layoffs after having been employed for at least three years).

130. Financial Crisis Costs, *supra* note 108, at 55–56.

131. Kelleher Testimony, *supra* note 100, at 11.

obstacle to Dodd-Frank's implementation, creating a situation in which "the public, the markets, and the economy as a whole will once again be vulnerable to another financial catastrophe."<sup>132</sup>

*C. The Financial Industry's Legislative Strategy to Roll Back Financial Reforms*

In addition to lobbying and suing regulators, the financial industry has pursued an aggressive strategy to secure favorable legislation that will (i) repeal or water down key provisions of Dodd-Frank or (ii) cripple the ability of regulatory agencies to implement those provisions. The industry's generous contributions helped Republicans to secure control of the House of Representatives and to increase their strength in the Senate in the 2010 midterm elections. After the new Congress convened in January 2011, Republican congressional leaders (with support from pro-industry Democrats) orchestrated a multipronged series of attacks on Dodd-Frank's reforms. Republican efforts to undermine Dodd-Frank persisted despite a series of new financial scandals that further tarnished Wall Street's already battered reputation.

1. The Industry's Legislative Efforts to Undermine Dodd-Frank

After the financial industry failed to prevent Dodd-Frank's passage, it immediately launched an aggressive campaign to secure legislative measures that would weaken or roll back Dodd-Frank's key reforms. During the midterm elections of 2010, financial institutions and their trade associations gave a majority of their political contributions to Republican congressional candidates.<sup>133</sup> The industry's tilt toward Republicans in 2010 represented a significant shift from 2008, when the industry gave a majority of its support to Democrats.<sup>134</sup> That shift reflected the industry's anger over the passage of Dodd-Frank, which was supported by most Democrats but opposed by most Republicans in Congress.<sup>135</sup>

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132. *Id.* at 7.

133. See *Finance/Insurance/Real Estate: Long-Term Contribution Trends*, CENTER FOR RESPONSIVE POLITICS (last visited on June 14, 2013), <http://www.opensecrets.org/industries/totals.php?cycle=All&ind=F> (showing that the finance, insurance and real estate sector gave Republican candidates 53% of its \$319 million of political contributions during the 2010 election cycle) [hereinafter *CRP Political Contribution Report*].

134. See *id.* (showing that the finance, insurance and real estate sector gave Democratic candidates 51% of its \$521 million of political contributions during the 2008 election cycle).

135. Wilmarth, *supra* note 19, at 889–90 (discussing reasons for the financial industry's shift from supporting Democrats in 2008 to supporting Republicans in 2010); see also *id.* at 889 n.25 (noting that only 19 Democratic House members and one Democratic Senator opposed Dodd-Frank, while only three Republican House members and three Republican Senators supported it).

The 2010 midterm elections gave Republicans control of the House and several additional seats in the Senate.<sup>136</sup> Even before the new Congress convened in January 2011, Republican House leaders announced plans to challenge Dodd–Frank’s reforms in several key areas.<sup>137</sup> The financial industry and its Republican allies particularly targeted the CFPB, which they had vehemently opposed during the debates leading up to Dodd–Frank’s passage.<sup>138</sup> In 2011, Republicans passed legislation in the House to weaken the CFPB’s independence and authority by (i) replacing CFPB’s single Director with a five-member bipartisan commission, (ii) expanding FSOC’s authority to veto CFPB’s regulations, and (iii) removing CFPB’s assured source of funding from the Fed and forcing CFPB to rely on congressional appropriations for its budget.<sup>139</sup>

In addition, Republican Senators voted to block confirmation of any Director of CFPB until the Senate and the President accepted the changes to CFPB’s governance and funding proposed by House Republicans.<sup>140</sup> President Obama sought to overcome this confirmation obstacle by using a recess appointment to install Richard Cordray as the first Director of CFPB in January 2012. However, the validity of Mr. Cordray’s appointment was challenged in a lawsuit filed by a Texas bank in June 2012 and was called into further question by a D.C. Circuit decision that struck down similar recess appointments issued to three members of the National Labor Relations Board (NLRB).<sup>141</sup>

Legislative allies of the financial industry introduced legislation to weaken several key derivatives reforms in Title VII of Dodd–Frank. For example, Rep. Jim Hines (D-CT), whose district in southwestern

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136. *Id.* at 890.

137. *See, e.g.*, Cheyenne Hopkins, *House GOP Oversight Likely to Shape Reform Rules*, AM. BANKER (Nov. 5, 2010), [http://www.americanbanker.com/issues/175\\_214/house-republicans-dodd-frank-1028295-1.html?CMP=OTC-RSS](http://www.americanbanker.com/issues/175_214/house-republicans-dodd-frank-1028295-1.html?CMP=OTC-RSS); Stacy Kaper, *Review 2010/Preview 2011: Redrawing the Battle Lines on Reform*, AM. BANKER (Jan. 3, 2011), <http://www.highbeam.com/doc/1G1-245499160.html>; Phil Mattingly, *Derivatives, ‘Volcker’ Rule Might Be Targets of House Republican Tactics*, BLOOMBERG (Nov. 19, 2010), <http://www.bloomberg.com/news/2010-11-19/derivatives-volcker-rules-may-be-house-republican-targets.html>.

138. Wilmarth, *supra* note 19, at 886–90.

139. *Id.* at 891–92, 901–04, 919–25.

140. *Id.* at 892–93, 895–96.

141. Kevin Wack, *CFPB Suit Faces Long Odds, But May Still Have Impact*, AM. BANKER (June 25, 2012), [http://www.americanbanker.com/issues/177\\_121/cfpb-suit-faces-long-odds-but-may-still-have-impact-1050373-1.html](http://www.americanbanker.com/issues/177_121/cfpb-suit-faces-long-odds-but-may-still-have-impact-1050373-1.html) (reporting on lawsuit challenging the validity of Mr. Cordray’s recess appointment). In *Noel Canning v. NLRB*, 705 F.3d 490 (D.C. Cir. 2013), *petition for cert. granted*, 81 U.S.L.W. 3695 (June 25, 2013), the D.C. Circuit invalidated President Obama’s recess appointments for three members of the NLRB. Those recess appointments were made on January 4, 2012, the same day that Mr. Cordray received his recess appointment. For a critical assessment of the *Canning* decision and its negative implications for Mr. Cordray’s recess appointment, see Peter M. Shane, *The Future of Recess Appointments in Light of Noel Canning v. NLRB*, 81 U.S.L.W. 1750 (June 4, 2013).

Connecticut is the home of many financial executives and hedge funds, sponsored a bill that would exempt foreign affiliates of U.S. swaps dealers from most of Title VII's provisions.<sup>142</sup> If enacted, Rep. Hines' bill could exempt half or more of the derivatives activities conducted by five major U.S. banks from regulation under Dodd–Frank.<sup>143</sup>

Republican leaders also introduced bills to repeal FSOC's authority to designate nonbank financial firms as SIFIs under Title I of Dodd–Frank.<sup>144</sup> The Republican bills would also prohibit the Fed from regulating nonbank SIFIs and would thereby prevent the Fed from acting to stop excessive risk-taking by large nonbank financial firms similar to AIG and Lehman.<sup>145</sup> Republicans asserted that designating nonbanks as SIFIs would give them “an advantage in the marketplace,” but that claim is unpersuasive.<sup>146</sup> Indeed, large nonbank firms have strongly opposed being designated as SIFIs because they want to avoid the FRB's oversight as well as the higher capital requirements and other prudential standards that Dodd–Frank imposes on nonbank SIFIs.<sup>147</sup> As Rep. Barney Frank (D-MA) observed, being designated as a SIFI “is a gift that no one wants.”<sup>148</sup>

House Republicans also sponsored legislation to repeal the “orderly liquidation authority” (OLA) created by Title II of Dodd–Frank.<sup>149</sup> The

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142. See Cohan, *supra* note 7 (criticizing H.R. 3283, sponsored by Rep. Hines); Taibbi, *supra* note 7, at 9 (same, and also criticizing H.R. 3336, which would grant broad exemptions from Title VII to any company that makes “extensions of credit” to customers).

143. See Brush, *supra* note 80 (reporting that overseas branches or affiliates accounted for the following shares of derivatives activities at five major U.S. banks: 62% at Goldman, 77% at Morgan Stanley, 59% at JPMorgan, 53% at Citigroup, and half at BofA). Although the financial industry's allies on Capitol Hill did not succeed in enacting any of the proposed bills to weaken Title VII in 2012, they introduced a new set of similar bills in 2013. See *infra* notes 404-05 and accompanying text.

144. *Systemic Risk: Bicameral Bill Takes Aim at FSOC SIFI Designations*, 99 BNA'S BANKING REPORT 266, Aug. 7, 2012, available at 2012 WL 3164880 (discussing H.R. 6317 and S. 3497 introduced by Rep. Scott Garrett (R-NJ) and Sen. David Vitter (R-LA)) [hereinafter *Systemic Risk*].

145. *Id.*; see also *supra* notes 30–38 and accompanying text (discussing the reasons why Congress authorized FSOC to designate nonbank SIFIs and the importance of Fed regulatory authority over those institutions); Wilmarth, *supra* note 12, at 993–95 (same).

146. Kevin Wack, *GOP Lawmakers Introduce Bill to Repeal Systemic Designations*, AM. BANKER (Aug. 2, 2012), [http://www.americanbanker.com/issues/177\\_149/gop-lawmakers-introduce-bill-repeal-systemic-designations-1051541-1.html](http://www.americanbanker.com/issues/177_149/gop-lawmakers-introduce-bill-repeal-systemic-designations-1051541-1.html); see also Donna Borak, *Is TBTF Over? Only One Way to Find Out*, AM. BANKER (June 15, 2011), [http://www.americanbanker.com/issues/176\\_114/too-big-to-fail-dodd-frank-1038950-1.html](http://www.americanbanker.com/issues/176_114/too-big-to-fail-dodd-frank-1038950-1.html) (describing Rep. Barney Frank's critique of efforts by House Republicans to repeal FSOC's authority to designate nonbank SIFIs).

147. See Wilmarth, *supra* note 12, at 994–95; Alistair Gray, *Insurers Warn on 'Too Big to Fail' Plans*, FINANCIAL TIMES (Dec. 16, 2012), <http://www.ft.com/cms/s/0/a528bd0e-460f-11e2-ae8d-00144feabdc0.html#axzz2JO5Q0JMM>; Borak, *supra* note 146.

148. Borak, *supra* note 146 (quoting Rep. Frank).

149. Kevin Wack, *House Committee Votes to Repeal Bank Liquidation Authority*, AM. BANKER (Apr. 18, 2012), [http://www.americanbanker.com/issues/177\\_75/liquidation-authority-House-republicans-dodd-frank-cfpb-1048541-1.html](http://www.americanbanker.com/issues/177_75/liquidation-authority-House-republicans-dodd-frank-cfpb-1048541-1.html) (reporting on vote to repeal the OLA by the House Financial Services Committee).

OLA authorizes the FDIC to liquidate a bank or nonbank SIFI that is placed in receivership by the Treasury Secretary.<sup>150</sup> Regulators and some commentators have supported the OLA as a preferable alternative to the “Hobson’s choice of bailout or disorderly bankruptcy” that confronted federal officials during the peak of the financial crisis.<sup>151</sup> A repeal of the OLA would put regulators back in the position they occupied when Lehman and AIG teetered on the brink of failure in September 2008. As one commentator explained:

If the FDIC cannot seize a failing firm [under the OLA], regulators are left with two choices: let a firm go bankrupt, a la Lehman Brothers, or try finding a way of bailing it out.

Both choices are equally bad. Lehman’s bankruptcy nearly caused the entire financial system to melt down and directly led to government bailouts of [AIG and] the largest banks.<sup>152</sup>

Lehman’s bankruptcy severely disrupted the global financial system, and regulators in the U.S. and Europe quickly decided that they would not allow a disorderly failure of another SIFI.<sup>153</sup> Additionally, it took nearly four years and \$1.8 billion of expenses before Lehman emerged from Chapter 11 bankruptcy in March 2012, and Lehman is expected to pay less than one-fifth of the \$300 billion it owes to creditors.<sup>154</sup> The snail’s pace and high costs of Lehman’s bankruptcy create serious

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150. See Wilmarth, *supra* note 12, at 993, 996–1000 (discussing the OLA).

151. *Id.* at 993, 996 (quoting speech on Feb. 26, 2010, by FRB Governor Daniel Tarullo); see also Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, U. CIN. L. REV., 2–3 (forthcoming), available at <http://ssrn.com/abstract=2037915> (describing the potential advantages and possible shortcomings of the OLA procedure in resolving the failure of a large global bank like Bank of America, and explaining why it would be very difficult to amend the Bankruptcy Code to deal successfully with such a failure). For a detailed analysis of the strong support expressed by regulators and some commentators for the OLA and the opposition voiced by other commentators, see Paul L. Lee, *The Dodd–Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part I*, 128 BANKING L.J. 771, 782–97 (2011) [hereinafter *Lee Part I*]; Paul L. Lee, *The Dodd–Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part II*, 128 BANKING L.J. 867, 868–71, 901–03 (2011).

152. Rob Blackwell, *House Banking Panel Cynically Uses Scare Tactics, Symbolic Votes*, AM. BANKER (Apr. 19, 2012), <http://www.americanbanker.com/bankthink/House-Financial-Services-Committee-Big-Brother-1048584-1.html>.

153. See, e.g., FCIC Report, *supra* note 36, at 335–43, 353–60, 373–86; see also Wolfgang Schäuble, *How to Protect EU Taxpayers Against Bank Failures*, FINANCIAL TIMES (Aug. 30, 2012), <http://www.ft.com/intl/cms/s/0/d270a89e-f213-11e1-8973-00144feabdc0.html#axzz2JO5QJMM> (stating that Lehman’s bankruptcy “tipp[ed] the world into a financial and economic crisis of nearly unprecedented magnitude” and “[a]fter Lehman Brother’s collapse, the international community agreed not to let another systemically relevant bank fail”).

154. Linda Sandler, *Lehman’s Year-End Fees, Filings Match Up With Biggest Bankruptcy*, BLOOMBERG (Dec. 21, 2012), <http://www.bloomberg.com/news/2012-12-21/lehman-s-year-end-fees-filings-match-up-with-biggest-bankruptcy.html>; Linda Sandler, *Lehman Comes Back From the Dead*, BLOOMBERG BUSINESSWEEK, July 12, 2012, at 34, available at <http://www.businessweek.com/articles/2012-07-12/lehman-comes-back-from-the-dead>.

doubts whether Chapter 11—even if amended to deal with failing SIFIs—could successfully resolve the failure of a megabank like BofA, which is far larger and more complex than Lehman.<sup>155</sup> In any event, when House Republicans voted in committee to repeal the OLA they did *not* vote to amend Chapter 11 to address any of the special challenges posed by failing SIFIs.<sup>156</sup>

House Republicans and several Senators, including Senator Mark Warner (D-VA), also pushed legislation that would require more stringent CBA for all regulations issued by the CFTC and SEC.<sup>157</sup> As described above, the financial industry has already invoked existing statutory references to cost–benefit studies as a basis for challenging regulations issued by the SEC and CFTC.<sup>158</sup> Imposing even stricter cost–benefit requirements would create a further obstacle to the adoption of rules under Dodd–Frank.<sup>159</sup>

As an additional method for slowing down Dodd–Frank’s implementation, Republicans blocked any significant increases in the budgets of the CFTC and SEC during 2010, 2011 and 2012.<sup>160</sup> CFTC

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155. See Lubben, *supra* note 151, at 33–35 (explaining that a resolution of BofA would be much more complicated and difficult than Lehman’s Chapter 11 proceeding).

156. See Blackwell, *supra* note 152 (“Republicans have now voted to repeal [the OLA] and replace it with . . . nothing.”) (ellipse in original); see also *Lee Part I*, *supra* note 151, at 792–97 (describing (i) significant shortcomings in Chapter 11 of the Bankruptcy Code that make it very difficult for Chapter 11 to deal effectively with the potential failure of a SIFI, and (ii) legislation that House Republicans introduced in 2009 to address those flaws but failed to pass).

157. Maria Lokshin, *Securities and Exchange Commission: House Passes Omnibus Bill That Would Tighten Cost–Benefit Analysis for SEC, CFTC*, 44 SEC. REG. & L. REP. (BNA) 1438 (July 30, 2012) (discussing House passage of H.R. 4078); Maria Lokshin, *Securities and Exchange Commission: Senate Bill Targets Cost–Benefit Analysis of Independent Agencies’ Rulemaking*, 44 SEC. REG. & L. REP. (BNA) 1529 (Aug. 13, 2012) [hereinafter Lokshin, *Senate Bill Targets Cost–Benefit Analysis*] (discussing introduction of S. 3468, which would require stricter cost–benefit studies by the CFTC, SEC and other independent agencies). The proposed legislation to require CBA for all CFTC and SEC rules was not enacted in 2012, but the financial industry’s allies on Capitol Hill introduced similar legislation in 2013. See *infra* note 405 and accompanying text.

158. See *supra* Part II(B)(1) (describing litigation brought by financial industry groups to invalidate SEC and CFTC regulations for allegedly inadequate cost–benefit studies).

159. John Kemp, *Wall St and Republicans Team up to Curb CFTC*, REUTERS (June 7, 2012), <http://www.reuters.com/article/2012/06/07/column-kemp-cftc-idUSL5E8H76GF20120607>; Lokshin, *Senate Bill Targets Cost–Benefit Analysis*, *supra* note 157 (citing arguments by House Democrats that “requiring [independent agencies] to ramp up their economic assessments would effectively paralyze their rulemaking”).

160. Wilmarth, *supra* note 19, at 952–53 (describing the Republicans’ success in blocking increased funding for the CFTC and SEC during 2011); Silla Brush, *House Republicans Seek Cuts in Financial Dodd–Frank Agencies*, BLOOMBERG (June 6, 2012), <http://www.bloomberg.com/news/2012-06-05/house-republicans-seek-cuts-in-dodd-frank-regulatory-agencies.html> (discussing Republican efforts to cut the CFTC’s budget and to freeze the SEC’s budget during 2012); Robert Schmidt et al., *The Great Regulatory Holdup*, BLOOMBERG BUSINESSWEEK, Feb. 14–20, 2011, at 24 (reporting that Congress froze the CFTC’s and SEC’s budgets for 2011 at their 2010 levels); Kelsey Snell, *Industry Looks to Derail Dodd–Frank Enforcement*, NATIONAL JOURNAL (Feb. 15, 2011), <http://www.nationaljournal.com/member/daily/industry-looks-to-derail-dodd-frank-enforcement->



chairman Gary Gensler and SEC chairman Mary Schapiro warned that budget constraints imposed by Congress jeopardized the ability of both agencies to adopt and enforce the new regulations mandated by Dodd–Frank.<sup>161</sup> Mr. Gensler (along with critics of the financial industry) also alleged that the Republicans’ budgetary actions were consciously designed to help Wall Street by undermining Dodd–Frank.<sup>162</sup>

## 2. The Financial Industry and Its Legislative Allies Have Persisted in Their Efforts to Weaken Dodd–Frank Despite Recent Financial Scandals

The financial industry and its congressional allies have maintained their legislative campaign to weaken Dodd–Frank despite a series of recent scandals involving major Wall Street firms and leading foreign banks. Those scandals further damaged the reputations of large financial institutions, which already had plummeted due to public anger over abusive financial practices and excessive risk-taking that led to the financial crisis.<sup>163</sup> The financial industry’s recent embarrassments have included the following revelations:

- MF Global, a large commodities broker led by Jon Corzine—a former co-head of Goldman Sachs who later served as New Jersey’s Governor and a United States Senator—filed for bankruptcy in late 2011 after suffering heavy trading losses. After becoming chairman of MF Global in 2010, Corzine pushed the firm to take highly aggressive trading positions, including bets on more than \$6 billion of sovereign bonds issued by high-

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161. Wilmarth, *supra* note 19, at 952–53; Stephen Joyce, *Derivatives: Gensler Criticizes Vote on CFTC Budget: Says Dodd–Frank Requires More Funding*, 98 BNA’S BANKING REPORT 1030, June 12, 2012, available at 2012 WL 2092519; Kevin Wack, *Reform Implementation and Budget Crunch Collide*, AM. BANKER (July 22, 2011), <http://www.highbeam.com/doc/1G1-261990109.html>.

162. Joyce, *supra* note 161 (quoting Mr. Gensler’s statement that Republican attempts to cut the CFTC’s budget would “effectively put the interests of Wall Street ahead of those of the American public”); Wilmarth, *supra* note 19, at 952–53 (criticizing industry-backed efforts by Republicans to cut the CFTC’s and SEC’s budgets); Kemp, *supra* note 159 (contending that it would be reasonable to describe Republican efforts to cut the CFTC’s and SEC’s budgets, while demanding “smarter regulation and more cost benefit analysis, . . . as deeply cynical”); Snell, *supra* note 160 (reporting that Mr. Gensler’s “worries” about the adverse impact of congressional budget cuts “are music to the industry”).

163. See, e.g., Dawn Kopecki, *Wall Street Leaderless in Rules Fight as Dimon Diminished*, BLOOMBERG (Aug. 21, 2012), <http://www.bloomberg.com/news/2012-08-20/wall-street-leaderless-in-rules-fight-as-dimon-diminished.html>; Floyd Norris, *Scandals May Cost The Banks Their Clout*, N.Y. TIMES, July 27, 2012, at B1; *The LIBOR Affair: Banksters*, ECONOMIST (July 7, 2012), <http://www.economist.com/node/21558260>; see also *Financial Crisis Costs*, *supra* note 108, at 10 (declaring that “Wall Street deserves to be at the top of any list of those responsible for causing the [financial and economic] crises”); *supra* notes 12–15 and accompanying text (discussing public anger over the central role of big banks in triggering the financial crisis).

risk European countries.<sup>164</sup> After investigating MF Global's collapse, the company's bankruptcy trustee sued Corzine and two other senior executives for pursuing high-risk trading strategies that "severely strained the company's liquidity" and "ultimately contributed to [the company's] downfall."<sup>165</sup>

- JP Morgan disclosed in July 2012 that it had lost almost \$6 billion—and faced the threat of additional losses—from massive trading in derivatives by a London unit within the bank's chief investment office (CIO).<sup>166</sup> JPMorgan created CIO to invest excess deposits that the bank did not use to fund its loans, and the bank's senior management (including chairman Jamie Dimon) encouraged CIO to take aggressive trading risks.<sup>167</sup> CIO's huge trading positions generated substantial profits in 2010 and 2011, but produced massive losses in 2012.<sup>168</sup> JPMorgan's trading losses triggered a congressional investigation and severely embarrassed Mr. Dimon, who was widely praised for steering JPMorgan through the financial crisis without reporting a quarterly loss.<sup>169</sup> In addition, JPMorgan and its senior executives faced a variety of potential legal claims after a Senate committee "accused [JPMorgan] of hiding losses, deceiving regulators and misinforming investors."<sup>170</sup>
- In June 2012, Barclays paid \$450 million to U.S. and U.K. regulators to settle charges that it conspired with other banks to manipulate the London interbank offered rate (Libor") and the

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164. Azam Ahmed et al., *A Romance With Risk That Brought On a Panic*, N.Y. TIMES, Dec. 11, 2011, at A1; Roben Farzad & Matthew Leising, "MF Global's Jon Corzine Runs Out of Luck," BLOOMBERG BUSINESSWEEK (Nov. 2, 2011), <http://www.businessweek.com/magazine/mf-globals-jon-corzine-runs-out-of-luck-11022011.html>.

165. Richard Hill, *Futures Trading: Trustee Freeh Sues Corzine, Deputies, Alleging They Led MF Global Into Ruin*, 100 BNA'S BANKING REPORT 805 (April 30, 2013) (quoting complaint filed by Louis Freeh, bankruptcy trustee for MF Global Holdings Ltd., against Jon Corzine, Bradley Abelow and Henri Steenkamp).

166. Jessica Silver-Greenberg, *New Fraud Inquiry as JPMorgan's Loss Mounts*, N.Y. TIMES, July 14, 2012, at A1 (reporting JPMorgan's disclosure of \$5.8 billion in trading losses and additional potential losses of \$1.7 billion).

167. Dawn Kopecki & Michael J. Moore, *Whale of a Trade Revealed at Biggest U.S. Bank With Best Control*, BLOOMBERG (June 3, 2013), <http://www.bloomberg.com/news/2013-06-03/whale-of-a-trade-revealed-at-biggest-u-s-bank-with-best-control.html>; see also *infra* Part IV(C)(2) (discussing the investigation of JPMorgan's "London Whale" trading scandal by the Senate Permanent Subcommittee on Investigations).

168. Kopecki & Moore, *supra* note 167; Jessica Silver-Greenberg & Susanne Craig, *JPMorgan Trade Loss May Reach \$9 Billion*, N.Y. TIMES, June 28, 2012, at B1.

169. Rob Blackwell, *Dimon's 'Blood-on-the-Leaf Moment': How JPM Losses Have Helped the Industry's Opponents*, AM. BANKER (May 21, 2012), [http://www.americanbanker.com/issues/177\\_92/jpmorgan-chase-Dimon-trading-loss-Volcker-Rule-Dodd-Frank-1049261-1.html](http://www.americanbanker.com/issues/177_92/jpmorgan-chase-Dimon-trading-loss-Volcker-Rule-Dodd-Frank-1049261-1.html); Kopecki, *supra* note 163.

170. Kopecki & Moore, *supra* note 167; see also *infra* Part IV(C)(2) (discussing the report issued by the Senate Permanent Subcommittee on Investigations).

euro interbank rate for several years beginning in 2005. Barclays' top two officers (Robert Diamond and Jerry del Missier) resigned under pressure from U.K. regulators and politicians.<sup>171</sup> Officials investigating the Libor scandal targeted more than a dozen major foreign banks—including UBS and RBS, which subsequently entered into settlements similar to Barclay's—along with BofA, Citigroup and JP Morgan.<sup>172</sup> The Libor-rigging scandal included efforts by bank employees to earn illegitimate trading profits as well as attempts by banks to disguise their precarious financial condition during the peak of the financial crisis in 2008.<sup>173</sup> The banks under investigation faced potentially massive liabilities from official penalties and investor lawsuits, because Libor determines the pricing for more than \$300 trillion in global financial instruments, including derivatives, corporate bonds, mortgages and student loans.<sup>174</sup> A leading financial journal remarked that the Libor scandal “corrodes further what little remains of public trust in banks and those who run them.”<sup>175</sup>

- A Senate committee report issued in July 2012 revealed that HSBC, a leading global bank, engaged in illegal money laundering for Mexican drug cartels, terrorists, and rogue states (including Iran) between 2003 and 2010. HSBC subsequently paid \$1.9 billion to settle criminal money laundering charges filed by federal prosecutors.<sup>176</sup> In August 2012, New York's

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171. Josh Gallu et al., *The Libor Scandal Claims Its First CEO*, BLOOMBERG BUSINESSWEEK, July 3, 2012, at 9–16, available at <http://www.businessweek.com/articles/2012-07-03/the-libor-scandal-claims-its-first-ceo>.

172. *Id.*; Caroline Salas Gage, *What's Fed to Do as 15 of 18 Banks Fixing Libor Aren't American*, BLOOMBERG (Aug. 9, 2012), <http://www.bloomberg.com/news/2012-08-09/what-s-fed-to-do-as-15-of-18-banks-fixing-libor-aren-t-american.html>; see also *infra notes* 441-43 and accompanying text (discussing UBS's agreement to pay \$1.5 billion in December 2012, and RBS's agreement to pay \$612 million in February 2013, in order to settle Libor-rigging charges).

173. Gary Gensler, CFTC Chairman, Testimony Before the U.S. Senate Committee on Agriculture (July 17, 2012), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-118>; see also *Libor's Trillion-Dollar Question*, BLOOMBERG (Aug. 27, 2012), <http://www.bloomberg.com/news/2012-08-27/libor-s-trillion-dollar-question.html>; *The Libor Scandal: The Rotten Heart of Finance*, ECONOMIST, July 7, 2012, at 3.

174. Gallu et al., *supra* note 171; Andrew Harris et al., *Wall Street Bank Investors in Dark on Libor Liability*, BLOOMBERG (July 5, 2012), <http://www.bloomberg.com/news/2012-07-05/wall-street-bank-investors-in-dark-on-libor-liability.html>; see also *Libor's Trillion-Dollar Question*, *supra* note 173.

175. *The Libor Scandal: The Rotten Heart of Finance*, *supra* note 173, at 2; see also *The Worst Banking Scandal Yet?*, BLOOMBERG (July 12, 2012), <http://www.bloomberg.com/news/2012-07-12/the-worst-banking-scandal-yet-.html> (“The Libor scandal offers a sad illustration of the moral bankruptcy that has infected some corners of finance.”).

176. Joe Adler, *HSBC: A Study in Anti-Laundering Blunders*, AM. BANKER (July 18, 2012), [http://www.americanbanker.com/issues/177\\_137/hsbc-a-study-in-anti-laundering-blunders-1050998-1.html](http://www.americanbanker.com/issues/177_137/hsbc-a-study-in-anti-laundering-blunders-1050998-1.html); Jeff Day, *Money Laundering: Senate Probe Finds Major AML Problems at HSBC 2003-2010; Blasts OCC AML Policy*, 99 BNA's BANKING REPORT 153 (July 24, 2012), available at 2012 WL

banking regulator charged Standard Chartered, another major foreign bank, with illegally laundering \$250 billion of funds for Iran from 2001 to 2007.<sup>177</sup> Standard Chartered ultimately paid \$670 million to settle New York's allegations as well as separate federal claims.<sup>178</sup>

The foregoing scandals further marred the already bruised credibility of major U.S. and foreign banks.<sup>179</sup> However, the scandals' negative impact on Wall Street's reputation did not deter the financial industry and its Capitol Hill allies from pursuing their anti-reform agenda.<sup>180</sup> Instead, the industry and its legislative allies redoubled their efforts to roll back Dodd–Frank's reforms.<sup>181</sup>

During the 2012 political campaign, Republican leaders and industry representatives announced that they would seek to repeal or cut back several key provisions of Dodd–Frank if Republicans gained control of the White House and both houses of Congress in the November elections. Top Republicans and industry groups particularly focused on (i) weakening the CFPB's authority and independence, (ii) repealing or watering down the Volcker Rule and many of the derivatives reforms in Article VII of Dodd–Frank, and (iii) requiring all financial regulators to perform stringent cost–benefit studies before adopting any new rules.<sup>182</sup>

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2995498; *see also infra* notes 434–38 and accompanying text (discussing HSBC's settlement of federal criminal charges in December 2012).

177. Greg Farrell & Tiffany Kary, *Standard Chartered Still Faces Fed Probes After N.Y. Deal*, BLOOMBERG (Aug. 15, 2012), <http://www.bloomberg.com/news/2012-08-14/standard-chartered-faces-fed-probes-after-n-y-deal.html>; Stephen Joyce & Len Bracken, *Money Laundering: Standard Chartered Bank Hid \$250 Billion In Iran Dealings, New York Regulator Says*, 99 BNA's BANKING REPORT 294 (Aug. 14, 2012), available at 2012 WL 3279507.

178. Farrell & Kary, *supra* note 177 (reporting that Standard Chartered paid \$340 million to settle New York's claims); *Standard Chartered to pay \$327 million to resolve U.S. case*, REUTERS (Dec. 10, 2012) (reporting on Standard Chartered's agreement to pay \$327 million to settle claims by federal agencies), <http://www.reuters.com/article/2012/12/10/us-stanchart-settlement-idUSBRE8B900T20121210>.

179. Kopecki, *supra* note 163; Norris, *supra* note 163, at B1.

180. Phil Mattingly, *Wall Street Supporters in Congress Unmoved by Libor Probe*, BLOOMBERG (July 3, 2012), <http://www.bloomberg.com/news/2012-07-03/wall-street-supporters-in-congress-unmoved-by-libor-probe.html> (“Wall Street's defenders in Congress are sticking by the industry, undaunted by the Barclays fine or trading losses . . . at JPMorgan Chase & Co.”); Alan Zibel, *Even After ‘Whale’ Losses, Bankers Hammer Volcker*, WALL ST. J. (Sept. 10, 2012), [http://blogs.wsj.com/deals/2012/09/10/even-after-whale-losses-bankers-hammer-volcker/?mod=wsj\\_streaming\\_stream](http://blogs.wsj.com/deals/2012/09/10/even-after-whale-losses-bankers-hammer-volcker/?mod=wsj_streaming_stream) (reporting that top financial trade associations continued to express strong opposition to the Volcker Rule despite the embarrassment caused by JPMorgan's trading losses).

181. Zibel, *supra* note 180; *see also* Chris Bruce, *Securities: Volcker Rule Needs Major Rewrite, Trade Associations Tell House Committee*, 99 BNA's BANKING REPORT 444 (Sept. 18, 2012), available at 2012 WL 4067935 (describing letters written by five leading financial trade associations to the House Financial Services Committee, calling for major cutbacks or an outright repeal of the Volcker Rule).

182. Phil Mattingly, *Why Romney Won't Kill Dodd–Frank*, BLOOMBERG BUSINESSWEEK (Sept. 6, 2012), <http://www.businessweek.com/articles/2012-09-06/why-romney-wont-kill-dodd-frank> (reporting

The financial industry supported Republicans even more strongly in 2012 than it did in 2010. The industry gave two-thirds of its political contributions to Republican candidates during the 2012 election cycle.<sup>183</sup> The financial industry's overwhelming support for Republican Presidential candidate Mitt Romney in 2012 represented a sharp departure from 2008, when the industry gave a significant majority of its contributions to Barack Obama.<sup>184</sup> The obvious reason for this shift was Wall Street's gratitude for Mr. Romney's strong opposition to Dodd-Frank and Wall Street's anger over President Obama's sponsorship of the legislation.<sup>185</sup>

Wall Street's lopsided support for Republican candidates did not cause Democratic leaders to move aggressively against the financial industry. Indeed, many observers criticized the Obama administration

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that Republicans, even if victorious, probably could not repeal Dodd-Frank but would be likely to "try to give the financial industry something it wants more: a diluted financial reform law that would relax restrictions on some of its most profitable—and riskiest—investments"); Kevin Wack, *What Romney Victory Would Mean for Banks*, AM. BANKER (Aug. 31, 2012), [http://www.americanbanker.com/issues/177\\_169/what-romney-victory-would-mean-for-banks-1052289-1.html](http://www.americanbanker.com/issues/177_169/what-romney-victory-would-mean-for-banks-1052289-1.html) (reporting that Mitt Romney's "stated goal" to repeal Dodd-Frank would probably not happen if he won the Presidential election, but Republicans would seek to "chip away at what they see as the worst parts of Dodd-Frank, continuing a legislative strategy they began in 2011"); Yin Wilczek, *Regulatory Reform: Shelby Vows to Pursue 'Real' Reform If Republicans Regain Control of Senate*, 99 BNA'S BANKING REP. 210 (July 31, 2012), available at 2012 WL 3067216 (reporting that Sen. Richard Shelby (R-AL) announced plans to push for legislation that "would require all financial regulators to conduct rigorous cost-benefit analysis before promulgating any regulations," amend "flawed" provisions of Dodd-Frank, and make major changes to the CFPB).

183. *CRP Political Contribution Report*, *supra* note 133 (showing that the finance, insurance and real estate sector gave 68% of its \$658 million of political contributions to Republican candidates during the 2012 election cycle); see also Jason Kelly & Katherine Burton, *Wall Street Wins Neither With Obama Nor Romney Amid Glare*, BLOOMBERG (June 27, 2012), <http://www.bloomberg.com/news/2012-06-27/wall-street-wins-neither-with-obama-nor-romney-amid-glare.html> (reporting that Mitt Romney had collected \$9.4 million from the securities and investment industry, compared to only \$3.4 million for President Obama); Kevin Wack, *'It Can't Get Any Worse'—Why Banks Are Making a One-Sided Political Bet*, AM. BANKER (May 7, 2012), [http://www.americanbanker.com/issues/177\\_87/Mitt-Romney-Obama-bank-industry-campaign-contributions-1049066-1.html](http://www.americanbanker.com/issues/177_87/Mitt-Romney-Obama-bank-industry-campaign-contributions-1049066-1.html) (reporting that the banking industry "is backing Mitt Romney and the Republican National Committee by a nearly 2-to-1 margin through political donations in the 2012 campaign"); see also *supra* note 133 and accompanying text (showing that the financial industry gave 53% of its campaign contributions to Republican candidates during the 2010 election cycle).

184. Wack, *supra* note 183, at 1–2 (reporting that "[t]he banking industry's strong backing of Romney in 2012 marks a sharp reversal from four years ago," when the industry gave \$42 million to the Obama campaign and only \$31 million to John McCain's campaign); Jonathan D. Salant, *Goldman Sachs Leads Split With Obama, as GE Jilts Him Too*, BLOOMBERG (Aug. 9, 2012), <http://www.bloomberg.com/news/2012-08-09/goldman-sachs-leads-split-with-obama-as-ge-jilts-him-too.html> (reporting that employees at six major banks—Bof A, Citigroup, Goldman, JPMorgan, Morgan Stanley and UBS—gave most of their contributions to Romney in 2012 after supporting Obama in 2008).

185. Jonathan D. Salant, *Goldman Sachs to Fund Romney Over Obama*, BLOOMBERG (Feb. 1, 2012), <http://www.bloomberg.com/news/2012-02-01/romney-sees-surge-in-wall-street-donations-as-obama-s-decline.html>; Wack, *supra* note 183, at 1.

for failing to take strong enforcement actions against large financial institutions at the center of the financial crisis or their top executives, and for not pushing for a vigorous implementation of Dodd–Frank.<sup>186</sup> At the Democratic national convention in August 2012, only one primetime speaker—Senate candidate Elizabeth Warren—spoke out strongly against Wall Street, while President Obama’s address included just a single mild criticism of large banks.<sup>187</sup>

Republican leaders’ eager embrace of Wall Street and Democratic leaders’ acquiescent attitude toward Wall Street stood in sharp contrast to the hostile attitudes of many delegates at both parties’ national conventions. One journalist found widespread support among delegates at both conventions for proposals that would mandate a breakup of the largest banks.<sup>188</sup> However, leaders in both parties showed no interest in attacking big banks.<sup>189</sup>

Perhaps the disjunct between party leaders and rank-and-file delegates was not surprising, after all. As one critic astutely observed, “Why would [party leaders] put pressure on the banks? Just look at who’s funding the conventions and the parties.”<sup>190</sup>

186. See, e.g., Barofsky, *supra* note 7; Simon Johnson, *Why Does Wall Street Always Win?*, BASELINE SCENARIO (Aug. 23, 2012), <http://baselinescenario.com/2012/08/23/why-does-wall-street-always-win/#more-10297>; Taibbi, *supra* note 7, at 2; see also Frank Rich, *The Betrayal*, OBSERVER, Aug. 14, 2011, at 24 (criticizing the Obama Administration for “the stunning lack of accountability for the greed and misdeeds that brought America to its gravest financial crisis since the Great Depression. There has been no legal, moral, or financial reckoning for the most powerful wrongdoers. Nor have there been meaningful reforms that might prevent a repeat catastrophe.”); *infra* Part IV(A)(2) (discussing the lack of effective enforcement efforts against large institutions that played major roles in the financial crisis or their corporate leaders).

187. Lisa Lerer & Julie Bykowitz, *Bankers Erect Fences to Deflect Attacks That Don’t Come*, BLOOMBERG.COM (Sept. 7, 2012), <http://www.bloomberg.com/news/2012-09-07/bankers-erect-fences-to-deflect-attacks-that-don-t-come.html> (reporting that Elizabeth Warren, the Democratic candidate for U.S. Senate in Massachusetts, declared in her convention speech that Wall Street bankers “wrecked” the economy and “destroyed millions of jobs,” while President Obama said only that “we don’t want bailouts for banks that break the rules”); see also *id.* (noting that Democratic leaders like Rep. Joe Crowley (D-CT), Sen. Charles Schumer (D-NY) and Chicago Mayor Rahm Emanuel maintained friendly relationships with Wall Street); Kevin Roose, *Can Wall Street Tame Elizabeth Warren?*, NEW YORK MAGAZINE, Nov. 30, 2012 (providing a more detailed account of Sen. Warren’s speech at the Democratic national convention, in which she declared, “The system is rigged” against ordinary people, while “Wall Street CEOs—the same ones who wrecked our economy and destroyed millions of jobs—still strut around Congress, no shame, demanding favors, and acting like we should thank them.”), available at <http://nymag.com/daily/intelligencer/2012/11/can-wall-street-tame-elizabeth-warren.htm>.

188. Kevin Wack, *Big-Bank Breakup Popular with Rank and File of Both Parties*, AM. BANKER (Sept. 6, 2012), [http://www.americanbanker.com/issues/177\\_172/big-bank-breakup-popular-with-rank-and-file-1052378-1.html](http://www.americanbanker.com/issues/177_172/big-bank-breakup-popular-with-rank-and-file-1052378-1.html).

189. *Id.*

190. Lerer & Bykowitz, *supra* note 187 (quoting Ben Carroll); see also Rivlin, *supra* note 7 (stating that, during the 2012 campaign, “President Obama chose not to trumpet Dodd–Frank so as not to alienate deep-pocketed backers on Wall Street”); Wack, *supra* note 188 (reporting that the idea of breaking up the big banks “enjoys broad bipartisan support,” but congressional leaders from both parties would not allow a floor vote on any such proposal due to “the reliance of members of Congress on

As discussed below in Part IV(A)(1), the financial industry did not succeed in its efforts to defeat President Obama and capture the Senate for the Republicans in November 2012. However, the industry's strong support helped Republicans to retain control of the House. As soon as the new Congress convened in 2013, House Republican leaders and the financial industry renewed their efforts to enact legislation that would repeal or weaken key Dodd–Frank reforms. In addition, as explained in Part IV(B)(3)(a), President Obama appointed a new Treasury Secretary (Jacob Lew) and a new SEC chairman (Mary Jo White) who had extensive Wall Street connections and were widely viewed as sympathetic to Wall Street's interests. Thus, the financial industry's electoral defeats in 2012 did not derail the industry's long-term campaign to undermine Dodd–Frank.

### III. FEDERAL REGULATORS AND CONGRESS FOLLOWED DEREGULATORY POLICIES PROMOTED BY THE FINANCIAL INDUSTRY THAT ENCOURAGED RECKLESS LENDING AND LED TO THE FINANCIAL CRISIS

The financial industry's ability to obstruct Dodd–Frank's reforms is, unfortunately, consistent with the industry's past record of success in promoting a deregulatory agenda that set the stage for the financial crisis. Federal agencies and Congress adopted a long series of measures between 1992 and 2007 that encouraged reckless lending and high-risk securitization, thereby fueling an enormous credit boom and an unsustainable housing bubble in the U.S. The financial industry eagerly supported those actions and helped to spur the greatest expansion of private-sector debt since the 1920s.<sup>191</sup> The industry also encouraged federal regulators to preempt efforts by state officials to stop abusive and predatory lending practices. Thus, major banks and their trade associations were deeply implicated in regulatory and legislative policy mistakes that paved the way for the financial crisis.

#### *A. Federal Regulators Permitted Financial Institutions to Engage in Unsound and Predatory Lending Practices That Produced an Unsustainable Credit Boom*

With the financial industry's enthusiastic support, federal banking agencies adopted deeply flawed policies that enabled large financial institutions to originate trillions of dollars of high-risk mortgages and to spread the risks of those mortgages to far-flung investors through

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campaign contributions from large banks").

191. Wilmarth, *supra* note 12, at 963–67, 971–79 (discussing causes of the credit boom and housing bubble that occurred between 1991 and 2007); Wilmarth, *supra* note 15, at 1002–43 (same).

hazardous securitization. This section highlights key policy errors that helped to inflate the nonprime lending boom, which in turn led to the financial crisis.

### 1. Federal Regulators Issued Weak “Guidelines” That Allowed Banks and Thrifts to Engage in High-Risk Mortgage Lending

In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in response to a severe financial crisis that resulted in the failures of almost 3,000 banks and thrifts during the 1980s and early 1990s.<sup>192</sup> One of FDICIA’s provisions required the federal banking agencies to adopt “uniform regulations” imposing strict new standards for real estate lending.<sup>193</sup> Congress expected that the new lending standards would be much stronger than the “flexible approach” followed by the OCC and other agencies during the 1980s.<sup>194</sup> The lax regulatory standards of the 1980s allowed banks and thrifts to make “imprudent” and “abusive” real estate loans that inflicted massive losses on depository institutions and the deposit insurance funds during the second half of the 1980s and the early 1990s.<sup>195</sup>

However, when federal banking agencies issued a proposed joint regulation to implement the 1991 statute, the financial industry strongly urged the agencies to adopt “flexible guidelines rather than regulations.”<sup>196</sup> The industry also argued that regulators should avoid

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192. *History of the Eighties: Lessons for the Future*, FED. DEPOSIT INS. CORP., at 10–11, 102–05, 186–88, 452–54 (Dec. 1997) (discussing the banking and thrift crises of the 1980s and early 1990s and the enactment of FDICIA) [hereinafter *FDIC History Lessons*]; FCIC Report, *supra* note 36, at 34–37 (same).

193. Michael Frachioni, *Leveraging the Land: The Changing Loan to Value Ratio for Real Estate Lending by National Banks*, 112 *BANKING L.J.* 41, 56 (1995) (discussing the enactment of 12 U.S.C. § 1828o in 1991); Arthur E. Wilmarth, Jr., *The OCC’s Preemption Rules Exceed the Agency’s Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 *ANN. REV. BANKING & FIN. L.* 225, 301 (2004) (same) [hereinafter *OCC’s Preemption Rules*].

194. Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 301; *see also* Real Estate Lending Standards, 57 *Fed. Reg.* 62890 (Dec. 31, 1992) (“The legislative history of [12 U.S.C. § 1828o] indicates that Congress wanted to curtail abusive real estate lending practices in order to reduce risk to the deposit insurance fund and enhance the safety and soundness of insured depository institutions.”) [hereinafter *1992 Real Estate Lending Standards*].

195. Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 301. For descriptions of the losses suffered by banks and thrifts due to unsound real estate lending during the 1980s, *see* Frachioni, *supra* note 193, at 53–56; *FDIC History Lessons*, *supra* note 192, at 9–10, 137–62, 301–378; L. WILLIAM SEIDMAN, *FULL FAITH AND CREDIT: THE GREAT S&L DEBACLE AND OTHER WASHINGTON SAGAS* 138–64 (1993).

196. *1992 Real Estate Lending Standards*, *supra* note 194 (summarizing comments submitted in response to the proposed regulation); *see also* Barbara A. Rehm, *Regulators Agree to Ease Limits On Realty Loans by Banks, Thrifts*, *AM. BANKER* (Oct. 14, 1992), [http://www.americanbanker.com/issues/157\\_106/-18380-1.html](http://www.americanbanker.com/issues/157_106/-18380-1.html) (reporting that “[b]anks and thrifts deluged regulators with 1,500 comment letters, arguing that [the original proposal for binding rules]



any “rigid application” of loan-to-value (LTV) limits for real estate loans, because such limits “would constrict credit, impose additional lending costs, reduce ending flexibility, [and] impede economic growth.”<sup>197</sup> Despite the industry’s lobbying efforts, the FDIC pushed for binding regulations that would impose strict LTV limits on real estate loans. However, the Treasury Department and the other three federal banking agencies (the FRB, OCC and the Office of Thrift Supervision (OTS)) agreed with the industry, and they ultimately persuaded the FDIC to accept “general guidelines that [would] give banks more leeway” in making real estate loans.<sup>198</sup>

The four banking agencies issued joint guidelines on real estate lending at the end of 1992. The interagency guidelines did not specify a maximum LTV limit for owner-occupied 1-to-4-family residences and allowed banks to make loans (including second mortgages and home equity loans) that exceeded 90% of a home’s appraised value.<sup>199</sup> The guidelines specified maximum LTV ratios for other types of real estate loans, but the guidelines permitted banks to make loans that exceeded those limits if “credit is justifiable under the specific circumstances.”<sup>200</sup> More generally, the interagency guidelines allowed banks to make loans that did *not* conform to the guidelines as long as the bank could justify such loans as “prudently underwritten exceptions to its lending policies.”<sup>201</sup>

In addition to the inclusion of generous exemptions, the 1992 interagency guidelines did not impose “mandatory” restrictions; instead, banks were required only to “*consider* the guidelines in establishing their own real estate lending policies.”<sup>202</sup> The 1992 guidelines marked the beginning of a fifteen-year trend in which federal bank regulators repeatedly issued nonbinding statements of guidance with respect to high-risk mortgage lending instead of adopting binding rules with

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would curtail lending”).

197. 1992 *Real Estate Lending Standards*, *supra* note 194 (summarizing comments submitted in response to the proposed regulation).

198. Barbara A. Rehm, *FDIC Eases Tough Plan to Limit Realty Lending*, AM. BANKER (Oct. 9, 1992), [http://www.americanbanker.com/issues/157\\_103/-18294-1.html](http://www.americanbanker.com/issues/157_103/-18294-1.html) (reporting that the FDIC’s concession represented “a big victory” for banks and thrifts); *see also* Rehm, *supra* note 196 (reporting that Treasury officials persuaded three of the four banking agencies to accept more flexible guidelines rather than regulations, and the FDIC finally gave in to the other agencies).

199. 1992 *Real Estate Lending Standards*, *supra* note 194 (requiring borrowers for residential mortgages with an LTV ratio above 90% to provide “appropriate credit enhancement in the form of mortgage insurance or readily marketable collateral”).

200. *Id.*

201. *Id.*

202. Vincent Di Lorenzo, *Principles-Based Regulation and Legislative Congruence*, 15 N.Y.U. J. LEGIS. & PUB. POL’Y 45, 54 (2012) (emphasis added).

clearly enforceable limits on such lending.<sup>203</sup> Between 1999 and 2001, the federal banking agencies issued three guidances dealing with subprime mortgages and high LTV real estate lending. The three guidances warned banks about the risks of “abusive lending practices,” including making loans without regard to the borrower’s ability to repay, but the guidances “did not prohibit the abusive practices.”<sup>204</sup> In 2003, the OCC issued two similar “advisory letters” that provided “supervisory guidance” rather than binding rules.<sup>205</sup>

The agencies’ reliance on precatory guidance created a permissive environment in which subprime mortgage originations grew rapidly from \$40 billion in 1993 to \$240 billion in 2002.<sup>206</sup> During the same period, several studies by federal agencies found growing evidence of predatory lending abuses, including “(i) loan flipping (i.e., frequent refinancing of high-cost home loans); (ii) equity stripping (i.e., the loss of equity resulting from repeated refinancing that requires the borrower to pay high fees and closing costs), (iii) asset-based lending (i.e., the extension of credit based primarily on the residual value of the borrower’s home and other personal assets without regard to the borrower’s income), (iv) excessive fees and penalty charges, (v) high-pressure sales tactics accompanied by inadequate or misleading disclosures, and (vi) aggressive foreclosure policies.”<sup>207</sup>

The statements of guidance issued by federal bank regulators between 1999 and 2003 warned banks against engaging in the foregoing abuses but did very little to stop them.<sup>208</sup> After reviewing these regulatory warnings, an OCC staff economist recently observed that “regulators knew the risks of subprime lending well and accurately,” and he asked,

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203. *Id.* at 54–62; see also ENGEL & MCCOY, *supra* note 19, at 165–66, 196–97 (describing decisions by federal banking agencies to issue nonbinding guidance instead of mandatory regulations between the late 1990s and 2008).

204. Di Lorenzo, *supra* note 202, at 57–58.

205. Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 309–310.

206. See ENGEL & MCCOY, *supra* note 19, at 165–66 (stating that agency guidances “allowed for slack regulation and permitted lenders to argue that compliance was optional,” resulting in a “downward spiral in lending standards”); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 393 n.766 (providing 1993 figure for subprime mortgage originations); Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 308 (providing 2002 figure).

207. Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 308–09 (summarizing findings made by government studies of predatory subprime lending practices); see also Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1260, 1260–70 (2002) (same); FCIC Report, *supra* note 36, at 76–77, 93, 95 (same).

208. Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 309–10 (noting that one of the OCC’s 2003 advisory letters “condemned ‘abusive’ lending practices that . . . involve unfair and deceptive conduct” but did not define unlawful conduct with any specificity) (quoting OCC Advisory Letter 2003-2).

“[H]ow could the subprime crisis happen?”<sup>209</sup> The unfortunate answer is that federal regulators utterly failed to take effective action in response to problems they clearly identified.<sup>210</sup> For example, the OCC and the FRB issued only three binding rules to address predatory lending problems in the early 2000s, and all three rules were weak and ineffective.<sup>211</sup>

While federal regulators dithered, several FDIC-insured institutions that engaged heavily in subprime lending and securitization failed between 1997 and 2002, resulting in losses to the FDIC of nearly \$2 billion.<sup>212</sup> The most spectacular of those failures involved Superior Bank, FSB, a federal savings association with more than \$2 billion of assets, which specialized in making and securitizing subprime mortgages and auto loans. Superior Bank failed due to high rates of delinquencies and defaults on its subprime loans as well as massive writedowns that it was forced to take on residual (equity or first loss) interests that it retained from its securitizations of those loans.<sup>213</sup>

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209. Douglas Robertson, *So That's Operational Risk!*, 16 (Off. Comptroller Curr. Econ., Working Paper 2011-1); see also *id.* at 15 (pointing out that the 1999 interagency guidance on subprime lending “reads like a prophecy from Cassandra” in describing the risks of making and securitizing subprime loans).

210. BARTH, CAPRIO & LEVINE, *supra* note 19, at 88–96, 177–78; ENGEL & MCCOY, *supra* note 19, at 167–205.

211. The OCC issued two rules in early 2004. The first rule prohibited national banks from making real estate loans based primarily on the “foreclosure or liquidation value” of the borrower’s home and “without regard to the borrower’s ability to repay the loan.” Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 306 (quoting 12 C.F.R. § 34.3(b)). However, that rule was relatively weak because it allowed national banks to make subprime mortgages based on the borrower’s credit history, thereby allowing national banks to rely on the borrower’s credit score (which frequently proved to be unreliable during the housing boom). ENGEL & MCCOY, *supra* note 19, at 168. The second rule prohibited national banks from making real estate loans by using unfair and deceptive practices, but that rule was vague and had little force because the OCC declared that it lacked “authority to specify by regulation that particular practices, such as loan ‘flipping’ or ‘equity stripping’ are unfair or deceptive.” *OCC’s Preemption Rules*, *supra* note 193, at 307 (quoting Bank Activities and Operations: Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1911 n.55 (2004)). The FRB issued a regulation in 2001 that slightly expanded the definition of “high-cost” loans that were subject to the protections provided by the Home Ownership and Equity Protection Act (HOEPA). However, that rule had “little if any effect” because it “only covered 1 percent of all subprime loans.” ENGEL & MCCOY, *supra* note 19, at 194–95; Arthur E. Wilmarth, *The Dodd–Frank Act’s Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 898 (2011) [hereinafter *Dodd–Frank Act*].

212. Wilmarth, *OCC’s Preemption Rules*, *supra* note 193, at 312–13.

213. *Id.* at 314. For discussions of the failure of Superior Bank, see Christian A. Johnson, *The Failure of Superior Bank, FSB: Regulatory Lessons Learned*, 121 BANKING L.J. 47 (2004); *Bank Regulation: Analysis of the Failure of Superior Bank, FSB, Hinsdale, Illinois*, GAO-02-419T (Feb. 7, 2002) (Statement of Thomas J. McCool).

## 2. Federal Agencies Adopted Weak Capital Rules That Encouraged Banks and Thrifts to Expand Their Involvement with High-Risk Mortgage Lending and Securitization

Unfortunately, federal regulators failed to heed the clear lessons from Superior Bank's failure about the dangers inherent in subprime lending and securitization. Federal banking agencies did issue a joint regulation in late 2001, which imposed much higher capital requirements on banks that retained unrated residual interests from securitizations.<sup>214</sup> However, banks that packaged subprime loans into residential mortgage-backed securities (RMBS) avoided the impact of the 2001 rule by selling the residual interests in RMBS to hedge funds and other institutional investors, including collateralized debt obligations (CDOs).<sup>215</sup> Some major banks (including Goldman and JPMorgan) allegedly permitted hedge funds that purchased residual interests in subprime CDOs to use credit default swaps (CDS) in order to bet against the CDOs' underlying portfolio of RMBS.<sup>216</sup>

In addition, the 2001 interagency capital rule contained a major flaw that helped to inflate the subprime lending boom. The regulation stated that tranches of subprime RMBS and CDOs would qualify for a 20% risk weight under the agencies' risk-based capital rules (with a resulting capital charge of only 1.6% instead of 8%) if the tranches were backed by credit enhancements, like CDS, issued by a company rated AAA or AA by credit rating agencies (CRAs).<sup>217</sup> Thus, the 2001 rule gave

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214. ENGEL & MCCOY, *supra* note 19, at 155; Risk-Based Capital Guidelines: Capital Treatment of Recourse, Direct Credit Substitutes and Residual Interests in Asset Securitizations, 66 Fed. Reg. 59615, 59616–21, 59625–26 (Nov. 29, 2001) [hereinafter *2001 Interagency Capital Rule*] (requiring lenders to satisfy a “dollar-for-dollar” capital charge by holding capital equal to 100% of retained residual interests that did not receive an investment-grade rating from a credit rating agency).

215. Engel & McCoy, *supra* note 2, at 2065–68. Large banks that securitized subprime loans frequently provided credit (as prime brokers) to hedge funds in order to enable those funds to purchase residual interests in RMBS and CDOs. In some cases, the lending banks suffered large losses when their hedge fund borrowers collapsed during the financial crisis. Wilmarth, *supra* note 15, at 1026, 1030; CHARLES R. MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN* 113–23 (2008).

216. See Wilmarth, *supra* note 12, at 1026–27 (discussing Goldman's payment of \$550 million to settle SEC charges that Goldman defrauded institutional investors by selling them interests in a 2007 CDO without disclosing that “a large hedge fund, Paulson & Co., had helped to select the CDO's portfolio of RMBS while intending to short the CDO by purchasing CDS from Goldman”); Hugh Son et al., *JPMorgan's \$153.6 Million Settlement with SEC Recalls Case Against Goldman Sachs*, BLOOMBERG (June 21, 2011), <http://www.bloomberg.com/news/2011-06-21/jpmorgan-to-pay-153-6-million-to-settle-sec-allegations-over-housing-cdos.html> (reporting that JPMorgan paid \$154 million to settle SEC charges that JPMorgan “failed to tell investors in 2007 that a hedge fund [called Magnetar Capital LLC (Magnetar)] helped pick, and bet against, underlying securities” in a CDO that JPMorgan sponsored and sold to investors); FCIC Report, *supra* note 36, at 191–93 (reporting on Goldman's settlement and also stating that Magnetar and other hedge funds purchased residual interests in CDOs while purchasing CDS to short other tranches in the CDOs).

217. *2001 Interagency Capital Rule*, *supra* note 214, at 59,625–27. In the late 1990s, federal bank regulators allowed JPMorgan and other leading banks to reduce their risk-based capital requirements

tranches of subprime RMBS or CDOs highly-favorable risk-based capital treatment that was equal to the treatment given to much less risky RMBS issued by government-sponsored enterprises (GSEs), like Fannie Mae and Freddie Mac, as long as the subprime tranches were supported by an AAA-rated or AA-rated company.<sup>218</sup>

Federal banking agencies adopted the 2001 regulation even though (i) Fannie and Freddie pointed out that the rule would allow banks to reduce dramatically the capital they were required to hold against subprime-related mortgage assets, and (ii) a leading group of economists warned that CRAs were subject to a dangerous conflict of interest that was likely to produce inflated credit ratings, because banks that issued RMBS and CDOs paid CRAs for their credit ratings.<sup>219</sup> The 2001 rule allowed Wall Street banks to reduce their capital requirements significantly by obtaining CDS from AIG or monoline insurance companies, and the business of issuing CDS ultimately brought AIG and several monoline insurers (including Ambac and MBIA) to the brink of collapse in 2008.<sup>220</sup> In addition, the 2001 rule “created the incentive for [CRAs] to provide overly optimistic assessment of the risk in mortgage pools” and also pushed the GSEs to reduce their own lending standards “in order to maintain a presence in the [residential mortgage] market.”<sup>221</sup>

Federal regulators also permitted Wall Street banks to sponsor structured investment vehicles (SIVs) and other off-balance-sheet (OBS) conduits, which were frequently used as receptacles for RMBS and CDOs that banks were unable to sell to arms-length investors. The sponsored conduits sold asset-backed commercial paper (ABCP) to investors and used the proceeds to buy structured-finance securities underwritten by the sponsoring banks. The conduits faced a dangerous funding mismatch between their longer-term, structured-finance assets and their shorter-term, ABCP liabilities. The sponsoring LCFIs covered that mismatch (in whole or in part) by providing explicit credit

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from 8% to 1.6% by pooling CDS on corporate loans to create synthetic CDOs and by obtaining CDS from AIG to backstop tranches of those CDOs. GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 48–56, 60–66 (2009). JPMorgan called its CDO structure “BISTRO,” and “some bankers started to joke that ‘BISTRO’ really stood for ‘BIS Total Rip Off,’” because JPMorgan used CDS from AIG to reduce drastically its risk-based capital requirements established by the Bank for International Settlements (BIS) through the Basel international capital accord. *Id.* at 60–64 (quote at 64).

218. Arnold Kling, *Not What They Had in Mind: A History of Policies That Produced the Financial Crisis of 2008*, 25 (Sept. 15, 2009), available at <http://ssrn.com/abstract=1474430>.

219. *2001 Interagency Capital Rule*, *supra* note 214, at 59,625 (discussing critical comments on the 2001 rule); Kling, *supra* note 218, at 25–26 (same); *see also* Wilmarth, *supra* note 12, at 967–70 (discussing problems created by conflicts of interest at CRAs).

220. *See, e.g.*, FCIC Report, *supra* note 36, at 139–42, 200–02, 276–78, 300–02, 347–51, 376–79.

221. Kling, *supra* note 218, at 26; *see also* FCIC Report, *supra* note 36, at 120–24, 131–33, 146–50.

enhancements (including lines of credit) or implicit commitments to ensure the availability of liquidity if the sponsored conduits could not roll over their ABCP.<sup>222</sup>

Federal banking agencies adopted risk-based capital rules that encouraged the use of OBS conduits. Those rules did not assess any capital charges against LCFIs for transferring securitized assets to sponsored conduits if banks provided only implicit (reputational) recourse. Instead, the rules required LCFIs to post capital only if they provided explicit credit enhancements to their conduits.<sup>223</sup> Moreover, federal regulators issued a joint regulation in 2004, which approved a very low capital charge for sponsors' lines of credit, equal to only one-tenth of the usual 8% capital charge, as long as the lines of credit had maturities of one year or less.<sup>224</sup>

The 2004 joint capital rule was deeply flawed because it allowed banks to obtain highly advantageous OBS treatment for ABCP conduits under the agencies' risk-based capital rules, even though the Financial Accounting Standards Board (FASB) had issued a 2003 interpretation requiring consolidated accounting treatment for many conduits.<sup>225</sup> The federal banking agencies declined to follow FASB's approach. The agencies concluded that bank sponsors for ABCP programs had only "limited risk exposure" and, therefore, consolidated risk-based capital treatment for ABCP conduits would "not appropriately reflect" the sponsors' actual risks.<sup>226</sup>

The agencies' optimistic assessment of the risks of ABCP conduits proved to be tragically mistaken. After the financial crisis began in

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222. For discussion of the risk exposures of major banks to SIVs and other sponsored conduits, see TETT, *supra* note 217, at 97–98, 127–28, 136, 196–98; Viral V. Acharya & Philipp Schnabl, *How Banks Played the Leverage Game*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 83, 88–94 (Viral V. Acharya & Matthew Richardson eds., 2009); Wilmarth, *supra* note 15, at 1033.

223. Acharya & Schnabl, *supra* note 222, at 89.

224. Risk-Based Capital Guidelines, 69 Fed. Reg. 44,908, 44,910–11 (July 28, 2004) [hereinafter *2004 Joint Capital Rule*]. See also Acharya & Schnabl, *supra* note 222, at 89 (noting that capital requirements for short-term "liquidity enhancements" were "only 0.8 percent of asset value").

225. *2004 Joint Capital Rule*, *supra* note 221, at 44,909 (explaining that FASB Interpretation No. 46-R "requires the consolidation of many ABCP programs onto the balance sheets of banking organizations").

226. *Id.* As Carolyn Sissoko has pointed out, the banking agencies issued "guidance" in August 2005 that further weakened the already lax terms of the 2004 capital rule. The 2005 "guidance" allowed sponsoring banks to provide lines of credit (as well as implicit recourse) to support mortgage-related assets held by ABCP conduits that were seriously delinquent, in default or below investment grade. In contrast, lines of credit supporting such doubtful assets would not have qualified for favorable treatment under the original 2004 capital rule. By expanding the ability of major banks to support low-quality assets held their sponsored conduits, the 2005 "guidance" helped ABCP conduits to secure top credit ratings and also greatly increased the risk exposures of the sponsoring banks. Carolyn Sissoko, *Is Financial Regulation Structurally Biased to Favor Deregulation?* 11–22 (USC CLEO Res. Paper C12–4, April 13, 2012), available at <http://ssrn.com/abstract=2039490>.

August 2007, several leading banks felt obliged, for reputational reasons, either to bring the assets of sponsored conduits back onto their balance sheets or to provide financial support that enabled their conduits to remain in business.<sup>227</sup> By allowing banks to disregard FASB's 2003 interpretation in calculating their risk-based capital, the 2004 joint capital rule encouraged banks to engage in abusive and misleading OBS transactions similar to those that banks had helped Enron to engineer—and that FASB had specifically tried to stop.<sup>228</sup>

As a result of their risk exposures to ABCP conduits and other OBS commitments, many of the largest banks were much more highly leveraged than their balance sheets indicated.<sup>229</sup> In addition, regulators failed to prevent large banks from creating “daisy chains” of CDOs that served as additional dumping grounds for the banks' hard-to-sell CDO tranches.<sup>230</sup> Ultimately, major banks (including Citigroup, HSBC, Merrill and UBS) suffered devastating losses due to their exposures to sponsored OBS conduits and CDOs, and those losses were a “significant reason why [Citigroup, Merrill and UBS] “needed extensive governmental assistance to avoid failure.”<sup>231</sup>

### 3. Federal Regulators Allowed Banks and Thrifts to Increase Their Exposure to High-Risk Loans by Acquiring Nonbank Mortgage Lenders

Regulators also permitted leading banks to become deeply enmeshed in the subprime mortgage markets by acquiring nonbank subprime lenders. For example, National City (a large Midwestern bank) purchased First Franklin in 1999, and WaMu (the nation's largest thrift)

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227. Wilmarth, *supra* note 12, at 975.

228. William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 46, 59 (Aug. 13, 2012), available at <http://ssrn.com/abstract=2126778>. Several major banks—including Citigroup, Merrill and JPMorgan—played leading roles in helping Enron to structure abusive OBS transactions that “enabled Enron to overstate its cash flow and disguise its [true] debt.” Wilmarth, *supra* note 15, at 999.

229. TETT, *supra* note 217, at 97–98; James Crotty, *Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture’*, 33 CAMBRIDGE J. ECON 563, 570 (2009); see also HENRY KAUFMAN, *THE ROAD TO FINANCIAL REFORMATION: WARNINGS, CONSEQUENCES, REFORMS* 104, 105 (exh. 8.4) (2009) (showing that the 15 largest U.S. financial institutions had total assets of \$13.6 trillion and OBS exposures of \$5.8 billion at the end of 2007).

230. Jake Bernstein & Jesse Eisinger, *Banks’ Self-Dealing Super-Charged Financial Crisis*, PROPUBLICA, (Aug. 26, 2010), <http://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis> (reporting that Merrill, Citigroup, UBS and other large banks created “fake demand” for their subprime CDOs by creating a “daisy chain” in which CDOs sponsored by each bank purchased hard-to-sell mezzanine tranches of CDOs sponsored by the other banks); Jake Bernstein & Jesse Eisinger, *Which CDOs and Banks Had Deals With the Most Cross-ownership?*, PROPUBLICA (Sept. 22, 2010), <http://www.propublica.org/article/who-was-self-dealing-cdos> (reporting that “the most cross-ownership [of CDO tranches] occurred in the CDOs built by the top CDO banks: Merrill, Citigroup and UBS”).

231. Wilmarth, *supra* note 12, at 973 (quotes); Wilmarth, *supra* note 15, at 1033.

bought Long Beach in the same year. Citigroup bought Associates First Capital (Associates) in 2000 and also acquired Argent (the parent company of Ameriquest) in 2007. JPMorgan bought Advanta in 2001, and HSBC purchased Household in 2002. Countrywide, the nation's largest mortgage lender, acquired a national bank and became a BHC in 2001. Countrywide thereafter established a securitization unit and expanded aggressively into subprime and Alt-A lending.<sup>232</sup>

The acquiring banks in the foregoing transactions “wagered that they could squeeze more fees and profits out of the subprime lending business . . . by taking over the direct lending function as well as the securitization process for nonprime loans.”<sup>233</sup> Federal regulators approved the transactions despite the fact that (i) Associates was the subject of a federal investigation when it was acquired by Citigroup (and Citigroup ultimately paid a large penalty to settle predatory lending charges against Associates), (ii) HSBC acquired Household after the latter company paid almost \$500 million to settle predatory lending charges filed by numerous states, and (iii) Citigroup acquired Argent after Ameriquest paid \$325 million to settle predatory lending charges filed by another group of states.<sup>234</sup>

Following their aggressive expansion into subprime lending, large banking and thrift companies controlled twelve of the 20 biggest subprime lenders between 2005 and 2007.<sup>235</sup> Banks, thrifts and nondepository lenders originated more than \$3 trillion of subprime and Alt-A mortgages between 2004 and 2007.<sup>236</sup> Wall Street banks securitized about \$2.7 trillion of those nonprime loans to create RMBS during the same period.<sup>237</sup> In addition to their roles as direct subprime lenders, major banks added more fuel to the subprime bonfire by funding and securitizing many of the loans originated by nondepository lenders.<sup>238</sup>

Federal regulators “discovered alarming concentrations of nontraditional mortgages at major national banks and federal thrifts” in

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232. For discussions of the foregoing acquisitions of nonprime mortgage lenders by BHCs, see ENGEL & MCCOY, *supra* note 19, at 199–203; Wilmarth, *supra* note 15, at 1017–18; FCIC Report, *supra* note 36, at 75, 92–93, 105.

233. Wilmarth, *supra* note 15, at 1018.

234. *Id.* at 1017–18; ENGEL & MCCOY, *supra* note 19, at 199–203; see also FCIC Report, *supra* note 36, at 92–93, 96–97.

235. Wilmarth, *Dodd–Frank Act*, *supra* note 211, at 917–18; see also ENGEL & MCCOY, *supra* note 19, at 205 (tbl.10.1) (showing that banking and thrift companies regulated by federal banking agencies accounted for 12 of the 15 top subprime lenders in 2006).

236. Wilmarth, *supra* note 15, at 1016–20.

237. Kenneth E. Scott, *The Financial Crisis: Causes and Lessons*, 22 J. APPLIED CORP. FIN. 3, 22, 23 (2010) (Subprime and Alt-A mortgages are frequently referred to collectively as “nonprime” mortgages); Wilmarth, *supra* note 15, at 1015–16.

238. Wilmarth, *supra* note 15, at 1017–20.



2005.<sup>239</sup> The agencies responded by issuing two more statements of precatory “guidance” in 2006 and 2007, which dealt with high-risk mortgages such as (i) option adjustable-rate mortgages (option ARMs), (ii) mortgages with little or no documentation of the borrower’s ability to pay, and (iii) “hybrid” subprime mortgages that featured low introductory “teaser” rates followed by sharply higher payments after two or three years.<sup>240</sup> Both statements of guidance “were presented merely as advice on good practices” and “were not directly enforceable” by the federal banking agencies.<sup>241</sup>

The FRB did not issue binding rules under HOEPA that required lenders to verify borrowers’ ability to repay high-cost mortgages until July 2008, “a year after the subprime market had shut down.”<sup>242</sup> Moreover, those rules did not take effect until October 2009 and were therefore too late to play any effective role in stopping the predatory nonprime lending that led to the financial crisis.<sup>243</sup> Thus, federal regulatory failures played a major role in allowing the largest banks and thrifts to become “the primary private-sector catalysts for the destructive credit boom that led to the subprime financial crisis.”<sup>244</sup>

*B. Federal Regulators Failed to Take Effective Enforcement Measures to Stop Predatory Lending and Preempted State Efforts to Do So*

In addition to the very weak “guidance” on nonprime lending issued by federal banking agencies, the agencies failed to take effective supervisory or enforcement actions to prevent predatory lending. In January 1998, the FRB announced that it would not conduct consumer compliance examinations of nonbank subsidiaries of BHCs, even though several large BHCs owned nonbank subsidiaries that were significantly engaged in nonprime mortgage lending.<sup>245</sup> The FRB previously

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239. Wilmarth, *Dodd–Frank Act*, *supra* note 211, at 901–02.

240. Di Lorenzo, *supra* note 202, at 60–61, 64–72 (discussing 2006 and 2007 guidance and the high risks inherent in nontraditional mortgages); Engel & McCoy, *supra* note 19, at 33–37, 174, 176, 196 (same); Wilmarth, *Dodd–Frank Act*, *supra* note 211, at 901–02 (same).

241. Wilmarth, *Dodd–Frank Act*, *supra* note 211, at 902.

242. FCIC Report, *supra* note 36, at 22, 95–96.

243. Di Lorenzo, *supra* note 202, at 62; Wilmarth, *supra* note 211, at 899.

244. Wilmarth, *supra* note 12, at 977 (quoting Wilmarth, *supra* note 15, at 1046); Wilmarth, *Dodd–Frank Act*, *supra* note 211, at 897–98, 917–18; *see also* ENGEL & MCCOY, *supra* note 19, at 204 (“As the collapse of the financial system unfolded in 2008, what had started as the subprime crisis became known as the ‘banking crisis.’ One major bank failure came to light that year after another, making painfully obvious that the largest commercial banking companies—all of which were supervised by federal banking regulators—were deeply implicated in the origination and securitization of bad mortgage loans.”).

245. ENGEL & MCCOY, *supra* note 19, at 198–203; FCIC Report, *supra* note 36, at 94–95; Wilmarth, *supra* note 211, at 900–01.

declined (in 1992) to apply the interagency real estate lending standards to nonbank subsidiaries of BHCs.<sup>246</sup>

The FRB maintained its no-supervision policy for nonbank subsidiaries of BHCs despite strong criticism of that policy in two reports issued by the Government Accountability Office (GAO) in 1999 and 2004.<sup>247</sup> FRB Chairman Greenspan rejected proposals in 2000 by FRB Governor Edward Gramlich and members of the FRB's consumer division staff to launch a pilot program to investigate whether nonbank mortgage lending subsidiaries of certain BHCs were engaging in predatory lending. The FRB imposed a \$70 million fine on CitiFinancial (a subprime lending subsidiary of Citigroup) for numerous consumer law violations in 2004, but the FRB did not take any other public enforcement action against a nonbank subsidiary of a BHC until after the financial crisis broke out in 2007.<sup>248</sup>

In July 2007, the FRB finally launched the pilot program that Gramlich had proposed seven years earlier to examine subprime mortgage lending by nonbank subsidiaries of several BHCs. Two years later, the FRB officially reversed its 1998 no-supervision policy and began to examine all nonbank subsidiaries of BHCs for compliance with consumer laws. However, the FRB's change in policy "came far too late" to prevent widespread predatory lending by nonbank subsidiaries of several large BHCs, including Citigroup, Countrywide and HSBC.<sup>249</sup>

Similarly, the OTS and OCC compiled very weak records in terms of enforcing consumer protection laws against the institutions they regulated. In a previous article, I summarized the lamentable enforcement records of those agencies as follows:

[T]he OTS brought only 'five to six' formal enforcement actions against federal thrifts for 'unfair and deceptive practices' between 2000 and 2008.

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Between 1995 and the outbreak of the financial crisis in 2007, the OCC issued only 13 public enforcement orders against national banks for violations of consumer protection laws. Most of the OCC's orders were issued against small national banks, and none of the orders were issued against the top eight national banks, even though large banks were the subject of most of the consumer complaints filed with the OCC.<sup>250</sup>

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246. 1992 Real Estate Lending Standards, *supra* note 194, at 62,894; *see also supra* notes 192–99 and accompanying text (discussing interagency real estate lending standards).

247. FCIC Report, *supra* note 36, at 77, 94–95.

248. Wilmarth, *supra* note 211, at 901.

249. *Id.*; ENGEL & MCCOY, *supra* note 19, at 198–203; FCIC Report, *supra* note 36, at 94–95.

250. Wilmarth, *supra* note 211, at 905–06 (footnotes omitted).

Even worse, the OTS and OCC aggressively preempted efforts by many states to enforce their anti-predatory lending (APL) laws against federal thrifts and national banks. Between 1999 and 2007, 30 states and the District of Columbia adopted APL laws that prohibited various types of unfair and deceptive mortgage lending practices.<sup>251</sup> State officials also launched aggressive enforcement efforts to clamp down on abusive lending practices, “including more than 3600 enforcement actions in both 2003 and 2006.”<sup>252</sup> State investigations produced settlements that required large, state-licensed lenders (including Household, Ameriquest, First Alliance and Countrywide) to pay more than \$1 billion in penalties and restitution.<sup>253</sup>

The OTS and OCC severely undermined the effectiveness of state efforts by declaring that federal law preempted states from applying their APL laws to federal thrifts and national banks and their respective operating subsidiaries and agents. The OTS and OCC also filed amicus briefs to support lawsuits brought by federal thrifts and national banks to block the enforcement of state APL laws based on preemption claims. The preemption initiatives launched by the OTS and OCC received enthusiastic support from large federal thrifts and national banks.<sup>254</sup> Federal agency preemption significantly weakened state APL laws because preemption (i) encouraged subprime lenders that were targets of state investigations to sell themselves to federally-chartered banks to avoid state enforcement, and (ii) discouraged state legislatures from passing additional APL laws that would constrain state-licensed lenders but would not bind federally-chartered competitors.<sup>255</sup>

*C. The Financial Industry Strongly Resisted Attempts by Federal Regulators to Impose Tighter Supervision during the Credit Boom*

On the rare occasions when federal banking agencies attempted to impose stronger regulations during the credit boom, their efforts triggered intense resistance from the financial services industry. During a congressional hearing in March 2008, FRB Vice Chairman Donald Kohn admitted that encouraging banks to follow more conservative lending policies was “a very hard sell” during the credit boom that led up to the financial crisis.<sup>256</sup> Similarly, Roger Cole, who served as the

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251. *Id.* at 909.

252. *Id.* at 910.

253. *Id.*

254. *Id.* at 910–14; Wilmarth, *supra* note 193, at 233–36, 276–77, 282–97.

255. Wilmarth, *supra* note 211, at 913–15.

256. “Banking—Mortgages: Senators Grill Financial Regulators on Failure to Supervise Banks During Mortgage Crisis,” 90 BANKING REPORT (BNA) 435 (Mar. 10, 2008) (quoting Mr. Kohn’s

FRB's Director of Bank Supervision from 2006 to 2009, told the Financial Crisis Inquiry Commission (FCIC) that FRB officials encountered significant "pushback" whenever they urged bank executives to follow more conservative risk management policies.<sup>257</sup>

Banks, thrifts and nondepository mortgage lenders strongly opposed even the weak and nonbinding regulatory guidance that federal regulators issued in 2006 and 2007 with regard to nontraditional mortgages and hybrid subprime ARMs.<sup>258</sup> When the FRB and other federal regulators proposed interagency guidance for nontraditional mortgages in late 2005, FRB officials "got tremendous pushback from the industry as well as Congress as well as . . . internally . . . [b]ecause it was stifling innovation, potentially, and it was denying the American dream [of homeownership] to many people."<sup>259</sup> The American Bankers Association (ABA) asserted that the proposed guidance "overstate[d] the risk of nontraditional mortgages,"<sup>260</sup> while the Financial Services Roundtable declared that it was "not aware of any empirical evidence that supports the need for further consumer protection standards."<sup>261</sup> The OTS actively supported the industry by blocking the issuance of the interagency guidance for nontraditional mortgages until September 2006.<sup>262</sup>

Similarly, when federal regulators issued their proposed guidance on hybrid subprime ARMs in early 2007, trade associations representing banks, thrifts and nondepository mortgage lenders vehemently opposed the guidance. The Mortgage Bankers Association asserted that the proposed guidance would "restrict credit to many consumers in high-cost areas and deny credit to many deserving low-income, minority, and first-time homebuyers."<sup>263</sup> Similarly, the ABA claimed that the

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testimony during a hearing before the Senate Banking Committee on Mar. 4, 2008).

257. Mr. Cole noted that "a lot of that pushback was given credence . . . by the fact that [firms] like Citigroup were earning \$4 to \$5 billion per quarter . . . . When that kind of money is flowing [in] quarter after quarter, and their capital ratios are way above the minimums, it's very hard to challenge." FCIC Report, *supra* note 26, at 307 (quoting from interview with Mr. Cole).

258. See *supra* notes 240-41 and accompanying text (discussing the 2006 and 2007 statements of guidance).

259. FCIC Report, *supra* note 36, at 173 (quoting from interview with Richard Siddique, former head of credit risk for the FRB's Division of Banking Supervision and Regulation); see also *id.* at 21 (quoting from interview with former FRB Governor Susan Bies, and also quoting Mr. Siddique's statement that "[t]he ideological turf war [over the proposed nontraditional guidance] lasted more than a year, while the number of nontraditional loans kept growing and growing").

260. *Id.* (quoting the ABA's letter of Mar. 29, 2006).

261. *Id.* (quoting the Financial Services Roundtable's letter of Mar. 29, 2006).

262. *Id.* at 172-73; ENGEL & MCCOY, *supra* note 19, at 176. When the nontraditional guidance was finally issued, OTS Director John Reich "refused to defend it. He even described the guidance as 'extremely controversial' and not something that OTS 'would have issued on [its] own.'" *Id.* (quoting from speech by Mr. Reich in Oct. 2006).

263. Joe Adler, *Agencies Propose Hybrid Clampdown: Critics Fret over Credit Access*, AM.

proposed subprime guidance would deny “credit options to creditworthy borrowers who otherwise would benefit from the flexibility afforded by the products covered by the proposed statement.”<sup>264</sup> Due in part to the industry’s strong opposition, the 2006 and 2007 statements of guidance “were phrased merely as advice on good practices, were not directly enforceable by the agencies, and did not give injured borrowers any right to file lawsuits if lenders failed to follow the guidance.”<sup>265</sup>

Federal bank regulators and the SEC also encountered “strong resistance” when they tried to issue guidelines to prevent banks from engaging in deceptive transactions involving “complex structured-finance transactions (CSFTs).”<sup>266</sup> The agencies issued their first proposed statement of guidance on CSFTs in May 2004, after taking enforcement actions against financial institutions for arranging CSFTs that Enron Corp. used “to shield the company’s true financial health from the public.”<sup>267</sup> For example, Citigroup and JPMorgan arranged more than \$8.3 billion of “prepaid commodity swaps” (prepays) for Enron that “were functionally equivalent to loans” but were structured in a way that “enabled Enron to inflate its reported cash flow [from operations] and disguise its actual debt obligations.”<sup>268</sup> Officials at Citigroup and JPMorgan “plainly recognized the deceptive nature of the structured-finance deals that their banks arranged for Enron.”<sup>269</sup>

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BANKER, Mar. 5, 2007, at 1 (quoting press release from the Mortgage Bankers Ass’n).

264. Cheyenne Hopkins, *Bankers Find Plenty Not to Like in Loan Guidance*, AM. BANKER, May 10, 2007, at 5 (quoting comment letter from the ABA). When federal regulators issued their final guidance on hybrid subprime mortgages in July 2007, they acknowledged that “many financial institution commenters expressed concern that certain aspects of the proposed statement . . . could unduly restrict subprime borrowers’ access to credit.” Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,570 (July 10, 2007).

265. Wilmarth, *supra* note 211, at 902 (quote), 907–08; *see also* Di Lorenzo, *supra* note 202, at 60–61 (noting that the 2006 and 2007 statements of guidance “continued to rely on disclosure, rather than regulation, in order to protect consumers”).

266. David M. Katz, *Feds Soften Structured-Finance Stance*, CFO.COM, Jan. 5, 2007 (available on Lexis).

267. Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, 69 Fed. Reg. 28,980, 28981–82, 28,982 n.1 (May 19, 2004) [hereinafter 2004 Proposed Interagency Statement on CSFTs]. For the SEC’s enforcement orders entered against Citigroup and JPMorgan with regard to their involvement with Enron, see *In re Citigroup*, SEC Administrative Proceeding No. 3-11192 (July 28, 2003), available at <http://www.sec.gov/litigation/admin/34-48230.htm> (requiring Citigroup to pay disgorgement and penalties for its Enron-related misconduct); SEC Litigation Release No. 18252 (July 28, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18252.htm> (requiring JPMorgan to pay disgorgement and penalties for its Enron-related misconduct).

268. Arthur E. Wilmarth, Jr., *Conflicts of Interest and Corporate Governance Failures at Universal Banks during the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom*, (Geo. Wash. Univ. L. Sch. Pub. L. & Leg. Theory Working Paper No. 234, Nov. 20, 2006), at 12, available at <http://ssrn.com/abstract=952486>.

269. *Id.* at 17. For example, “[a JPMorgan] Chase officer remarked that ‘Enron loves [prepay] deals as they are able to hide funded debt from their equity analysts.’ Similarly, Citibank’s Capital

The 2004 proposed guidance on CSFTs “called for banks to review how companies planned, accounted for, and disclosed CSFTs in both their financial and tax reporting.”<sup>270</sup> Even though Citigroup, JP Morgan and other banks had incurred heavy financial and reputational injuries due to their involvement with Enron,<sup>271</sup> financial industry trade groups strongly attacked the 2004 guidance for “requiring that [banks] police their corporate customers.”<sup>272</sup> Banks and industry trade groups also vigorously opposed the 2004 proposed guidance because its broad definition of CSFTs appeared to include RMBS, CDOs and ABCP conduits.<sup>273</sup> In response to the industry’s determined opposition, federal regulators withdrew the 2004 proposed guidance and issued a revised and much weaker proposal in May 2006.<sup>274</sup>

Federal regulators did not issue final guidelines on CSFTs until January 2007, and those guidelines represented a “considerable retreat” from the 2004 proposal.<sup>275</sup> Instead of warning banks to refrain from engaging in CSFTs that “create significant legal or reputational risks,” the final guidelines merely advised banks to “take appropriate steps to address those risks,” including obtaining “representations or assurances from the customer.”<sup>276</sup> The final guidelines contained broad exemptions and disclaimers that greatly diminished their impact. For example, the guidelines stated that they did not apply to RMBS, CDOs, ABCP

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Markets Approval Committee noted that a prepay swap requested by Enron was ‘effectively a loan, [but] the form of the transaction would allow [Enron] to reflect its ‘liabilities from price risk management activity’ on their [sic] balance sheet and also provide a favourable [sic] impact on reported cash flow from operations.’” *Id.* at 17–18 (quoting from sources quoted in Third Interim Report of Neal Batson, court-appointed bankruptcy examiner for Enron) (footnotes omitted).

270. Katz, *supra* note 266; see also 2004 Proposed Interagency Statement on CSFTs, *supra* note 267, at 28,983 (stating that a bank should refuse to participate in a CSFT if the bank determined that “a proposed transaction may result in the customer filing materially misleading financial statements”).

271. Wilmarth, *supra* note 268, at 24 (stating that, as of September 2006, banks involved with Enron “had paid more than \$8 billion and had surrendered about \$3 billion of their credit claims against Enron, in order to settle various claims asserted by the SEC, Enron’s investors, and Enron itself”); Eric Dash, *Citigroup Resolves Claims That It Helped Enron Deceive Investors*, N.Y. TIMES, Mar. 27, 2008, at C3 (reporting that Citigroup agreed to pay \$1.66 billion to Enron’s bankruptcy estate to settle claims by Enron’s creditors, and that Citigroup was “the last of 11 financial institutions to resolve claims going back to 2003”).

272. Tim Reason, *Who’s Holding the Bag?*, CFO MAG., Oct. 2005 (available on Lexis).

273. Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities, 71 Fed. Reg. 28, 326, 28, 328–29, 28,331 (May 16, 2006) [hereinafter 2006 Proposed Guidance on CSFTs].

274. *Id.* at 28,236; see also George M. Cohen et al., *Have US Regulators Been Soft on Banks Over Structured Products? Yes*, (June 2, 2006), at 2–4 (criticizing the 2006 revised proposal, and maintaining that “what began as a presumptive condemnation of deals with [deceptive structured] characteristics [in the 2004 proposed guidance] morphed into what can (and we believe will) easily be read as permission” in the 2006 revised proposal), available at <http://ssrn.com/abstract=1523712>.

275. Katz, *supra* note 266.

276. Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities,” 72 Fed. Reg. 1372, 1379 (Jan. 11, 2007).

conduits, or “hedging-type transactions involving ‘plain-vanilla’ derivatives.”<sup>277</sup> The final document also declared that it “does not, by itself, establish any legally enforceable requirements or obligations” for banks, including any duties or obligations to bank shareholders, customers or other third parties.<sup>278</sup>

Given the regulators’ long delay in issuing the 2007 guidelines on CSFTs and the very weak tenor of those guidelines, it is not surprising that the guidelines did not deter major banks from engaging in abusive CDO transactions. Goldman and JPMorgan jointly paid over \$700 million to settle SEC charges arising out of CDOs that the banks structured and marketed to investors with inadequate disclosures. In each case, the bank marketed a CDO’s securities without revealing to investors that a hedge fund (i) would select mortgage-related assets for the CDO’s portfolio and (ii) intended to short those assets, thereby creating a direct conflict of interest with other investors.<sup>279</sup>

Similarly, Citigroup agreed to pay \$285 million to settle SEC charges that Citigroup marketed \$1 billion of CDO’s securities to investors without disclosing the bank’s stunning conflict of interest. Citigroup sold the CDO’s securities while secretly taking short positions so that it could bet against about half of the CDO’s mortgage-related assets.<sup>280</sup> In addition, a major Japanese bank (Mizuho) agreed to pay \$127 million to settle charges that it structured and marketed a CDO’s securities to investors while misrepresenting the type and quality of assets that were actually held in the CDO’s portfolio.<sup>281</sup>

The SEC’s complaints against Goldman, JPMorgan, Citigroup and

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277. *Id.* at 1374, 1377.

278. *Id.* at 1375.

279. SEC Litigation Release No. 21592, July 15, 2010, available at <http://www.sec.gov/litigation/litreleases/2010/lr21592.htm> (describing Goldman’s agreement to pay \$550 million to settle SEC charges); SEC Litigation Release No. 22008, June 21, 2011, available at <http://www.sec.gov/litigation/litreleases/2011/lr22008.htm> (describing JPMorgan’s agreement to pay \$154 million to settle SEC charges); *supra* note 216 (describing SEC charges that led to settlements with Goldman and JPMorgan).

280. SEC Litigation Release No. 22134, Oct. 19, 2011, available at <http://www.sec.gov/litigation/litreleases/2011/lr22134.htm> (describing Citigroup’s agreement to pay \$285 million to settle the SEC’s charges). A federal district court issued an order rejecting the SEC’s proposed settlement with Citigroup, but the district court’s order was stayed by the Second Circuit Court of Appeals, and the case is currently pending on appeal before the Second Circuit. Yin Wilczek, *Securities: Second Circuit Stays SEC, Citigroup Case; Slams Lower Court Rejection of Parties’ Pact*, 98 BNA’S BANKING REPORT 502 (Mar. 20, 2012); *SEC Enforcement: Rakoff Defends Rejection of \$285M Pact Between SEC, Citigroup in Brief to 2d Cir.*, 44 SECURITIES REGULATION & LAW REPORT (BNA) 1560 (Aug. 17, 2012).

281. SEC Litigation Release No. 22417, July 19, 2012, available at <http://www.sec.gov/litigation/litreleases/2012/lr22417.htm> (describing Mizuho’s agreement to pay \$127.5 million to settle SEC charges that Mizuho structured and marketed a CDO to investors with a “portfolio containing millions of dollars in dummy assets that inaccurately reflected the [actual] collateral held by [the CDO]”).

Mizuho for structuring and marketing abusive CDOs were disturbingly reminiscent of the charges that the SEC had previously leveled against Citigroup, JPMorgan and other banks for arranging deceptive transactions for Enron.<sup>282</sup> Indeed, leading banks must have recognized the risk that their structuring of RMBS, CDOs and ABCP conduits could potentially lead to Enron-type problems, because they fought very hard (as described above) to exempt those transactions from the agencies' guidelines on CSFTs.

*D. Bank Regulators and Congress Provided Massive Assistance to Major Banks during the Financial Crisis*

Federal officials provided huge amounts of financial assistance to large, complex financial institutions (LCFIs) during the financial crisis. The 19 largest U.S. banks (each with more than \$100 billion of assets) and AIG collectively received \$290 billion of capital assistance from the Troubled Asset Relief Program (TARP) established by Congress. Federal regulators also authorized the same 19 banks and GE Capital (a large finance company subsidiary of General Electric) to issue \$290 billion of FDIC-guaranteed, low-interest debt. In contrast, banks smaller than \$100 billion received only \$41 billion of TARP capital assistance and issued only \$11 billion of FDIC-guaranteed debt.<sup>283</sup>

Additionally, the Federal Reserve System (Fed) provided enormous amounts of liquidity assistance to financial institutions through a series of emergency lending programs. The total outstanding amount of the Fed's emergency credit facilities reached a single-day peak of \$1.2 trillion in December 2008. The Fed extended the vast majority of this emergency credit to large U.S. and European banks and provided very little help to smaller institutions.<sup>284</sup>

The Fed and the Treasury also provided extensive support to financial institutions and the financial markets by making large-scale purchases of debt obligations and RMBS that were issued or guaranteed by Fannie Mae and Freddie Mac.<sup>285</sup> In combination, the federal government

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282. FCIC Report, *supra* note 36, at 59–60, 137–39, 142–46, 190–200, 247–48; *see also supra* notes 228, 267–69 (discussing involvement of Citigroup, JPMorgan and other banks in Enron's fraudulent deals).

283. Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-to-Fail Problem*, 35 BROOKLYN J. INT'L LAW 707, 737–38 (2010).

284. The highest daily amount of the Fed's emergency credit to the ten largest U.S. commercial and investment banks reached \$669 billion, representing more than half of the daily peak amount for all Fed lending programs. Bradley Keoun & Phil Kuntz, *Wall Street Aristocracy Got \$1.2 Trillion in Secret Fed Loans*, BLOOMBERG.COM, Aug. 22, 2011; Bob Ivry, Bradley Keoun & Phil Kuntz, *Secret Fed Loans Helped Banks Net \$13 Billion*, BLOOMBERG.COM, Nov. 27, 2011.

285. Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), Quarterly Report to Congress, July 21, 2010, at 118–22, 135–38 [hereinafter SIGTARP July 2010



provided more than \$6 trillion of support to financial institutions between 2008 and mid-2010, when such support is measured by the peak amounts of outstanding assistance under the TARP capital assistance programs, Fed emergency lending programs, FDIC debt guarantees, and other asset purchase and guarantee programs.<sup>286</sup> The United Kingdom (U.K.) and European nations similarly provided more than \$4 trillion of financial support to their financial institutions by the end of 2009.<sup>287</sup>

As discussed above, the federal government publicly guaranteed in early 2009 that none of the 19 largest U.S. banks would be allowed to fail.<sup>288</sup> Regulators also stated that they would not impose regulatory sanctions on the top 19 banks under the “prompt corrective action” (PCA) regime established by Congress in 1991, notwithstanding the non-discretionary nature of those sanctions. Instead of issuing public enforcement orders, regulators entered into private and confidential “memoranda of understanding” with BofA and Citigroup despite the gravely weakened conditions of both banks.<sup>289</sup> Federal regulators did

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Report] (showing that the Fed and Treasury had purchased more than \$1.6 trillion of GSE debt securities and GSE-guaranteed RMBS by mid-2010), available at [http://www.sig tarp.gov/Quarterly%20Reports/July2010\\_Quarterly\\_Report\\_to\\_Congress.pdf](http://www.sig tarp.gov/Quarterly%20Reports/July2010_Quarterly_Report_to_Congress.pdf). In 2009 and 2010, under its first quantitative easing (QE) program, the Fed purchased \$1.45 billion of GSE debt securities and GSE-guaranteed RMBS, along with \$300 billion of Treasury securities, in order to reduce short-term and long-term interest rates and thereby produce lower borrowing costs for banks and other participants in the financial markets. *Id.* at 150–54; Michael D. Bauer, Fed Asset Buying and Private Borrowing Rules, *FRBSF Economic Letter* 2012–16, May 21, 2012, at 1–3, available at <http://www.frbsf.org/publications/economics/letter/2012/el2012-16.html>. In order to provide additional monetary stimulus to the struggling U.S. economy, the Fed announced a second QE program in late 2010 (resulting in the purchase of \$600 billion of Treasury securities) and a third QE program in September 2012 (authorizing the purchase each month of \$40 billion of GSE-guaranteed RMBS and \$45 billion of Treasury securities for an indefinite period). Bauer, *supra*; Aaron E. Lorenzo, *Monetary Policy: Fed’s Open-Ended QE3, Longer Window on Zero Rate Stronger Than Some Expected*, 99 BNA’S BANKING REPORT 445 (Sept. 18, 2012). By May 2003, the Fed had purchased “more than \$3 trillion in longer-term Treasury and mortgage related securities” under its combined QE programs. John C. Williams, *Economic Outlook: Moving in the Right Direction*, FRBSF ECONOMIC LETTER 2013-15, at 4 (May 20, 2013), available at <http://www.frbsf.org/economic-research/publications/economic-letter/2013/may/economic-outlook-moving-right-direction/>.

286. The “high-water mark” of the combined programs, based on the largest outstanding amount of each program at any one time, was \$6.3 trillion in mid-2010. The federal government’s maximum potential commitment under those programs was \$23.9 trillion. SIGTARP July 2010 Report, *supra* note 285, at 116–19, 118 tbl.3.1.

287. Adrian Blundell-Wignall et al., *The Elephant in the Room: The Need to Deal with What Banks Do*, in 2 ORG. ECON. CO-OPERATION & DEV. J., No. 2, at 1, 4–5, 14, 15 tbl.4, available at <http://www.oecd.org/dataoecd/13/8/44357464.pdf> (stating that the U.S. provided \$6.4 trillion of assistance to financial institutions through capital infusions, asset purchases, asset guarantees, and debt guarantees as of October 2009, while the United Kingdom and European nations provided \$4.3 trillion of such assistance).

288. See *supra* note 110 and accompanying text.

289. Wilmarth, *supra* note 283, at 744. A Federal Reserve staff economist determined that Citigroup’s tangible common equity (TCE) ratio (common equity as a percentage of tangible assets) was

not issue PCA orders or other formal capital enforcement orders against any of the largest banks during the financial crisis, even though two very large banks (Wachovia and WaMu) failed and two others (BofA and Citigroup) needed extraordinary government assistance to avoid failure.<sup>290</sup> In contrast, regulators issued hundreds of PCA orders and other formal capital enforcement orders against smaller banks from between 2008 and 2010, and regulators allowed many of those banks to fail.<sup>291</sup>

*E. Federal Agencies Provided Extensive Forbearance to the Largest Banks during the Financial Crisis*

In addition to forgoing any use of PCA sanctions against major banks, federal officials provided extensive accounting and regulatory forbearance to large financial institutions. As described below, federal officials enabled leading banks to avoid or postpone recognition of large losses on troubled mortgage-related securities. Officials also allowed

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“very low” (less than 2%) at the end of 2008. The TCE ratio is viewed by analysts and investors as a “more conservative indicator of stability.” Sherrill Shaffer, *Fair Value Accounting: Villain or Innocent Victim—Exploring the Link Between Fair Value Accounting, Bank Regulatory Capital and the Recent Financial Crisis*, (Fed. Res. Bank of Boston Quant. Analysis Unit Working Paper No. 10-01, Jan. 31, 2010), at 19–21, 21 tbl.5, available at <http://ssrn.com/abstract=1543210>. A second analyst recently reached a similar conclusion as to Citigroup and also found that BofA was in a vulnerable condition at the end of 2008. Marc Jarsulic, Chief Economist, Better Markets, Inc., Written Testimony at a joint hearing on “Examining the Impact of the Proposed Rules to Implement Basel III Capital Standards,” before the Subcomm. on Financial Institutions and Consumer Credit and the Subcomm. on Insurance, Housing and Community Opportunity of the House Comm. on Financial Services, Nov. 29, 2012, at 5 (determining that Citigroup’s TCE ratio was 1.3% at the end of 2008, while BofA’s TCE ratio was 2.8%), available at <http://www.bettermarkets.com/sites/default/files/Better%20Markets%20Testimony-%20FSC-%2011-29-12.pdf>.

290. Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L. J. 645, 690–993 (2012); see also *supra* note 110 and accompanying text (discussing failures of Wachovia and WaMu and rescues of BofA and Citigroup). In early 2009, FDIC Chairman Sheila Bair determined, based on findings by FDIC examiners, that “Citi[bank] was a troubled 4 by every established standard used to measure bank health.” SHEILA BAIR, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF 168 (Free Press eds., 2012). However, Chairman Bair ultimately decided not to insist on a “4” (problem bank) rating for Citibank because she was concerned that Citibank’s foreign depositors would quickly withdraw their funds when they learned that Citibank had been placed on the FDIC’s “troubled-bank list.” *Id.* at 168–69.

291. Hill, *supra* note 290, at 672–77, 690–93; Wilmarth, *supra* note 283, at 744, 744 n.145. More than 400 banks failed during the four-year period ending December 31, 2011, and only one of those institutions (WaMu) had more than \$50 billion of assets. In sharp contrast to their unprecedented measures to protect the 19 largest banks, the federal government did not take significant steps to prevent smaller banks from failing. See Hill, *supra* note 290, at 668–77, 690–93; Wilmarth, *supra* note 283, at 744; 6 *FDIC Quarterly* No. 1, 4th Qtr. 2011, at 17 (tbl.II-B) (providing information about banks that failed between 2007 and 2011), available at [http://www.fdic.gov/bank/analytical/quarterly/2012\\_vol6\\_1/FDIC\\_Quarterly\\_Vol6No1.pdf](http://www.fdic.gov/bank/analytical/quarterly/2012_vol6_1/FDIC_Quarterly_Vol6No1.pdf); 2 *FDIC Quarterly* No. 4, 3d Qtr. 2008, at 14 (referring to the failure of WaMu, with \$307 billion of assets, in September 2008), available at [http://www.fdic.gov/bank/analytical/quarterly/2012\\_vol6\\_1/FDIC\\_Quarterly\\_Vol6No1.pdf](http://www.fdic.gov/bank/analytical/quarterly/2012_vol6_1/FDIC_Quarterly_Vol6No1.pdf).

the largest banks to defer recognition of major losses on second-lien housing loans held on their balance sheets.

### 1. Federal Officials Demanded Changes in Accounting Rules That Enabled Large Banks to Avoid Mark-to-Market Losses on Troubled Mortgage-Related Assets

During the spring of 2009, political leaders, regulators and the financial industry pressured the Financial Accounting Standards Board (FASB) to relax fair value accounting rules that forced major banks to recognize large losses on RMBS, CDOs and other mortgage-related investments. Under the mark-to-market accounting practices that prevailed before 2009, financial institutions were generally required (i) to establish fair values for investment securities based on the most recent available market transactions and (ii) to recognize mark-to-market losses on those investments unless banks could demonstrate both their intention and their ability to hold those investments to maturity.<sup>292</sup>

Mark-to-market accounting placed great pressure on banks to sell their RMBS and CDOs as prices for mortgage-related assets plummeted during the financial crisis, in order to avoid the possibility of even greater losses if they continued to hold such investments. As a consequence, some observers blamed fair value accounting for creating “fire sale” conditions in already stressed markets, thereby forcing financial institutions to recognize unwarranted, panic-driven losses.<sup>293</sup>

To mitigate the continuing mark-to-market losses that banks were incurring, FRB Chairman Ben Bernanke, SEC Chairman Mary Schapiro, and House Financial Services Committee chairman Barney Frank urged FASB to make changes to its fair value rules.<sup>294</sup> In addition, the financial services industry launched an intense lobbying campaign to force FASB to relax those rules. At a House committee hearing on March 12, 2009, members of Congress threatened FASB chairman Robert Herz that they would pass legislation to override FASB’s fair value rules if FASB refused to make the requested changes.<sup>295</sup>

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292. Gauri Bhat et al., *Panacea, Pandora’s Box, or Placebo: Feedback in Bank Mortgage-Backed Security Holdings and Fair Value Accounting* (June 2011), at 2–3, 6, 9–10, available at <http://ssrn.com/abstract=1856727>; Richard A. Epstein & M. Todd Henderson, *Do Accounting Rules Matter? The Dangerous Allure of Mark to Market*, 36 J. CORP. L. 513, 517–20 (2011).

293. Bhat et al., *supra* note 292, at 2–3, 6–10; Robert M. Bowen et al., *The Economic Consequences of Relaxing Fair Value Accounting and Impairment Rules on Banks during the Financial Crisis of 2008–09* (Jan. 10, 2010), at 1, 1, 2 n.3, available at <http://ssrn.com/abstract=1498912>; Epstein & Henderson, *supra* note 288, at 519–21, 534, 544–46.

294. Bowen et al., *supra* note 293, at 10–11, 34 (tbl.1).

295. Ian Katz & Jesse Westbrook, *Mark-to-Market Lobby Buys Bank Profits 20% as FASB May*

In response to the financial industry's impressive display of political clout, FASB issued interpretations that substantially eased mark-to-market rules on April 2, 2009. Those interpretations allowed banks (i) to use internal models (rather than recent market prices) to determine the fair value of securities traded in illiquid or disorderly markets, (ii) to reject "distress sale" prices as a reliable indicator of fair values, and (iii) to avoid recognizing impairment losses on securities as long as banks did not intend to sell the securities prior to maturity.<sup>296</sup> In late 2008, European politicians and banks forced the International Accounting Standards Board to make similar emergency changes to mitigate mark-to-market losses by large European banks.<sup>297</sup>

According to event studies, FASB's rule changes produced significant gains in stock prices for U.S. banks, and the largest gains occurred at banks that had (i) greater vulnerability to contagion from Lehman's failure, (ii) lower regulatory capital, (iii) larger amounts of illiquid investments subject to treatment as "Level 2" or "Level 3" assets, and (iv) higher exposures to potential mark-to-market losses on impaired investments.<sup>298</sup> The greatest beneficiaries of FASB's rule changes were Citigroup, BofA and other leading banks that were burdened with large exposures to mortgage-related investments.<sup>299</sup>

## 2. Federal Regulators Postponed the Imposition of Consolidated Capital Requirements for Assets Held by Off-Balance-Sheet Conduits

Regulators also provided accounting forbearance with regard to ABCP conduits, SIVs and other OBS entities that major banks sponsored and used as dumping grounds for tranches of RMBS and CDOs that they could not easily sell to arms-length investors.<sup>300</sup> By

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*Say Yes*, BLOOMBERG, Mar. 30, 2009 (reporting that FASB was under "tremendous pressure" to change its fair value rules due to aggressive lobbying efforts by the financial industry); Susan Pulliam & Tom McGinty, *USA Inc.: Congress Helped Banks Defang Key Rule*, WALL ST. J., June 3, 2009, at A1 (describing the "multimillion dollar lobby campaign" mounted by financial firms and trade groups).

296. Bhat et al., *supra* note 292, at 7–8; Bowen et al., *supra* note 293, at 10–11, 28–29 (Appendix); Ian Katz, *FASB Eases Fair-Value Rules Amid Lawmaker Pressure (Update 3)*, BLOOMBERG, Apr. 2, 2009.

297. Bowen et al., *supra* note 293, at 8–9; Denise Lugo, *Accounting: Former SEC Chief Accountant Turner Fears IASB Actions May Slow U.S. Move to IFRS*, 91 BNA'S BANKING REP. 779 (Nov. 3, 2008); Joe Kirwin, *Accounting: European Union Quickly Approves Changes to Fair-Value Accounting*, 91 BNA'S BANKING REP. 683 (Oct. 20, 2008).

298. Bowen et al., *supra* note 293, at 3–4, 20–26; *see also* Bhat et al., *supra* note 292, at 4–5, 26–27, 33–34 (finding that (i) the largest gains in stock prices after FASB's rule changes occurred at U.S. banks that held larger amounts of private label (non-GSE) RMBS and nonperforming loans, and (ii) FASB's revised rules significantly changed reduced the adverse impact of "feedback trading" on such banks).

299. *See* authorities cited *supra* in note 298; Katz & Westbrook, *supra* note 295.

300. *See supra* notes 222–31 and accompanying text (discussing OBS conduits that were

early 2008, FASB officials recognized that large banks had exploited ambiguities in accounting rules to create OBS risk exposures that resembled the abusive transactions created by Enron.<sup>301</sup> For example, Citigroup justified its transfer of \$72 billion of assets to its sponsored OBS conduits by arranging for outside investors to purchase just \$77 million of “first-loss notes” issued by those conduits. Notwithstanding the allegedly independent status of the conduits, Citigroup was later obliged (due to reputational concerns as well as liquidity backstops) to bring most of their assets back onto its balance sheet.<sup>302</sup>

In the summer of 2008, FASB proposed new accounting rules that would force banks to bring many securitized assets back onto their balance sheets.<sup>303</sup> Major financial institutions launched another aggressive lobbying campaign to delay the effective date of FASB’s proposed new rules. Regulators and members of Congress again strongly supported the industry because of their desire to “shore up major financial institutions and keep their vulnerabilities from causing near-term damage to the ailing economy.”<sup>304</sup> In July 2008, FASB agreed to defer the effective date for its new rules until January 2010, although two of its five members “expressed discomfort with the delay.”<sup>305</sup>

FASB issued final rules in July 2009 that required consolidated accounting treatment (beginning in 2010) for securitized assets held by most OBS conduits and many other “special purpose entities.”<sup>306</sup> One

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sponsored by large banks and later inflicted heavy losses on several of those banks).

301. David Reilly, *Look Under the Banks’ Hoods: FASB to Re-Examine Whether Financing Vehicles That Added to Woes Should Stay Off Books*, WALL ST. J., Feb. 29, 2008, at C1; Steve Burkholder, *Accounting: FASB Chief Blames Loss of U.S. Reporting System’s Global Credibility on Subprime Woes*, 89 BANKING REP.(BNA) 949 (2007).

302. Reilly, *supra* note 301; *see also* Wilmarth, *supra* note 12, at 973–75 (discussing Citigroup’s decision to absorb \$84 billion of assets from SIVs and other OBS conduits).

303. Harry Terris, *FASB Rule Delay: Impact Goes Beyond GSEs*, AM. BANKER (July 31, 2008), [http://www.americanbanker.com/issues/173\\_150/-358851-1.html](http://www.americanbanker.com/issues/173_150/-358851-1.html); Denise Lugo, *Financial Coalition Wants FASB to Delay Proposals on Off-Balance-Sheet Activities*, 40 SEC.REG. & L. REP. 1100 (2008).

304. David S. Hilzenrath, *Potentially Disruptive Lender Rule Is Delayed*, WASH. POST, July 31, 2008, at D1; *see also* Lugo, *supra* note 303 (describing lobbying efforts by a “Wall Street coalition” to “delay accounting standards under study by [FASB] that would require companies to bring certain securitized assets back on their balance sheets”). For example, a House Republican leader urged FASB to postpone its rules while using “talking points” that had been prepared by the financial industry coalition that was lobbying for the postponement. Hilzenrath, *supra* (quoting letter sent to FASB by House Financial Services Committee ranking member Spencer Bachus (R-AL)).

305. Hilzenrath, *supra* note 304 (quoting FASB chairman Robert Herz, who stated that “[i]t does pain me to allow something that has been . . . abused by certain folks, to let that go on another year,” and FASB member Lawrence Smith, who stated that “[i]n my mind, things have been broken for a while, and it’s about time we fixed the problem”); *see also* Steve Burkholder, *Accounting: FASB Votes to Defer Planned Changes on Securitizations, Consolidations to 2010*, 91 BANKING REP. (BNA) 185 (Aug. 4, 2008) (reporting on FASB’s decision).

306. *See* Risk-Based Capital Guidelines; Final rule, 75 Fed. Reg. 4636, 4636–37 (Jan 28, 2010)

analyst estimated that FASB's consolidation rules would compel the four largest U.S. banks to bring \$550 billion of assets back onto their balance sheets.<sup>307</sup> The financial industry pressured regulators to grant a further delay before imposing regulatory capital charges on securitized assets that would be consolidated under the FASB's new rules.<sup>308</sup> As a practical matter, consolidated regulatory capital treatment required banks to post ten times as much capital as they previously held for OBS conduits under the federal regulators' 2004 capital rule.<sup>309</sup> In response to the industry's entreaties, regulators provided a one-year phase-in period for consolidated capital treatment, thereby permitting banks to postpone full implementation of the much higher capital requirements until 2011.<sup>310</sup>

### 3. Federal Officials Provided Forbearance for Second-Lien Loans Held by Banks but Refused to Provide Meaningful Principal Relief for "Underwater" Homeowners

Federal regulators granted additional leniency to major banks with regard to their extensive holdings of second mortgage liens. During the housing boom, many large banks and thrifts made first and second mortgages simultaneously in order to permit borrowers to purchase homes with little or no down payments. Lenders frequently securitized the first mortgages while retaining the "piggyback" second mortgages

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[hereinafter 2010 Capital Rule] (describing FASB's adoption of Statements of Financial Accounting Standards (FAS) 166 and 167 in June 2009); *Accounting Principles: New FASB Rules for Securitizations Portend Big Changes to Bank Ledgers*, 41 SEC. REG. & L. REP. (BNA) 1179 (June 22, 2009) (same); see also Risk-Based Capital Guidelines: Notice of Proposed Rulemaking, 74 Fed. Reg. 47,138, 47,140–42 (Sept. 15, 2009) (explaining the accounting changes made by FAS 166 and 167, and admitting that "the recent turmoil in the financial markets has demonstrated the extent to which the credit risk exposure of the sponsoring banking organizations to [OBS conduit] structures (and their related assets) has in fact been greater than the [federal banking] agencies had expected").

307. David Reilly, *Banks Need to End \$1 Trillion Kick the Can Game*, BLOOMBERG (Sept. 3, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acPs3f5Wlny0> (citing report by Barclays Capital analyst Jason Goldberg regarding the impact of the new FASB rules on Citigroup, JPMorgan, BofA and Wells Fargo).

308. 2010 Capital Rule, *supra* note 306, at 4637–39 (stating that financial industry commenters "overwhelmingly supported a delay and/or phase-in of the regulatory capital requirements associated with the implementation of FAS 167 for a period of up to three years").

309. Bradley Keoun, *Citigroup's Costly Guarantees May Be Curbed*, BLOOMBERG (Apr. 16, 2010), <http://www.bloomberg.com/news/2010-04-16/-liquidity-puts-that-cost-citigroup-may-be-curbed-occ-s-bailey-says.html> (reporting that consolidated treatment of conduit assets under regulatory capital rules would force banks to provide "10 times as much capital support" for those assets compared to prior rules); see also *supra* note 224 and accompanying text (describing 2004 capital rule that allowed banks to provide liquidity support for OBS conduits while posting only one-tenth of the capital required for on-balance-sheet assets).

310. 2010 Capital Rule, *supra* note 306, at 4638–39.

on their balance sheets.<sup>311</sup> In 2006, almost a third of subprime mortgages and about one-half of Alt-A loans were made in tandem with “piggyback” second mortgages.<sup>312</sup>

From 2001 to 2007, home purchase transactions that included “piggyback” second mortgages typically resulted in combined LTV ratios of 95% or more.<sup>313</sup> Regulators allowed banks and thrifts to provide “piggyback” second mortgages despite repeated complaints from mortgage insurers that those mortgages did not comply with either the agencies’ capital rules or their high-LTV lending standards.<sup>314</sup> Banks and thrifts also extended home equity loans and home equity lines of credit (HELOCs) that enabled homeowners to extract large amounts of cash from their homes.<sup>315</sup>

At the peak of the mortgage lending boom in 2007, about \$1 trillion of second mortgage liens (including home equity loans and HELOCs) were outstanding.<sup>316</sup> The four largest banks—JPMorgan, BofA, Citigroup and Wells Fargo—held \$475 billion of second-lien loans at the end of 2008,<sup>317</sup> and they retained about \$400 billion of those loans

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311. *Bernanke: Housing Will Stay Strong*, NAT’L MORTGAGE NEWS, July 18, 2005, at 6; Erick Bergquist, *New Radian CEO Predicts Piggybacks Will Wane*, AM. BANKER, May 2, 2005, at 18; Eric Bergquist & Marc Hochstein, *For MGIC—Slower Growth, Tougher Rivals*, AM. BANKER, July 15, 2004, at 1; *see also* Harry Terris, *As Home Prices Fall, Banks Hold Home Equity Bag*, AM. BANKER, April 28, 2011 (stating that “[p]iggyback loans—or second liens underwritten simultaneously with first liens—were standard substitutes for substantial down payments and mortgage insurance in subprime and alternative-A lending, and the data suggests that bank balance sheets were a principal source for such borrowing”); *infra note* 476 (describing the “piggyback” loans provided by Countrywide as part of their “80/20” subprime lending program).

312. Wilmarth, *supra* note 15, at 1021 & n.289.

313. Donghoon Lee et al., *A New Look at Second Liens*, Fed. Res. Bank of NY, Staff Report No. 569, (Aug. 2012), at 14–15, 34 (fig. 13), available at <http://ssrn.com/abstract=2130061>.

314. Private mortgage insurers criticized “piggyback” second mortgages because they enabled borrowers to avoid buying mortgage insurance, which generally had been required prior to the housing boom for borrowers whose down payments were less than 20% of the purchase price for their homes. Bergquist & Hochstein, *supra* note 311. In 2003 and again in 2005, mortgage insurers complained that banks and thrifts were using “piggyback” second mortgages to circumvent regulatory standards for high-LTV lending as well as agency rules requiring extra capital for banks and thrifts that retained “recourse” exposures to securitized loans. The federal banking regulators refused to act on those complaints, asserting that (i) second mortgages, even if originated simultaneously with first mortgages, did not represent a “recourse arrangement” for securitized first mortgages, and (ii) regulators were applying appropriate “scrutiny” to high LTV mortgage financing. *See* Off. of the Comptroller of Currency, Interpretive Letter 1058 (April 20, 2005), available at <http://www.occ.gov/static/interpretations-and-precedents/may06/int1058.pdf> (joint letter from the federal banking agencies to Suzanne Hutchinson of the Mortgage Insurance Cos. of Am.); Off. of the Comptroller of Currency, Interpretive Letter 987 (Mar. 17, 2003), available at <http://www.occ.gov/static/interpretations-and-precedents/apr04/int987.pdf> (joint letter from the federal banking agencies).

315. Lee et al., *supra* note 313, at 10; Wilmarth, *supra* note 15, at 1009–10.

316. Lee et al., *supra* note 313, at 10.

317. The large holdings of second-lien loans by the top four banks were due in part to BofA’s purchase of Countrywide, JPMorgan’s purchase of WaMu and Wells Fargo’s acquisition of Wachovia

on March 31, 2012.<sup>318</sup>

The top four banks were also the largest servicers of first mortgages (including securitized loans), and their extensive holdings of second liens created a clear conflict of interest.<sup>319</sup> The big bank servicers often refused to approve principal reductions for homeowners on their first mortgages, through either mortgage modifications or short sales, because those transactions would have required the banks to write down or write off their second liens on the same properties.<sup>320</sup> Indeed, some commentators claimed that bank servicers “encourage[ed] borrowers to miss first lien payments while remaining current on their second liens,” because banks could postpone writing down second-lien loans as long as borrowers kept making payments on them.<sup>321</sup>

Analysts strongly criticized regulators for not forcing major banks to recognize losses on their second-lien loans, especially for “underwater” homes whose market values were less than their combined mortgage liens.<sup>322</sup> In 2011, BofA still carried second-lien loans on its books at 93% of their face value, even though investors typically discounted such loans by 50%.<sup>323</sup> The OCC supported BofA and other big banks by declaring that they were “adequately reserved against losses on second-liens” in 2011, and the OCC also claimed that national banks did not have to write down second-lien loans on “underwater” homes as long as the borrowers continued to make payments.<sup>324</sup> As indicated above, bank

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during 2008. Kate Berry, *Surprising Surge in Home Equity Loans*, AM. BANKER, July 2, 2009, at 9.

318. Prashant Gopal & John Gittlesohn, *Second Loans Keep Houses in Limbo*, BLOOMBERG BUSINESSWEEK, July 30–Aug. 5, 2012, at 40-1 (reporting that the four largest banks “held 48 percent of the \$849.5 billion in second liens as of March 31, [2012]”).

319. Kate Berry & Jeff Horwitz, *Hamp Loan Mods Surge at Banks, Languish at Nonbanks*, AM. BANKER, Aug. 3, 2012 (reporting that the four largest banks and Ally Financial were the top five mortgage servicers and controlled the servicing for 66% of all home loans); Lee et al., *supra* note 313, at 2 (describing conflict of interest faced by banks that serviced first mortgages and held second-lien loans on the same properties); Alex Ulam, *Why Second-Lien Loans Remain a Worry*, AM. BANKER, May 2, 2011, at 7 (same).

320. Kate Berry, *Why Writedowns on 2nd Mortgages Are So Scarce*, AM. BANKER, Sept. 20, 2010, at 1; Ulam, *supra* note 319.

321. Lee et al., *supra* note 313, at 2; Ulam, *supra* note 319 (quoting comments by Josh Rosner).

322. Berry, *supra* note 320; Ulam, *supra* note 319; *see also* Kathleen Howley, *Banks Win Reprieve on Home Equity Loans in Settlement*, BLOOMBERG (Feb. 27, 2012) <http://www.bloomberg.com/news/2012-02-27/banks-win-reprieve-on-home-equity-loans-in-settlement-mortgages.html> (reporting that 4.4 million of “underwater” homes had second-lien loans totaling \$180 billion in late 2011, representing about 20% of all second-lien loans).

323. Ulam, *supra* note 319 (reporting that “[e]xcluding impaired [second-lien] loans it acquired with its purchase of Countrywide, BofA’s allowance for home equity losses was equal to 6.5% of its portfolio at March 31, [2011,] suggesting a carrying value of more than 93 cents on the dollar.”); Jesse Eisinger, *In Proposed Mortgage Fraud Settlement, a Gift to Big Banks*, N.Y. TIMES, Mar. 17, 2011, at B11 (reporting that investors were “bidding about 50 cents on the dollar” for second-lien loans).

324. Ulam, *supra* note 319 (reporting on comments by Tim Long, senior deputy comptroller and chief national bank examiner); *see also* Berry, *supra* note 320 (citing statement in September 2010 by OCC spokesman Bryan Hubbard that a national bank “does not have to classify a home equity loan if



servicers reportedly urged borrowers to continue making payments on “underwater” second liens even after they defaulted on their first mortgages.<sup>325</sup>

In February 2012, the four largest banks and Ally Financial agreed to a nationwide settlement of state and federal charges that all five banks had systematically engaged in unlawful and abusive practices while foreclosing on mortgages they serviced. The national mortgage settlement, which included 49 states and the federal banking agencies, required the five banks to pay \$5 billion in penalties and to earn \$20 billion of credits by approving principal relief for borrowers through mortgage modifications and short sales.<sup>326</sup> The settlement allowed the banks to receive substantial credits for writing down their second-lien loans, even though many of those loans were already “underwater” and presumably uncollectible.<sup>327</sup> A prominent analyst argued that the settlement credits for writing down second-lien loans represented “a gift to the banks” because “[s]econd liens would typically be wiped out before senior-mortgage investors take a loss.”<sup>328</sup> The foreclosure settlement also gave credits to the banks if they approved principal reductions for first mortgages they serviced for others, thereby allowing the banks to transfer some of the settlement’s costs to securitized mortgages owned by investors.<sup>329</sup>

Shortly before the national settlement was announced, federal bank

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the value of the property has dropped”). One analyst suggested that big national banks, which often serviced first mortgages owned by investors while holding second liens on the same properties, sometimes agreed to postpone foreclosures on the delinquent first mortgages if the borrowers were willing to continue making payments on their second liens. Ulam, *supra* note 319 (quoting comments by Josh Rosner).

325. See *supra* notes 321, 324 and accompanying text; see also Berry, *supra* note 320 (stating that banks were postponing writedowns on “underwater” second liens because borrowers continued to make payments on those loans; for example, in mid-2010 Citigroup reported that 47% of its second liens were “underwater,” due to combined LTV ratios higher than 100%, but also reported that only 2.4% of its second-lien loans were delinquent).

326. Kate Davidson, Kate Berry & Joe Adler, *Cheat Sheet: Long-Awaited Final Terms of \$25B Mortgage Settlement*, AM. BANKER, Mar. 13, 2012; see also Kate Berry, *Too Many Short Sales Mar Mortgage Settlement, Advocates Say*, AM. BANKER, Feb. 22, 2013, 2013 WLNR 4457884 (reporting that, under the settlement, “servicers get \$1 of credit for each \$1 of principal forgiveness [through a first-lien mortgage modification], but only 45 cents of credit for each \$1 in principal forgiven on a short sale, and only 20 cents of it if the loan is owned by an investor.”).

327. Davidson, Berry & Adler, *supra* note 326 (reporting that banks would “receive 90 cents for every \$1 principal write-down for performing second loans. For seriously delinquent second loans, they receive 50 cents of credit per \$1 of write-down. For second liens that are 6 months delinquent, they receive just 10 cents of credit for every \$1 of write-down.”); Howley, *supra* note 322 (discussing the settlement’s favorable treatment of the banks).

328. Howley, *supra* note 322 (quoting Laurie Goodman).

329. *Id.* (citing comments by Ms. Goodman and Scott Simon); Kate Berry, *MBS Investors Cry Foul Over National Mortgage Settlement*, AM. BANKER, Mar. 20, 2012 (“The settlement allows [bank] servicers to receive 45 cents of credit for every dollar of principal reductions paid for by investors” on first-lien loans).

regulators issued guidance advising banks to create larger loan loss reserves for second-lien loans in circumstances where (i) borrowers had defaulted on first-lien loans covering the same properties or (ii) market values of those properties had fallen below the outstanding amounts of the first and second liens.<sup>330</sup> The national settlement and the interagency guidance finally induced the top five bank servicers to begin approving loan modifications and short sales due to (A) settlement credits they could earn from approving such transactions,<sup>331</sup> and (B) regulatory pressure to recognize accrued losses on their second-lien loans.<sup>332</sup>

From March 2012 through March 2013, the five big bank servicers provided \$44.4 billion of principal relief to 475,000 borrowers. However, servicers provided more than three-quarters of that principal forgiveness through short sales (\$20.1 billion) and second-lien writedowns (\$14.2 billion). Servicers provided a much smaller amount of principal relief through first-mortgage modifications (\$10.1 billion).<sup>333</sup> Consumer and civil rights groups criticized the big bank servicers for failing to comply with the “spirit of the settlement,” because the banks gave “the bulk of relief through short sales and forgiveness of second liens”—transactions that frequently did not enable borrowers to “stay in their homes.”<sup>334</sup>

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330. Bd. of Governors of Fed. Res. Sys. et al., Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1–4 Family Residential Properties, at 2–3 (Jan. 31, 2012), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120131a1.pdf> (advising banks holding second liens to adjust their loss reserves for “high-risk junior lien” loans based on factors such as “[d]elinquency and modification status of senior lien loans associated with an institution’s junior liens” as well as the combined LTV ratios for first and second lien loans when compared to the property’s current market value).

331. Berry & Horwitz, *supra* note 319 (explaining that the foreclosure settlement and other federal incentives encouraged the top five bank servicers to approve mortgage modifications and other transactions resulting in principal reductions); Kate Davidson, *Banks Can Live with \$25B Deal—If It Gets Approved*, AM. BANKER, Mar. 14, 2012.

332. See Gretchen Morgenson, *Here Comes the Catch in Home Equity*, N.Y. TIMES, July 15, 2012, § BU, 1 (reporting that Wells Fargo “moved \$1.7 billion of junior lien mortgages to nonaccrual status as a result of the [interagency] guidance” in the first quarter of 2012). In June 2012, the OCC ordered national banks to write down second-lien loans for borrowers who had completed Chapter 7 bankruptcy proceedings. JPMorgan Chase, Wells Fargo and Citigroup responded by collectively charging off more than \$2 billion of their second-lien loans during the third quarter of 2012. Kate Berry, *Third-Quarter Earnings Feature More Home Equity Losses*, NAT’L MORTGAGE NEWS, Oct. 22, 2012. The fact that major banks had not previously written off such loans indicates the general laxity of federal regulatory treatment for second-liens prior to 2012.

333. Office of Mortgage Settlement Oversight, *Fact Sheet: Updated National Consumer Relief Data* (May 21, 2013), available at [https://www.mortgageoversight.com/wp-content/uploads/2013/05/Fact-Sheet\\_May-progress-reportFINAL.pdf](https://www.mortgageoversight.com/wp-content/uploads/2013/05/Fact-Sheet_May-progress-reportFINAL.pdf); see also Kevin Wack, *Mortgage Relief Surpassing Estimates, Iowa AG Says*, AM. BANKER, May 22, 2013, 2013 WLNR 12467907 (reporting on the types of principal relief provided by the five big banks servicers).

334. Kate Berry, *Civil Rights Groups Call for More Disclosure in Mortgage Settlement*, AM. BANKER, Feb. 28, 2013, 2013 WLNR 4946771 (also noting that the national mortgage settlement

Large holdings of impaired second liens by major banks appear to have been a significant factor behind the Obama Administration's repeated refusals to adopt programs that could have provided significant principal relief to homeowners threatened with foreclosure. As noted above, seven million mortgage holders have lost their homes to foreclosures or short sales since 2007, and an additional five million delinquent borrowers could lose their homes during the next few years.<sup>335</sup> The FRB and private analysts have pointed to this massive wave of foreclosures as a major problem that has prevented a sustained recovery of the U.S. housing market and the general economy.<sup>336</sup>

In recently-published memoirs, former TARP Special Inspector General Neil Barofsky and former FDIC Chairman Sheila Bair strongly criticized the Treasury Department for rejecting their proposals to create federal programs offering substantial principal reductions to "underwater" homeowners who could meet their mortgage obligations with such assistance.<sup>337</sup> As Barofsky, Bair and other analysts pointed

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monitor, Joseph A. Smith, acknowledged that "[t]here is a fair amount of discretion that the servicers have" in determining the types of principal relief they would offer to borrowers under the settlement); *see also* Berry, *supra* note 326 ("A chief criticism of the \$25 billion settlement has been that banks get credit for completing short sales—which result in borrowers giving up the property—when the goal is to [have] consumers keep their homes."); Jessica Silver-Greenberg, *Despite Aid, Borrowers Still Face Foreclosure*, N.Y. TIMES, Feb. 22, 2013, at B1 (reporting that only 71,000 borrowers had received principal relief through first-mortgage modifications under the settlement, and that other types of principal relief—including writedowns of second mortgages—frequently did not allow borrowers to stay in their homes).

335. *See supra* notes 124–25 and accompanying text.

336. *See, e.g.*, Letter from Ben Bernanke, Fed. Res. Bd. Chairman, to Spencer Bachus, Chairman of Committee on Financial Services, House of Representatives and Barney Frank, Ranking Member of Committee on Financial Services, House of Representatives, at 1 (Jan. 4, 2012), (with an attached Federal Reserve staff study entitled "The U.S. Housing Market: Current Conditions and Policy Considerations") (stating that "continued weakness in the housing market poses a significant barrier to a more vigorous economic recovery," and noting that "the large inventory of foreclosed or surrendered properties is contributing to excess supply in the for-sale market, placing downward pressure on house prices and exacerbating the loss in aggregate housing wealth"), *available at* <http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf>; Binyamin Appelbaum, *Cautious Moves on Foreclosures Haunting Obama*, N.Y. TIMES, Aug. 20, 2012, at A1 (reporting that "housing, left to fester, had become Mr. Obama's biggest economic problem" because "millions of people lost their homes and the economic recovery stalled somewhere between crisis and prosperity"); Peter Coy & Robert Farzad, *A Long Way From Normal*, BLOOMBERG BUSINESSWEEK, July 30-Aug. 5, 2012, at 37 (describing continuing problems with delinquent mortgages and foreclosures, and noting that "[h]ousing is most Americans' biggest asset and crucial to the health of the overall economy"); Clive Crook, *U.S. Needs to Be Much More Forgiving on Home Loans*, BLOOMBERG (Aug. 7, 2012), <http://www.bloomberg.com/news/2012-08-07/u-s-needs-to-be-much-more-forgiving-on-home-loans.html> ("The housing market is where the Great Recession started. It's the main thing delaying recovery."); Zachary Goldfarb, *Why has the U.S. recovery sputtered?*, WASH. POST, Nov. 23, 2012, at A1 (citing several senior economists who maintained that home foreclosures and underwater borrowers represented "a persistent and largely unaddressed problem" that caused "the slow economic recovery").

337. NEIL BAROFSKY, *BAILOUT: AN INSIDE ACCOUNT OF HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET* 124–28, 156–57, 193–200, 226–28 (Free Press eds., 2012);

out, Franklin Roosevelt's administration created the Home Owners' Loan Corporation (HOLC) in response to a similar foreclosure crisis during the Great Depression. The HOLC restructured and refinanced a fifth of U.S. home mortgages with significant principal reductions, thereby saving a million families from losing their homes.<sup>338</sup> In contrast, the Obama Administration rejected proposals for programs that could have provided significant principal reductions to large numbers of underwater borrowers. The Administration also refused to support legislation in early 2009 that would have given bankruptcy courts the authority to reduce the principal balances of individual mortgages by ordering "cramdowns" in consumer bankruptcy cases.<sup>339</sup>

Instead, the Treasury Department created the Home Affordable Modification Program (HAMP), which gave mortgage servicers financial incentives to modify first-lien mortgages but did not provide meaningful support for principal reductions. Barofsky, Bair and other critics contend that HAMP was poorly designed and lacked crucially-needed incentives to persuade mortgage servicers to provide principal relief to borrowers.<sup>340</sup> As of March 31, 2013, Treasury had spent only \$7.3 billion on HAMP and other housing relief programs, and \$38.5 billion of TARP-authorized funding for housing programs remained unused.<sup>341</sup> HAMP's mortgage modification program produced only 863,000 permanent first-lien modifications by March 2013, and only 96,000 of those modifications included principal relief, while more than a million modifications failed.<sup>342</sup> In August 2009, Treasury established a Second-Lien Modification Program, which offered incentive payments to mortgage servicers and investors for writing down second-lien loans, but that program disbursed less than \$360 million and generated only 142,000 writedowns of second liens by February 2013.<sup>343</sup>

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BAIR, *supra* note 290, at 128–29, 147–53, 248–51.

338. Appelbaum, *supra* note 336; BAIR, *supra* note 290, at 115, 155; *see also* Adam J. Levitin & Susan M. Wachter, *The Public Option in Housing Finance* 23–26 (Geo. Univ. Law Ctr. Pub. L. & Leg. Theory Working Paper 12-051, Mar. 13, 2012) (describing the HOLC's activities), *available at* <http://ssrn.com/abstract=1966550>.

339. *See* authorities cited *supra* in note 337; *see also* Appelbaum, *supra* note 336; Clara Benson, *Obama Housing Fix Faltered on Carrots-Not-Sticks Policy*, BLOOMBERG (Jan. 11, 2012), <http://www.bloomberg.com/news/2012-06-11/obama-housing-fix-faltered-on-carrots-not-sticks-policy.html>; Ezra Klein, *The Best Case Against Obama's Economic Policy*, WASH. POST, Aug. 21, 2012, at A10.

340. *See* authorities cited *supra* in notes 337 and 339.

341. Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), *Quarterly Report to Congress* (April 24, 2013) at 49-50, 59, 60 (tbl.2.12), *available at* [http://www.sig tarp.gov/Quarterly%20Reports/April\\_24\\_2013\\_Report\\_to\\_Congress.pdf](http://www.sig tarp.gov/Quarterly%20Reports/April_24_2013_Report_to_Congress.pdf).

342. *Id.* at 63 (including tbl.2.14), 64, 75–76.

343. *Id.* at 78–79. Moreover, HAMP's very limited programs for principal forgiveness applied only to mortgages that were not owned or guaranteed by Fannie Mae or Freddie Mac. The GSEs refused to participate in any mortgage modification programs offering principal reductions to borrowers.

According to Barofsky and Bair, the Treasury Department showed no interest in providing meaningful principal relief for underwater borrowers and instead pursued measures that served the interests of the big bank servicers.<sup>344</sup> In a hearing before the Congressional Oversight Panel during the fall of 2010, Treasury Secretary Geithner stated that HAMP would help “foam the runway” for the banks by enabling them to “handle up to ‘10 million foreclosures,’ over time.”<sup>345</sup> During a meeting with President Obama and seven leading economists in October 2011, Geithner rejected the economists’ proposal for a plan to go beyond HAMP and provide principal forgiveness to millions of underwater homeowners.<sup>346</sup>

Similarly, Treasury assistant secretary Herbert Allison stated that he wanted to help the banks “earn their way out of this,” and he opposed principal reductions for underwater mortgages because they could create “moral hazard” among borrowers.<sup>347</sup> Barofsky concluded that bank servicers had fee-based incentives that discouraged them from granting principal reductions, and he also decided that Treasury would never support a principal forgiveness program that could reduce bank profits.<sup>348</sup> Bair reached similar conclusions about the motivations of the big banks and Treasury.<sup>349</sup>

Thus, it seems likely that a major factor behind Treasury’s opposition to large-scale principal reductions for first mortgages was Treasury’s recognition that such reductions would have forced the four largest banks—which were also the four largest mortgage servicers—to recognize significant losses on their \$400 billion holdings of second-lien

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*Id.* at 75; Marceline White, *Not enough relief: Despite deal reached with banks, too many Md. families are still losing their homes*, BALTIMORE SUN (Dec. 12, 2012), at 21A (reporting that Edward DeMarco, acting director of the Federal Housing Finance Authority, would not allow Fannie Mae or Freddie Mac to include principal reductions in any modifications of mortgages that they owned or guaranteed).

344. BAROFSKY, *supra* note 337, at 125–28, 193–98; BAIR, *supra* note 290, at 141–53, 249–56.

345. BAROFSKY, *supra* note 337, at 156–57 (quoting testimony by Geithner).

346. Goldfarb, *supra* note 336 (reporting that Geithner rejected the proposal because “he didn’t think anything of such ambition was possible”).

347. BAROFSKY, *supra* note 337, at 157, 197. Geithner similarly opposed a principal reduction program for underwater mortgages because he feared “it could reward people who tapped home equity to support lavish lifestyles.” Benson, *supra* note 339. Given the federal government’s massive assistance programs for large banks, Barofsky found it “beyond ironic that Treasury was now emphasizing moral hazard with respect to home owners. Though some home owners might try to take advantage of [a principal reduction] program . . . that risk paled in comparison to that created by Treasury by the way it had rescued the too-big-to-fail banks.” BAROFSKY, *supra* note 337, at 197.

348. BAROFSKY, *supra* note 337, at 125–26, 196–97.

349. BAIR, *supra* note 290, at 131–53, 249–56; *see also id.* at 153 (“HAMP was a program designed to look good in a press release, not to fix the housing market. Larry [Summers] and Tim [Geithner] didn’t seem to care about the political beating the president took on the hundreds of billions of dollars thrown at the big-bank bailouts . . . I don’t think helping home owners was ever a priority for them.”).

loans. In September 2010, a prominent analyst pointed out that if regulators forced the big banks to write down their second liens, it would probably compel the banks to “come back to the federal government for additional bailout money.”<sup>350</sup>

The Obama Administration also declined to support bankruptcy “cramdown” legislation in 2009 because it “feared the consequences for the nation’s biggest banks, which had been rescued just months earlier.”<sup>351</sup> Similarly, Lawrence Summers (President Obama’s chief economic adviser) rejected plans to provide extensive principal relief for underwater homeowners because he believed those plans could have “‘effects worse than the cure’ . . . , such as cratering the financial system by forcing banks to absorb huge losses.”<sup>352</sup> In short, the Obama Administration—like its predecessor, the George W. Bush Administration—assigned a much lower priority to solving the home foreclosure crisis than it did to shoring up the largest banks (which bore significant responsibility for causing the crisis in the first place).<sup>353</sup>

#### *F. The Financial Industry Persuaded Congress to Pass a Series of Measures That Facilitated the Subprime Credit Boom*

In addition to the financial industry’s repeated successes in obtaining favorable regulatory treatment, the industry achieved a series of landmark legislative victories between 1994 and 2006. With the industry’s fervent support, Congress enacted several key statutes that encouraged rapid growth in the size, revenues and influence of the

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350. Berry, *supra* note 320 (quoting George Mason professor Anthony Sanders); *see also supra* notes 317–18 and accompanying text (stating that JPMorgan, BofA, Wells Fargo and Citigroup held \$475 billion of second-lien loans at the end of 2008 and still held \$400 billion of those loans at the end of the first quarter of 2012).

351. Paul Kiel, *The Great American Foreclosure Story: The Struggle for Justice and a Place to Call Home*, PROPUBLICA (Apr. 10, 2012), <http://www.propublica.org/article/the-great-american-foreclosure-story-the-struggle-for-justice-and-a-place-t> (discussion under heading entitled “Obama’s options”); *see also id.* (stating that the Administration was concerned that “[i]f too many consumers were lured into bankruptcy, they wouldn’t have only their mortgages reduced. They might very well have other debts slashed, such as home-equity loans and credit-card debt. The cumulative effect could devastate the banks, plunging the nation back into a financial crisis”); Benson, *supra* note 339 (quoting former Obama housing finance policy coordinator Peter Swire, who confirmed that “[g]etting the financial system to work was a huge priority [for the Obama Administration] . . . . The vote on cram-down happened in that context.”).

352. Goldfarb, *supra* note 336.

353. BAIR, *supra* note 290, at 131–53, 249–56; *see also* BAROFSKY, *supra* note 337, at 124–28, 194–200, 226–28 (“Under Paulson, Treasury chose to bail out the largest banks without insisting that they effect meaningful mortgage reform. Under Geithner, that original sin was compounded by a series of further choices in program design (to ‘foam the runway’ for the banks) and execution (refusing to penalize servicers) that always seemed to put home owners’ interests second. The simple truth is that Geithner and Treasury chose to never treat the foreclosure crisis . . . with the same seriousness and resolve that they applied to rescuing the banks.”).

largest banks and also set the stage for the financial crisis:

- In 1994, Congress adopted legislation that (i) authorized bank holding companies to make interstate acquisitions of banks and (ii) empowered national banks and state banks to establish interstate branches. The 1994 statute made possible the establishment of large nationwide banking organizations and triggered a wave of bank mergers. As a consequence, the share of U.S. banking assets held by the ten largest banks rose from 25% in 1990 to 55% in 2005.<sup>354</sup>
- In 1999, Congress enacted the Gramm–Leach–Bliley Act (GLBA), which authorized banks to affiliate with securities firms and insurance companies by establishing financial holding companies. GLBA ratified and expanded a long series of regulatory approvals that opened loopholes in the walls separating banks from securities firms and insurance companies—a trend that culminated in the FRB’s approval of the merger of Citicorp and Travelers to form Citigroup in 1998.<sup>355</sup> GLBA opened the door to the formation of large “universal banks” (financial conglomerates). In turn, many of those financial conglomerates became the “private-sector catalysts for the credit boom that led to the [financial] crisis” as well as “the epicenter of the world’s financial turmoil.”<sup>356</sup>
- In 2000, Congress passed the Commodity Futures Modernization Act (CFMA), which largely exempted OTC derivatives from federal regulation. CFMA’s deregulatory philosophy helped a small group of major financial institutions to dominate national and global markets for OTC derivatives.<sup>357</sup> CFMA was a “huge mistake” because it created a “regulatory void” that allowed OTC derivatives markets (including the CDS market) to expand rapidly and create dangerous concentrations of risk in leading financial firms like AIG.<sup>358</sup>
- In 2005, Congress enacted bankruptcy “reform” legislation that “radically altered the policies underlying consumer bankruptcy . . . in favor of creditors” by making it much more

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354. Wilmarth, *supra* note 15, at 975–76, 1012–13 (describing the significance of the 1994 interstate banking legislation); JOHNSON & KWAK, *supra* note 15, at 89 (same).

355. JOHNSON & KWAK, *supra* note 15, at 89, 91–92, 133–34 (discussing GLBA’s importance); Wilmarth, *supra* note 15, at 972–75 (same); *see also* Wilmarth, *supra* note 206, at 306–07 (noting that the financial industry spent more than \$300 million on lobbying expenses and political contributions to secure GLBA’s enactment).

356. Wilmarth, *supra* note 15, at 968–97, 1008–20, 1027–46 (quotes at 1043).

357. JOHNSON & KWAK, *supra* note 15, at 7–11, 78–82, 121–26, 134–37; Wilmarth, *supra* note 15, at 980–81, 991–94.

358. BAIR, *supra* note 290, at 333; *see also* JOHNSON & KWAK, *supra* note 15, at 7–9, 92, 134–37, 169–70, 202 (discussing the impact of CFMA and AIG’s role in the financial crisis).

difficult for consumers to use bankruptcy proceedings to obtain a substantial or complete discharge of their debts.<sup>359</sup> A recent study found that the 2005 statute triggered a significant rise in the subprime mortgage foreclosure rate by reducing the ability of subprime borrowers to discharge their unsecured debts (including credit card debts) and thereby free up more income to pay their mortgages.<sup>360</sup> The study concluded that the bankruptcy “reform” law was one of several factors contributing to “the destabilizing surge in subprime foreclosures” after 2005.<sup>361</sup>

- BAPCPA also significantly expanded “safe harbors” in the Bankruptcy Code that provided highly favorable treatment for holders of derivatives and financial repurchase agreements (repos).<sup>362</sup> As amended by BAPCPA, the safe harbors confer two very important rights on holders of derivatives and repos: (i) the right to engage in “close-out” and “cross-product” netting (i.e., the ability to terminate derivatives and repos immediately after a counterparty files for bankruptcy, and to set off any obligations the holder owes the counterparty against any amounts the counterparty owes the holder under all such contracts), and (ii) the right to seize collateral posted by a counterparty for derivatives or repos either before or after the counterparty files for bankruptcy.<sup>363</sup> The safe harbors, as enlarged by BAPCPA, effectively give holders of derivatives and

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359. Ronald J. Mann, *Bankruptcy Reform and the ‘Sweat Box’ of Credit Card Debt*, 2007 U. ILL. L. REV., 375, 376–77 (2007) (discussing the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)); see generally Eugene R. Wedoff, *Major Consumer Bankruptcy Effects of BAPCPA*, 2007 U. ILL. L. REV. 31 (2007) (surveying the changes made by BAPCPA to consumer bankruptcy statutes).

360. Donald P. Morgan et al., *Subprime Foreclosures and the 2005 Bankruptcy Reform*, FRBNY ECON. POL’Y REV., (Mar. 2012), at 47, 47–51, available at <http://www.newyorkfed.org/research/epr/12v18n1/1203morg.html>. This study determined that, for a state with average home equity exemptions and median home prices, the subprime foreclosure rate rose by 11% during the seven quarters following the bankruptcy statute’s enactment in 2005. *Id.* at 48, 54–55.

361. *Id.* at 48, 55.

362. Rhett G. Campbell, *Financial Market Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 701–09 (2005) (explaining BAPCPA’s expansion of the Bankruptcy Code’s favorable treatment for derivatives and repurchase agreements); Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 322–26 (2010) (same); Mark J. Roe, *The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 546 (2011) (explaining that a “financial repurchase agreement—called “repo” in the market—is a sale of a financial instrument . . . with the seller promising to buy that asset back, often the next day. The agreed repurchase price is a little higher than the sale price, with the difference being the de facto interest. The instrument sold is usually called the collateral, as the transaction is functionally a loan.”).

363. Campbell, *supra* note 362, at 702, 705–06 (explaining “cross-product netting” under BAPCPA); Rober R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout* (Fed. Res. Bank of Chi. Working Paper 2005-03, May 10, 2005), at 4–7 (explaining “close-out netting” permitted for holders of derivatives and repos), available at <http://ssrn.com/abstract=730648>.



repos a “superpriority” over other types of creditors who are barred under the Bankruptcy Code from taking similar self-help measures against bankrupt counterparties.<sup>364</sup> BAPCPA also expanded the classes of repos that receive safe-harbor treatment to include repos collateralized by mortgage-related assets (including mortgage loans and RMBS).<sup>365</sup>

- BAPCPA’s enlarged safe harbors served the interests of large financial institutions that were leading participants in the derivatives and repo markets.<sup>366</sup> Those institutions pushed hard to create and expand the safe harbors, which in turn facilitated the rapid growth of the derivatives and repo markets during the period leading up to the financial crisis.<sup>367</sup> Some experts maintain that BAPCPA’s expanded safe harbors (i) weakened market discipline and encouraged excessive risk-taking in the derivatives and repo markets during the pre-crisis period, (ii) played a significant role in the failures of AIG, Bear and Lehman, and (iii) imposed greater risks on the U.S. government as the implicit guarantor for TBTF financial institutions that were heavily involved in the derivatives and repo markets.<sup>368</sup>

In addition to the foregoing legislative victories, the financial services industry defeated numerous attempts by members of Congress to pass anti-predatory lending bills prior to the outbreak of the financial crisis in 2007.<sup>369</sup> The industry successfully lobbied to block more than a dozen bills introduced in Congress between 2000 and 2007 that would have imposed tighter restrictions on high-risk mortgage lending.<sup>370</sup>

364. Roe, *supra* note 362, at 546–49 (explaining that the amended “safe-harbor” provisions of the Bankruptcy Code give holders of derivatives and repos, “exemptions, insulations and special treatment” that amount to “a superpriority over disfavored creditors”).

365. Campbell, *supra* note 362, at 702–03 (explaining that, prior to BAPCPA, repos qualified for “safe harbor” treatment only if they were collateralized by government securities, bank certificates of deposit or bankers’ acceptances).

366. Lubben, *supra* note 362, at 326 (explaining that “the safe harbors are most likely to benefit large financial institutions, as these institutions are more likely to have either demanded pre-bankruptcy collateral . . . or have a variety of derivative positions with a single debtor”); *see also* Campbell, *supra* note 362, at 712 (“A cynic might argue that the financial safe harbors are indeed a ‘bankruptcy opt-out clause’ for a certain class of capitalists because their money is more important than anyone else’s . . . . BAPCPA suggests that financial markets contracts . . . fall within the privileged class.”).

367. Lubben, *supra* note 362, at 326–28; Roe, *supra* note 362, at 543–44, 576–78; Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L. J. 253, 279–83 (2009).

368. Lubben, *supra* note 362, at 319–21, 318–32; Roe, *supra* note 362, at 549–72; Simkovic, *supra* note 367, at 282–89.

369. *See* BAIR, *supra* note 290, at 50 (explaining that the financial services industry “successfully stopped antipredatory lending proposals on Capitol Hill,” including bills proposed by Rep. Barney Frank (D-MA), Rep. Spencer Bachus (R-FL) and Sen. Paul Sarbanes (D-MD)).

370. Deniz Igan, Prachi Mishra & Thierry Tresselt, *A Fistful of Dollars: Lobbying and the Financial Crisis* 10, 17–18, 25–26, 54–59 (Appendix) (Dec. 2009) (IMF Working Paper WP/09/87) (Int’l Monetary Fund), available at <http://ssrn.com/abstract=1531520>.

#### IV. WHY DOES WALL STREET EXERCISE SO MUCH INFLUENCE OVER WASHINGTON?

##### A. *The Financial Industry Wields Enormous Political Influence through Campaign Contributions and Lobbying*

###### 1. The Financial Industry's Formidable Political Clout

The finance, insurance and real estate sector (financial sector or financial industry) has become a dominant political force in Washington over the past two decades by devoting massive resources to political campaigns and lobbying.<sup>371</sup> Between 1990 and 2012, the financial sector spent more than \$3.3 billion on political campaigns and was “far and away the largest source of campaign contributions to federal candidates and parties . . . .”<sup>372</sup> The financial industry also spent more than \$5.3 billion on lobbying between 1998 and 2012 and ranked third among all industry sectors in lobbying outlays.<sup>373</sup> Indeed, the financial industry accounted for 15% of lobbying expenditures by *all* industry sectors between 1999 and 2006.<sup>374</sup> The financial sector employed 3,000 lobbyists in 2007, and many of those lobbyists were former senior

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371. See, e.g., BARTH, CAPRIO & LEVINE, *supra* note 19, at 7, 38, 210 (observing that “financial institutions spend enormous amounts of time and money on lobbying politicians both to enact sympathetic laws and to pressure regulatory agencies to interpret and implement those laws in sympathetic ways”); JEFF CONNAUGHTON, *THE PAYOFF: WHY WALL STREET ALWAYS WINS* 19–24, 106–10, 144–57, 233–50 (2012) (memoir by former senior Senate aide and lobbyist, explaining that “Washington has The Blob [, a term that] refers to the government entities that regulate the finance industry . . . and the army of Wall Street representatives and lobbyists that continuously surrounds and permeates them”); JOHNSON & KWAK, *supra* note 15, at 4–11, 89–104, 118–19, 134–37, 55–57, 191–92 (“The Wall Street banks are the new American oligarchy—a group that gains political power because of its economic power, and then uses that political power for its own benefit,” *id.* at 6); ESSENTIAL INFORMATION & CONSUMER EDUCATION FOUNDATION, *SOLD OUT: HOW WALL STREET AND WASHINGTON BETRAYED AMERICA* 15 (2009) [hereinafter *SOLD OUT*] (“The financial sector showered campaign contributions on politicians from both parties [and] invested heavily in a legion of lobbyists,” spending \$1.7 billion on political contributions and \$3.4 billion on lobbying between 1998 and 2008).

372. *Finance/Insurance/Real Estate: Long-Term Contribution Trends*, CENTER PUB. INTEGRITY (as of Mar. 25, 2013), <http://www.opensecrets.org/industries/totals.php?cycle=2012&ind=F>; Kiersh, Aaron, *Finance/Insurance/Real Estate: Background*, CENTER FOR PUBLIC INTEGRITY (updated July 2009), <http://www.opensecrets.org/industries/background.php?cycle=2012&ind=F>; *Interest Groups*, CENTER PUB. INTEGRITY (as of Mar. 25, 2013), <http://www.opensecrets.org/industries/index.php> (showing that the financial sector made \$658 million of campaign contributions during the 2012 election cycle, an amount that was more than \$100 million larger than the contributions of any other industry sector).

373. *Lobbying: Ranked Sectors*, CENTER PUB. INTEGRITY, <http://www.opensecrets.org/lobby/top.php?indexType=c> (last visited on Jan. 15, 2013) (showing that the top three industry sectors for lobbying expenditures between 1998 and 2012 were “Miscellaneous Business,” with \$5.42 billion, “Health,” with \$5.35 billion, and “Finance/Insurance/Real Estate,” with \$5.34 billion).

374. Igan, Mishra & Tressel, *supra* note 370, at 18, 32 (tbl.1a).

administration officials, members of Congress and congressional staffers.<sup>375</sup>

The financial industry achieved true political dominance when major banks, securities firms and insurance companies put aside many years of conflict and joined forces to support GLBA's passage in 1999. Previously, divergent interests among the three groups had stymied repeated efforts to remove statutory walls that separated banks from securities firms and insurers.<sup>376</sup> As previously noted, GLBA endorsed a "universal banking" model that encouraged banks, securities firms and insurers to affiliate by forming financial holding companies.<sup>377</sup> After GLBA's enactment, the common interests of the largest financial institutions coalesced to produce a "new financial oligarchy" that "used its political power to protect its [business interests] from interference and to clear away any remaining obstacles to its growth."<sup>378</sup>

The financial sector received excellent returns from the huge political investments it made during the period leading up to the financial crisis. As described above in Part III(F), the financial industry achieved a series of landmark legislative victories and also defeated numerous bills that tried to impose tighter constraints on subprime and Alt-A mortgage lending. A recent International Monetary Fund (IMF) staff study concluded that lobbying by the financial industry between 1999 and 2006 significantly increased the likelihood of passage for bills favored by the industry, and also enhanced the probability of defeat for bills opposed by the industry.<sup>379</sup>

Unfortunately, the business judgment of leading financial firms did not match their political acumen during the credit boom that led to the financial crisis. According to a second IMF staff study, financial institutions that were the most active lobbyists also pursued more risky business strategies (including higher-risk mortgage lending and securitization) and suffered above-average losses in their stock market values during the financial crisis.<sup>380</sup> By early 2010, eighteen global

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375. SOLD OUT, *supra* note 371, at 100–01 (reporting that the financial sector employed 2,996 lobbyists in 2007, and lobbyists employed by 20 leading financial firms between 1998 and 2008 included 142 individuals who were formerly senior executive branch officials, members of Congress and congressional staffers).

376. Sandra Suarez & Robin Kolodny, *Paving the Road to 'Too Big to Fail': Business Interests and the Politics of Financial Deregulation in the U.S.*, pt. II (June 15, 2010), available at <http://ssrn.com/abstract=1625289>; Charles C.Y. Yang & Yi David Wang, *Explaining the Glass-Steagall Act's Long Life and Rapid Eventual Demise* 24–36 (Dec. 8, 2010), available at <http://ssrn.com/abstract=1722373>.

377. See *supra* note 355–56 and accompanying text.

378. JOHNSON & KWAK, *supra* note 15, at 89, 133–34.

379. Deniz Igan & Prachi Mishra, *Three's Company: Wall Street, Capitol Hill, and K Street* 4, 15–18 (IMF Working Paper, June 2011), available at <http://ssrn.com/abstract=1915164>.

380. Igan, Mishra & Tressel, *supra* note 370, at 4–6, 19–20, 22, 24–27; see also Wilmarth, *supra*

financial conglomerates had collectively suffered about \$900 billion of losses from defaulted loans and depreciated securities.<sup>381</sup>

Large financial institutions responded to the crisis by appealing for and obtaining government bailouts.<sup>382</sup> Political influence played a key role in determining which firms received bailouts and how much help they secured. Ryan Duchin and Denis Sosyura found that U.S. banks were significantly more likely to receive TARP capital assistance if they established political connections with government officials, including connections based on political contributions and lobbying.<sup>383</sup> In addition, the preferential treatment given to politically connected banks could not be explained by merit-based factors. The financial performance of politically connected banks and unconnected banks was about the same before the TARP program was announced in October 2008. Moreover, politically connected banks performed significantly worse than unconnected banks after receiving TARP assistance.<sup>384</sup>

The weaker post-TARP performance of politically influential banks indicated that “political connections . . . benefit[ed] connected firms and politicians at public expense.”<sup>385</sup> Similarly, a study by Benjamin Blau and others found that politically influential banks received significantly larger amounts of TARP assistance, compared with banks that were not actively involved in politics. Blau and his co-authors determined that financial institutions which lobbied actively and hired lobbyists who were former federal government employees “received between \$3.73 billion and \$6.18 billion more in TARP support than firms that did not have both types of political ties.”<sup>386</sup> For every dollar that financial

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note 12, at 963–75 (explaining that large financial institutions played key roles in inflating the unsustainable credit boom that precipitated the global financial crisis).

381. Wilmarth, *supra* note 12, at 958–59, 977–78.

382. *See id.* at 957–59, 977–81 (discussing government bailout programs in the U.S., United Kingdom and Europe).

383. Ran Duchin & Denis Sosyura, *The Politics of Government Investment* 3–4, 16–20 (Ross School of Business, Working Paper No. 1127, 2011), available at <http://ssrn.com/abstract=1426219>. The study treated a bank as “politically connected” if, during 2008 and 2009, the bank had any of the following types of political ties: (i) one or more of the bank’s directors held a current or former position with the Treasury, a banking agency or Congress, (ii) the bank maintained its headquarters in the congressional district of a member of the House Financial Services Committee, (iii) the bank made political contributions to one or more members of the House Financial Services Committee, or (iv) the bank lobbied the Treasury, banking regulators or Congress on financial issues. *Id.* at 3, 11–14. The study determined that each of those sources of political influence played a statistically significant role in increasing the bank’s likelihood of receiving TARP Capital assistance. *Id.* at 4, 17–20.

384. *Id.* at 5, 25–28 (finding, based on accounting-based and stock-based measures, that politically connected banks performed significantly worse than unconnected banks after receiving TARP capital infusions).

385. *Id.* at 28.

386. Benjamin M. Blau, Tyler J. Brough, & Diana W. Thomas, *Corporate Lobbying, Political Connections, and the 2008 Troubled Asset Relief Program* 4 (Sept. 30, 2011), available at <http://ssrn.com/abstract=1878653>.

companies spent on lobbying during the five years prior to TARP, the same firms received about \$500 of TARP support.<sup>387</sup>

Due to widespread public anger over Wall Street's role in causing the financial crisis and the federal government's bailouts of large financial firms, the financial industry could not prevent passage of the Dodd-Frank Act.<sup>388</sup> However, the financial sector used its political clout to weaken Dodd-Frank's reforms. In 2009 and 2010, the financial industry retained more than 1,400 lobbyists who were former federal employees, including 73 former members of Congress and two former Comptrollers of the Currency.<sup>389</sup> During the same period, the six largest U.S. banks employed more than 240 lobbyists who were former members of Congress, congressional staffers or senior executive branch officials.<sup>390</sup>

During consideration of the Dodd-Frank Act by the Senate and subsequently by the House-Senate conference committee, the financial industry achieved several notable victories that significantly reduced Dodd-Frank's potential impact on the largest financial institutions. For example, the industry and its congressional allies (i) defeated an amendment offered by Senators Sherrod Brown (D-OH) and Ted Kaufman (D-DE), which would have placed maximum size limits on financial institutions and thereby forced a breakup of the six largest U.S. banks;<sup>391</sup> (ii) blocked proposals that would have required large financial institutions to prefund the Orderly Liquidation Fund so that future resolutions of failing financial giants would be paid for in the first instance by Wall Street rather than by taxpayers;<sup>392</sup> and (iii) inserted numerous loopholes in the Volcker Rule and the Lincoln Amendment that substantially undermined the effectiveness of both provisions.<sup>393</sup>

According to a recent study by Yu Gao and others, investors in the

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387. *Id.* at 4, 22.

388. See Wilmarth, *supra* note 12, at 962, 1026–27.

389. *Banking on Connections: Financial Services Sector Has Dispatched Nearly 1,500 "Revolving Door" Lobbyists Since 2009* 3 (Center for Responsive Politics & Public Citizen, June 3, 2010), available at <http://www.citizen.org/documents/FinancialRevolvingDoors.pdf> (reporting that financial industry lobbyists included former Speaker of the House Dennis Hastert (R-IL), former Senate Majority Leaders Bob Dole (R-KN) and Trent Lott (R-MS), and former House Majority Leaders Dick Army (R-TX) and Dick Gephardt (D-MO)).

390. Kevin Connor, *Big Bank Takeover: How Too-Big-To-Fail's Army of Lobbyists Has Captured Washington*, INSTITUTE FOR AMERICA'S FUTURE (May 11, 2010), <http://www.ourfuture.org/report/2010051911/big-bank-takeover>.

391. CONNAUGHTON, *supra* note 371, at 227–31, 238–44; Wilmarth, *supra* note 12, at 1055.

392. Wilmarth, *supra* note 12, at 1015–19; Taibbi, *supra* note 7.

393. Wilmarth, *supra* note 12, at 1028–35; Christine Harper, *Out of Lehman's Ashes Wall Street Get Most of What It Wants*, BLOOMBERG.COM (Dec. 28, 2010), <http://www.bloomberg.com/news/2010-12-28/out-of-lehman-s-ashes-wall-street-gets-what-it-wants-as-government-obliges.html>; Taibbi, *supra* note 7.

stock and bond markets assessed the financial industry's legislative victories as having significantly diminished the possibility that the top six banks might lose their TBTF status—including their presumed access to future government bailouts—after Dodd–Frank's passage.<sup>394</sup> Moreover, after the credit rating agencies evaluated Dodd–Frank's impact on the probability that banks would continue to receive “systemic support” from the federal government, the ratings agencies were more likely to maintain their bond ratings for the six largest banks and to reduce their ratings for smaller banks. Thus, post-Dodd–Frank bond ratings indicated that “[credit] rating agencies still assume some level of systemic support from the US government for the [top six banks]” despite Dodd–Frank's enactment.<sup>395</sup> Similarly, a July 2011 report by Standard & Poor's (S&P) concluded that “under certain circumstances and with selected systemically important financial institutions, future extraordinary government support is still possible.”<sup>396</sup>

In addition to its success in diluting the strength of Dodd–Frank's reforms, the financial industry (as shown above) has used its formidable lobbying and litigating resources to undermine the implementation of those reforms.<sup>397</sup> Since Dodd–Frank's passage, the vast majority of meetings held by Treasury officials and other federal financial regulators to discuss Dodd–Frank's implementation have been meetings with the financial industry's agents. For example, industry representatives held 351 meetings to lobby regulators on implementation of the Volcker Rule between Dodd–Frank's enactment in July 2010 and the federal agencies' issuance of proposed regulations in October 2011, compared with only 31 similar meetings attended by advocates of financial reform.<sup>398</sup> Similarly, during the two years after Dodd–Frank's enactment, the twenty largest U.S. banks and their trade associations held 1,298 meetings with regulators to discuss all aspects of Dodd–Frank's implementation, compared with only 242 similar meetings attended by “groups favoring tighter regulations of the financial markets.”<sup>399</sup> Seven megabanks—Goldman, JPMorgan, Morgan Stanley, BofA, Citigroup, Barclays and Wells Fargo—accounted for more than

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394. Yu Gao, Scott Liao, & Xue Wang, *The Economic Impact of the Dodd–Frank Act on Systemically Important Financial Firms: Evidence from Market Reactions* 3–6, 22–27, 31 (May 21, 2012), available at <http://ssrn.com/abstract=1919630>.

395. *Id.* at 6, 29–30.

396. Wilmarth, *supra* note 109, at 12 (quoting S&P report).

397. *See supra* Parts (II)(A)–(B).

398. Krawiec, *supra* note 12, at 29–32, 50 (tbl.8).

399. Lee Drutman, *Big Banks Dominate Dodd–Frank Meetings with Regulators*, SUNLIGHTFOUNDATION.COM (July 19, 2012), <http://sunlightfoundation.com/blog/2012/07/19/dodd-frank-two-years-later/> (describing results of study by Sunlight Foundation).

900 of those meetings with regulators.<sup>400</sup>

The enactment of Dodd–Frank showed, and the 2012 elections confirmed, that Wall Street is not omnipotent. President Obama won reelection in 2012 despite the financial industry’s overwhelming support for his Republican challenger, Mitt Romney.<sup>401</sup> The financial sector also invested heavily in two key Senatorial elections but failed to defeat Sherrod Brown (D-OH) and Elizabeth Warren (D-MA), who actively campaigned as opponents of Wall Street.<sup>402</sup>

Even so, the 2012 elections hardly dethroned the financial industry as a political heavyweight. President Obama promptly reached out to Wall Street executives and other business leaders after the election, and he eagerly invited their support for his economic policy (including his budget and tax proposals).<sup>403</sup> Undeterred by the election results, financial industry representatives declared that they would continue to push for legislation to weaken Dodd–Frank’s reforms, and would also lobby regulators and file lawsuits to undermine Dodd–Frank’s implementation.<sup>404</sup> By June 2013, House Republicans (with support from some Democrats) had advanced several bills that would punch significant holes in Dodd–Frank’s regulatory regime for derivatives, freeze the CFTC’s budget and require the SEC to perform a more

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400. *Id.*

401. Susanne Craig & Nicholas Confessore, *On Wall Street, Time to Mend Fences With Obama*, N.Y. TIMES, Nov. 8, 2012, at B1; Sarah N. Lynch, Emily Stephenson, & Rick Rothacker, *Wall Street Left to Rebuild Obama Ties After Backing Romney*, REUTERS (Nov. 7, 2012), <http://www.reuters.com/article/2012/11/07/us-usa-campaign-financialregulation-idUSBRE8A60R620121107>; David Weidner, *Wall Street Took a Beating at the Polls*, WALL ST. J. (Nov. 8, 2012), <http://online.wsj.com/article/SB10001424127887324073504578105433706996720.html>; see also *supra* notes 183–85 and accompanying text (explaining that the financial sector gave two-thirds of its political contributions to Mr. Romney and other Republican candidates in 2012).

402. Robert Scheer, Op-Ed., *Will Obama Stand up to Banking Industry and Wall Street in Second Term?*, SAN GABRIEL VALLEY TRIB. (CA) (Nov. 11, 2012) (available on Lexis); Katharine Q. Seelye, *A New Senator, Known Nationally and Sometimes Feared*, N.Y. TIMES, Nov. 11, 2012, at A33; Deidre Shesgreen, *GOP Spent \$40 Million in Unsuccessful Attempt to Unseat Brown in Ohio*, GANNETT NEWS SERVICE (Nov. 8, 2012) (available on Lexis).

403. Dawn Kopecki & Margaret Talev, *Obama Meets With Blankfein, Dimon and Moynihan Today*, BLOOMBERG (April 11, 2013) (reporting that President Obama would meet “with 15 heads of the world’s largest banks,” including the CEOs of Goldman, JPMorgan, BofA, Citigroup and Wells Fargo, and that Obama was “seeking to rebuild relationships with big business leaders as he struggles to create more jobs”), <http://www.bloomberg.com/news/2013-04-11/obama-meets-with-blankfein-dimon-and-moynihan-today.html>; Zeke Miller, *Obama Makes Peace With Business*, BUZZFEED.COM (Dec. 8, 2012), [www.buzzfeed.com/zekejmiller/obama-makes-peace-with-business](http://www.buzzfeed.com/zekejmiller/obama-makes-peace-with-business); Nelson D. Schwartz & Jonathan Weisman, *Unlikely Backers in a Battle Over Taxes*, N.Y. TIMES, Dec. 12, 2012, at B1; Andrew Tangel & Jim Puzanghera, *Wall St., Obama Healing Rift*, L.A. TIMES, Nov. 15, 2012, at B1.

404. Cheyenne Hopkins, *Technical Fixes Prompt Suspicion From Dodd–Frank Backers*, BLOOMBERG.COM (Dec. 10, 2012), <http://www.bloomberg.com/news/2012-12-10/technical-fixes-prompt-suspicion-from-dodd-frank-backers.html>; Victoria McGrane & Jean Eaglesham, *Battle Plan Shifts on Dodd–Frank*, WALL ST. J., Nov. 9, 2012, at C1.

stringent cost-benefit analysis before issuing new rules.<sup>405</sup>

The significant benefits that the financial industry has achieved through campaign contributions and lobbying are consistent with more broadly-based evidence indicating that business firms exploit political influence to secure important advantages. For example, studies have shown that (i) from 1979 to 2004, publicly-traded U.S. firms that made political contributions to larger numbers of political candidates also produced significant “abnormal returns” for their shareholders;<sup>406</sup> (ii) from 1999 to 2006, publicly-traded U.S. nonfinancial firms that spent larger amounts on lobbying also boosted their stock values significantly;<sup>407</sup> and (iii) from 1997 through 2002, publicly-traded financial and nonfinancial companies in 35 countries significantly increased their chances of securing government bailouts (including bailouts supported by the IMF and World Bank) if the companies maintained significant connections with leading politicians.<sup>408</sup>

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405. Richard Hill & Stephen Joyce, *Derivatives: House Easily Passes Bill Requiring SEC, CFTC to Issue Joint Dodd–Frank Rule*, 100 BNA’S BANKING REP. 1080 (June 18, 2013) (reporting that the House passed H.R. 1256 by a vote of “301-124, with 73 Democrats voting in favor,” and explaining that the bill “would require the CFTC and the SEC to issue joint rules that would exempt from Dodd–Frank [any trading in swaps by] any ‘non-U.S. person’ who is in compliance with swaps requirements of any Group of 20 member nation [that] are ‘broadly equivalent’ to U.S. requirements”); Marcy Gordon, *House passes bill that would exempt foreign trades*, BLOOMBERG BUSINESSWEEK (June 12, 2013) (explaining that, under H.R. 1256, “trading in the nine biggest foreign markets for derivatives would be exempt from U.S. regulation,” thereby negating the CFTC’s proposal for regulating cross-border swaps trading), <http://www.businessweek.com/ap/2013-06-12/house-passes-bill-that-would-exempt-foreign-trades>; Richard Hill, *Derivatives: Appropriations Subcommittee Advances Bill That Would Freeze CFTC Spending at \$195M*, 49 SEC. REG. & L. REP. (BNA) 1098 (JUNE 10, 2013); Sarah N. Lynch, *House votes for more scrutiny of economic impact of SEC rules*, REUTERS (May 17, 2013) (reporting that House Republicans passed a bill (with the support of 17 Democrats) that would require the SEC, the Public Company Accounting Oversight Board and the Financial Industry Regulatory Authority to perform more demanding cost-benefit studies before issuing any new regulations), <http://www.reuters.com/article/2013/05/17/us-congress-sec-costbill-idUSBRE94G0OD20130517>; Cheyenne Hopkins & Silla Brush, *Dodd–Frank Swaps Pushout Would Be Eased by Bipartisan Bills*, BLOOMBERG (Mar. 6, 2013) (reporting that House and Senate members introduced bipartisan bills to weaken Dodd–Frank’s Lincoln Amendment (Section 716) by allowing banking organizations to continue to trade “[c]ommodity, equity and structured swaps tied to some asset-backed securities” within their banks instead of forcing them to conduct such trades within separately capitalized affiliates that would not have access to the federal safety net); see *supra* notes 72, 80-86 and accompanying text (discussing the CFTC’s proposed guidance for cross-border swaps trading and the Lincoln Amendment, which would be vitiated by the foregoing bills).

406. Michael J. Cooper, Huseyin Gulen, & Alexei V. Ovtchinnikov, *Corporate Political Contributions and Stock Returns*, 65 J. FIN. 687, 688–90, 718–19 (2010) (noting that firms which make larger political contributions also tend to engage heavily in lobbying).

407. Matthew D. Hill et al., *Determinants and Effects of Corporate Lobbying* 3–4, 13, 22–28 (Jan. 23, 2011), available at <http://ssrn.com/abstract=1420224>.

408. Mara Faccio, Ronald W. Masulis, & John J. McConnell, *Political Connections and Corporate Bailouts*, 61 J. FIN. 2597, 2598–2602, 2627–29 (2006) (reporting on results of a study of 121 financial firms and 329 nonfinancial companies in 35 countries, and defining a company as “politically connected” if at least one of its top corporate officers or large shareholders was either (i) a head of state, government minister or member of the national parliament or (ii) a relative with the same last name as



## 2. Does Wall Street's Political Clout Help to Explain Why Federal Officials Have Not Taken Strong Enforcement Actions Against Major Financial Institutions and Their Top Executives?

An even darker side of corporate lobbying emerges when one considers evidence that fraudulent and insolvent firms have frequently used political influence to mask their unsound condition and to impede enforcement measures. For example, between 1998 and 2005—a period that witnessed massive accounting frauds at Enron, WorldCom, Adelphia, Global Crossing and Tyco—publicly-traded U.S. companies that engaged in fraud spent significantly more on lobbying, compared to non-fraudulent firms.<sup>409</sup> Moreover, in contrast to corrupt firms that did not lobby, fraudulent companies that actively lobbied succeeded in escaping detection for substantially longer periods of time, thereby enabling their insiders to sell large amounts of their stock.<sup>410</sup> Fraudulent companies also used lobbying to reduce significantly the likelihood that regulators would discover their frauds. Notably, however, lobbying did *not* reduce the effectiveness of scrutiny by *other* types of corporate monitors, such as analysts, company stakeholders or the media.<sup>411</sup>

Similarly, during the 1980s Charles Keating (owner of the notorious Lincoln Savings) and owners of other fraudulent, insolvent thrifts made large political contributions that induced Speaker of the House Jim Wright (D-TX) and other members of Congress—including five Senators known as the “Keating Five”—to obstruct regulatory and enforcement efforts by the Federal Home Loan Bank Board.<sup>412</sup> Studies also found that, during the same period, federal regulators acted much more slowly in closing insolvent banks and thrifts if they were located in congressional districts whose representatives served on congressional committees with direct oversight over financial regulatory policies.<sup>413</sup>

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such a politician).

409. Frank Yu & Xiaoyun Yu, *Corporate Lobbying and Fraud Detection* 3, 10–13, 30 (June 9, 2010), available at <http://ssrn.com/abstract=954368> (finding that “fraudulent firms spend 77% more on lobbying expenses than non-fraudulent firms”); see also ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING 127–94, 200–01, 208–11 (2004) (describing scandals at Enron, WorldCom, Global Crossing, Adelphia and Tyco); FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 297–373, 391–94 (2003) (same); Wilmarth, *supra* note 268, at 6–10, 25–30 (discussing collapses of Enron and WorldCom).

410. Yu & Yu, *supra* note 409, at 2–3, 14–18, 16–28.

411. *Id.* at 2, 15–21, 50 (tbl.5, panel A).

412. WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE: HOW CORPORATE EXECUTIVES AND POLITICIANS LOOTED THE S&L INDUSTRY 62–166, 184–92, 199–237 (2005); MARTIN MAYER, THE GREATEST-EVER BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY 188–242 (1990).

413. Wilmarth, *supra* note 206, at 307, n.379 (citing Randall W. Bennett & Christine Loucks, *Politics and the Length of Time to Bank Failure: 1986–90*, *Contemp. Econ. Pol’y*, Oct. 1996, at 29, 37–38; Lin Guo, *When and Why Did FSLIC Resolve Insolvent Thrifts?*, 23 *J Banking & Fin.*, 972–73, 980–

As noted above, an IMF staff study determined that financial institutions which were most active in lobbying prior to the recent financial crisis also pursued more risky mortgage lending and securitization strategies and suffered greater losses during the crisis.<sup>414</sup> That study raises significant questions about the impact of recent financial industry lobbying on financial regulatory and enforcement policies. Indeed, many commentators have asked why federal officials have failed to take vigorous enforcement actions against large financial institutions that were at the center of the financial crisis and their top executives.<sup>415</sup>

As the following discussion shows, the federal government's enforcement efforts related to the financial crisis were pathetically weak when compared to the enormous damage inflicted by major financial institutions and their senior officers. To date federal officials have not secured any criminal convictions against major financial institutions or their top executives. In addition, federal agencies have entered into only

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83, 986–87).

414. Igan & Mishra, *supra* note 370, at 4, 15–18.

415. See, e.g., Gleen Greenwald, *The Untouchables: How the Obama administration protected Wall Street from prosecutions*, GUARDIAN.CO.UK (Jan. 23, 2013) (describing a PBS “Frontline” program broadcast on January 22, 2013, which revealed “one of the greatest and most shameful failings of the Obama administration, the lack of even a single arrest or prosecution of any senior Wall Street banker for the systematic fraud that precipitated the 2008 financial crisis;” and quoting Harvard law professor Larry Lessig’s remark that “we live in a world where the architects of the financial crisis regularly dine at the White House”) (available on Lexis); John C. Coffee Jr., *SEC Enforcement: What Has Gone Wrong?*, NAT’L L. J. (Dec. 3, 2012) (“[T]he only senior executive at a truly major bank named as a defendant by the SEC in a case growing out of the 2008 crisis appears to be Angelo Mozilo, the former chief executive officer of Countrywide Financial Corp., who settled” civil charges without admitting or denying liability); Danielle Douglas, *RBS will pay \$612 million to settle Libor case*, WASH. POST, Feb. 7, 2013, at A11 (reporting that “no senior bank executives have faced jail time”); Jonathan Weil, *Eric Holder Owes America Some Answers*, BLOOMBERG.COM (Nov. 15, 2012), <http://www.bloomberg.com/news/2012-11-15/banker-math-meets-the-justice-department-s-cooks.html> (“[T]here have been no criminal convictions of any top executives at the center of the 2008 financial crisis.”); William D. Cohan, *How to Crash an Economy and Escape the Scene*, BLOOMBERG.COM (Oct. 21, 2012), <http://www.bloomberg.com/news/2012-10-22/how-to-crash-an-economy-and-escape-the-scene.html> (“No one—no one—on Wall Street has paid a serious price . . . Every bank has received its slap on the wrist, [amounting to] the cost of doing business, don’t you know—and has moved on.”); Ben Hallman, *Federal Investigators Punt on Goldman Sachs Prosecutions*, HUFFINGTONPOST.COM (Aug. 10, 2012), [http://www.huffingtonpost.com/2012/08/10/investigation-goldman-sachs\\_n\\_1765368.html?view=print&comm\\_ref=false](http://www.huffingtonpost.com/2012/08/10/investigation-goldman-sachs_n_1765368.html?view=print&comm_ref=false) (quoting former TARP Special Inspector General Neal Barofsky, who described the Justice Department’s decision not to prosecute Goldman as “a stark reminder that no individual or institution has been held meaningfully accountable for their role in the financial crisis.”); Gretchen Morgenson & Louise Story, *A Financial Crisis With Little Guilt*, N.Y. TIMES, April 14, 2011, at A1 (“[S]everal years after the financial crisis, which was caused in large part by reckless lending and excessive risk-taking by major financial institutions, no senior executives have been charged or imprisoned.”); Matt Taibbi, *Why Isn’t Wall Street in Jail*, ROLLING STONE (Mar. 3, 2011), <http://www.rollingstone.com/politics/news/why-isnt-wall-street-in-jail-20110216> (“Not a single executive who ran the companies that cooked up and cashed in on the phony financial boom—an industrywide scam that involved the mass sale of mismarked, fraudulent mortgage-backed securities—has ever been convicted.”).

a small number of relatively weak civil settlements with large banks and a handful of their senior officers.

*a. The Lack of Criminal Enforcement Against Leading Financial Institutions and Their Senior Executives*

As of mid-2013—nearly six years after the financial crisis began—not one major financial institution or any senior executive has been convicted of, or pleaded guilty to, a single criminal offense.<sup>416</sup> In sharp contrast, federal officials brought more than 1,100 criminal prosecutions against financial executives arising out of bank and thrift failures during the 1980s and early 1990s, and more than 800 of those executives (including Charles Keating of Lincoln Savings and David Paul of CenTrust Bank) were convicted and jailed.<sup>417</sup> Similarly, the Department of Justice (DOJ) successfully prosecuted and jailed senior executives of Enron, WorldCom, Adelphia, Rite Aid and Tyco following corporate accounting scandals in the late 1990s and early 2000s.<sup>418</sup>

Criminal referrals by bank regulators to DOJ fell sharply soon after wave of bank and thrift failures ended in the early 1990s. Bank regulators made over 1,800 criminal referrals in 1995 but made only about 70 referrals per year between 2006 and 2010.<sup>419</sup> OTS failed to make a single criminal referral between 2000 and 2010, despite the collapse of several of the largest institutions it regulated, while OCC made only three referrals during the same period.<sup>420</sup>

Beginning in 2004, Federal Bureau of Investigation (FBI) assistant director Chris Swecker issued public warnings about the growing “epidemic” of mortgage fraud that threatened to undermine the U.S. financial system.<sup>421</sup> Swecker repeatedly asked for additional funding to combat mortgage fraud, but senior FBI officials denied Swecker’s requests and instead focused FBI’s available resources on fighting terrorism.<sup>422</sup> As a result, FBI assigned only 240 agents to investigate mortgage fraud in 2007, compared with the 1,000 agents that

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416. See authorities cited *supra* in note 415.

417. Morgenson & Story, *supra* note 415; see also Morgenson & Story, *supra* note 415 at B10, B11 (“Two Financial Crises and Responses Compared: The Savings and Loan Debacle and the Mortgage Mess.”).

418. Gretchen Morgenson & Louise Story, *Behind the Gentler Approach to Banks by U.S.*, N.Y. TIMES, July 8, 2011, at A1.

419. Morgenson & Story, *supra* note 415, at B10, B11 (“Two Financial Crises and Responses Compared: The Savings and Loan Debacle and the Mortgage Mess.”).

420. *Id.*; see also ENGEL & MCCOY, *supra* note 19, at 157–86 (describing regulatory laxity by OCC and OTS during the credit boom that led to the financial crisis).

421. FCIC Report, *supra* note 36, at 15, 161.

422. *Id.* at 162–63.

investigated crimes related to bank and thrift failures during the late 1980s and early 1990s.<sup>423</sup> Although the Fraud and Enforcement Recovery Act of 2009 authorized \$165 million of additional funding to investigate frauds connected to the financial crisis, Congress subsequently appropriated only \$30 million for that purpose.<sup>424</sup>

In addition to the problems created by a lack of adequate resources for investigating complex financial frauds, FBI and DOJ chose to investigate and prosecute borrowers and mortgage brokers instead of pursuing large financial institutions that funded and securitized fraudulent mortgages.<sup>425</sup> By late 2012, DOJ had prosecuted more than 2,000 real estate agents, mortgage brokers and borrowers for criminal fraud but had not indicted a single top financial executive or any of the big financial institutions that financed the housing bubble.<sup>426</sup> Analysts criticized federal prosecutors for focusing on “easy targets—low-level fraudsters—while going easy on Wall Street executives whose banks packaged billions of dollars worth of toxic mortgage securities.”<sup>427</sup>

DOJ convicted executives of a midsized mortgage bank (Taylor Bean & Whitaker) for defrauding Colonial Bank, but that one successful prosecution occurred only after SIGTARP officials repeatedly urged federal prosecutors to take action.<sup>428</sup> Federal prosecutors failed to convict two hedge fund managers of Bear Stearns on criminal fraud charges, and they showed little interest thereafter in bringing criminal charges against Wall Street bankers.<sup>429</sup> DOJ ultimately decided not to bring criminal charges against any top officials connected with AIG, Bear, Countrywide, Lehman or other major financial institutions that played key roles in precipitating the financial crisis.<sup>430</sup>

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423. CONNAUGHTON, *supra* note 371, at 29–30.

424. *Id.* at 26–36.

425. William K. Black, Testimony Before the Financial Crisis Inquiry Commission, Miami, Florida (Sept. 21, 2010) (hereinafter Black FCIC Testimony), available at <http://ssrn.com/abstract=1729344>; see also CONNAUGHTON, *supra* note 371, at 71 (explaining that the author and Senator Ted Kaufman (D-DE) learned in December 2009 that the FBI’s mortgage fraud investigation “was targeted exclusively on small-fry mortgage brokers and bankers; we heard nothing about investigations of the higher-level securitizations by major Wall Street firms.”).

426. Kara Scannell, *US housing: After the Gold Rush*, FT.COM (Oct. 29, 2012), <http://www.ft.com/cms/s/0/11aa9914-1d36-11e2-abeb-00144feabdc0.html#axzz2KXbF56fK>.; Joe Nocera, *The Mortgage Fraud Fraud*, N.Y. TIMES, June 2, 2012, at A21.

427. Scannell, *supra* note 426; see also Nocera, *supra* note 426 (noting that “not a single top executive at any of the firms that nearly brought down the financial system has spent so much as a day in jail” and criticizing the Justice Department for going “after the smallest of small fry—and then trumpet[ing] those prosecutions as proof of how tough it is on mortgage fraud. It is a shameful way for the government to act.”).

428. BAROFKY, *supra* note 337, at 104–08, 210.

429. *Id.* at 210, 228–29; CONNAUGHTON, *supra* note 367, at 65–95; Hallman, *supra* note 415.

430. CONNAUGHTON, *supra* note 371, at 75–80; Hallman, *supra* note 415; Morgenson & Story, *supra* note 415; Michael Rapoport, *Global Finance: Law’s Big Weapon Sits Idle—Sarbanes-Oxley’s*

By mid-2013, only one FDIC-insured bank—Abacus Federal Savings Bank, a small New York City thrift that primarily served Chinese immigrants—had been indicted for mortgage fraud.<sup>431</sup> As one journalist observed, “If the point [of indicting Abacus] was to send a message to Wall Street, it was a curious choice . . . . Compared to the whales of global finance, [Abacus is] plankton, with roughly one-ten-thousandth the assets of JPMorgan Chase.”<sup>432</sup>

DOJ’s decisions not to indict leading banks or their senior executives apparently reflected the Obama Administration’s reluctance to take any action that might threaten the stability of systemically important financial institutions or the financial markets.<sup>433</sup> DOJ explicitly invoked those concerns in December 2012, when it declined to file criminal charges against two major foreign banks with substantial U.S. operations. In early December, DOJ entered into a deferred prosecution agreement that required U.K. megabank HSBC to pay \$1.9 billion in penalties for massive money laundering violations.<sup>434</sup> HSBC’s illegal money laundering activities continued for a decade and encompassed billions of dollars of prohibited transactions involving nations linked with terrorists (including Iran, Burma, Cuba, North Korea and Sudan) and Latin American drug cartels.<sup>435</sup>

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*Jail-Time Threat Hasn’t Been Applied in Crisis-Related Cases*, WALL ST. J., July 30, 2012, at C3; Taibbi, *supra* note 415.

431. Drake Bennett, *Small Enough to Fail*, BLOOMBERG BUSINESSWEEK, Feb. 4-10, 2013, at 66, 67-68 (reporting on the indictment of Abacus Federal Savings Bank by the Manhattan District Attorney’s office).

432. *Id.* at 68.

433. That is the conclusion reached by Jeff Connaughton, senior counsel to Senator Ted Kaufman (D-DE), who made repeated but unsuccessful efforts to persuade the Justice Department to file criminal charges against Wall Street bankers during 2009 and 2010. CONNAUGHTON, *supra* note 371, at 66–68, 84–85, 269–70. Neil Barofsky, the former Special Inspector General for TARP, has expressed a similar view. Neil Barofsky, *Geithner doctrine lives on in Libor affair*, FT.COM (Feb. 7, 2013) (“The ‘Geithner doctrine’ made the preservation of the largest banks, no matter the consequences, a top priority of the US government. Aside from moral hazard, it has also meant the perversion of the U.S. criminal justice system.”).

434. Ben Protess & Jessica Silver-Greenberg, *HSBC to Pay \$1.92 Billion to Settle Charges of Money Laundering*, N.Y. TIMES BLOGS (Dec. 10, 2012), <http://dealbook.nytimes.com/2012/12/10/hsbc-said-to-near-1-9-billion-settlement-over-money-laundering/>; Aruna Viswanatha & Brett Wolf, *HSBC to Pay \$1.9 billion U.S. Fine in Money-Laundering Case*, REUTERS (Dec. 11, 2012), <http://www.reuters.com/article/2012/12/11/us-hsbc-probe-idUSBRE8BA05M20121211>; see also U.S. Senate, Permanent Subcommittee on Investigations, *U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History* (Majority and Minority Staff Report, July 2012), at 13, available at <http://www.levin.senate.gov/newsroom/press/release/hsbc-exposed-us-financial-system-to-money-laundering-drug-terrorist-financing-risks> [hereinafter *Senate HSBC Report*] (stating that “HSBC Group is one of the largest financial institutions in the world, with \$2.5 trillion in assets,” and its subsidiary, HSBC North America Holdings Inc. is “one of the ten largest bank holding companies in the United States” with \$345 billion of assets).

435. Protess & Silver-Greenberg, *supra* note 434; Viswanatha & Wolf, *supra* note 434; *Senate HSBC Report*, *supra* note 434, at 2–12 (summarizing HSBC’s illegal money laundering activities

In announcing HSBC's deferred prosecution agreement, Assistant Attorney General Lanny Breuer (head of DOJ's criminal division) declared that the "record of dysfunction that prevailed at HSBC for many years was simply astonishing," and he confirmed that HSBC had been a "vital player" in facilitating large-scale money laundering involving drug cartels and terrorists.<sup>436</sup> However, Mr. Breuer stated that DOJ decided not to indict HSBC because of concerns about "collateral" damage to the global financial system, and he emphasized that "[o]ur goal here is not to bring HSBC down."<sup>437</sup> Commentators warned that the HSBC settlement raised "questions about whether certain financial institutions, having grown so large and interconnected, are too big to indict."<sup>438</sup>

In the fall of 2012—just a few months before the HSBC settlement—DOJ obtained guilty pleas on criminal money laundering charges against G&A Check Cashing, a small Los Angeles store, and two of its senior officers. DOJ charged G&A and its officers with illegally laundering \$8 million—a tiny fraction of the billions of dollars allegedly laundered by HSBC. Both G&A officers were sentenced to prison following their guilty pleas.<sup>439</sup> The dramatically different treatment of HSBC and G&A and their respective senior officers can hardly be squared with any meaningful concept of "equal justice under the law."<sup>440</sup>

A week after DOJ settled with HSBC, Swiss megabank UBS agreed to pay \$1.5 billion in penalties to U.S., U.K. and Swiss regulators to settle charges that dozens of its managers and traders manipulated the setting of Libor rates to generate fraudulent trading profits.<sup>441</sup> The

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stretching from 2001 through 2010).

436. Tom Braithwaite, *DoJ Holds 'Sword of Damocles' over HSBC*, FT.COM (Dec. 11, 2012), <http://www.ft.com/cms/s/0/dc80fcf2-43cc-11e2-844c-00144feabdc0.html#axzz2LmsP6yri> (quoting Mr. Breuer).

437. *Id.* (quoting Mr. Breuer).

438. Protes & Silver-Greenberg, *supra* note 434; *see also* Barofsky, *supra* note 433 (contending that the HSBC settlement showed that large global banks "are still too big to fail—and they are still too big to jail").

439. U.S. Dept. of Justice, Press Release, *Los Angeles Check Cashing Store, Its Head Manager and Compliance Office Sentenced for Violations of Anti-money Laundering Laws* (Jan. 14, 2013) (stating that G&A Check Cashing paid a \$1 million fine, while its head manager and compliance officer were sentenced to prison for five years and eight months, respectively), available at <http://www.justice.gov/opa/pr/2013/January/13-crm-059.html>.

440. *See* Victoria Finkle, *Are Some Banks 'Too Big to Jail'?*, AM. BANKER (Jan. 22, 2013), 2013 WLNR 1675707 (quoting my statement that "[c]oncerns about the 'stability' of the financial system do not justify DOJ's policy of leniency for TBTF banks and their executives, especially when DOJ routinely indicts smaller institutions and sends their managers to jail for similar offenses."); Jonathan Weil, *Why Didn't Anyone Get Pinched at HSBC?*, BLOOMBERG (Dec. 11, 2012), <http://www.bloomberg.com/news/print/2012-12-11/why-didn-t-anyone-get-pinched-at-hsbc-.html> ("Too big to fail has turned equal justice under the law into a mockery.").

441. Lindsay Fortado, Gavin Finch, & Liam Vaughan, *UBS Is Fined \$1.5 Billion for Manipulating Libor Rates*, BLOOMBERG.COM (Dec. 19, 2012),

charges against UBS “detailed a pattern of repeated, far-reaching and brazen lawbreaking over a six-year period,” amounting to “a ‘simply astonishing’ conspiracy to manipulate rates affecting trillions of dollars of home loans, derivatives and other financial contracts around the world.”<sup>442</sup> UBS’s Libor settlement, like Barclays’s previous settlement and RBS’s subsequent settlement, indicated widespread collusion involving a dozen or more other global banks, including Deutsche, HSBC, BofA, Citigroup and JPMorgan.<sup>443</sup> The systematic rigging of Libor likely imposed many billions of dollars of losses on parties holding contracts with interest rates linked to Libor.<sup>444</sup>

UBS was in a particularly vulnerable position, because it had entered into two previous agreements with DOJ to settle criminal charges that the bank (i) enabled thousands of U.S. clients in to evade taxes and (ii) conspired to rig auctions for municipal investment contracts.<sup>445</sup>

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<http://www.about.bloomberhlaw.com/legal-news/ubs-is-fined-1-5-billion-for-manipulating-libor-rates/>; see also UBS’s ‘Captain Chaos’ Breaks New Ground in Libor Scandal, BLOOMBERG.COM (Dec. 19, 2012), <http://www.bloomberg.com/news/2012-12-19/ubs-s-captain-caos-breaks-new-ground-in-libor-scandal.html> (“What sets UBS apart [from other banks involved in the Libor scandal] is not only the sheer extent of the behavior, but also the level of collusion with traders at other banks and the outright bribery of brokers who helped coordinate the manipulation.”); Alison Frankel, *After Libor, Arguments Against Financial Regulation Are a Joke*, REUTERS (Dec. 19, 2012) (describing “the brazenness of the misconduct” at UBS, and noting that “[t]he corruption was breathtakingly widespread” as UBS bribed brokers at other institutions to cooperate in rigging Libor rates).

442. Jean Eaglesham & Evan Perez, *Critics Say UBS Let Off Too Easy*, WALL ST. J. ONLINE (Dec. 21, 2012), <http://www.online.wsj.com/article/SB100014242127887324731304578191801981480008.html>.

443. Ben Protess, *Leniency Denied, UBS Unit Admits Guilt in Rate Case*, N.Y. TIMES, Dec. 20, 2012, at A1; Liam Vaughan & Gavin Finch, *Secret Libor Transcripts Expose Trader Rate Manipulation*, BLOOMBERG.COM (Dec. 13, 2012), <http://www.bloomberg.com/news/2012-12-13/rigged-libor-with-police-nearby-shows-flaw-of-light-touch.html>; Carrick Mollenkamp, Jennifer Ablan & Matthew Goldstein, *Special Report: How Gaming Libor Became Business as Usual*, REUTERS (Nov. 20, 2012), <http://www.reuters.com/article/2012/11/20/us-libor-fixing-origins-idUSBRE8AJ0MH20121120>; see also Gallu et al., *supra* note 171 and accompanying text (discussing Barclays’ settlement of Libor manipulation charges in June 2012). In February 2013, RBS entered into a deferred prosecution agreement with DOJ and paid \$612 million to settle Libor-rigging charges by U.S. and U.K. authorities, while RBS’s Japanese subsidiary pleaded guilty to one count of felony wire fraud. Mark Scott & Ben Protess, *R.B.S. to pay \$612 million in rate-fixing settlement; Japanese subsidiary pleads guilty to charge of felony wire fraud*, INT’L HERALD TRIBUNE (Feb. 7, 2013), at 16 (reporting that the Libor investigation “centered on R.B.S. and a dozen other banks, including Citigroup and HSBC,” and noting that “government complaints against R.B.S. portray a permissive culture that allowed rate rigging to persist for about four years”) (available on Lexis).

444. Peter Eavis, *Making It Easier to Estimate Libor Losses*, N.Y. TIMES BLOGS (Dec. 20, 2012), <http://dealbook.nytimes.com/2012/12/20/making-it-easier-to-estimate-libor-losses/> (citing government report estimating that Libor manipulation may have cost Fannie Mae and Freddie Mac than \$3 billion); Darrell Preston, *Rigged Libor Hits States-Localities With \$6 Billion: Muni Credit*, BLOOMBERG.COM (Oct. 9, 2012), <http://www.bloomberg.com/news/2012-10-09/rigged-libor-hits-states-localities-with-6-billion-muni-credit.html>. (citing estimate by analyst Peter Shapiro that Libor manipulation inflicted \$6 billion of losses on issuers of state and local municipal bonds).

445. Eaglesham & Perez, *supra* note 442; see also James B. Stewart, *For UBS, A Record of Averting Prosecution*, N.Y. TIMES, July 21, 2012, at B1 (“UBS obtained a deferred prosecution

However, federal officials allowed UBS to avoid a criminal indictment once again by accepting yet another deferred prosecution arrangement (although DOJ did force UBS's Japanese subsidiary to plead guilty to criminal wire fraud and also indicted two former UBS traders).<sup>446</sup> Assistant Attorney General Lanny Breuer explained that DOJ "weighed the consequences to market confidence" in deciding not to prosecute UBS, a globally significant bank.<sup>447</sup> Mr. Breuer also stated—in terms virtually identical to what he had said about HSBC—that "[o]ur goal here is not to destroy a major financial institution."<sup>448</sup> Senator Charles Grassley (R-IA) criticized the DOJ's settlement, declaring that the "reluctance of U.S. prosecutors to file criminal charges over big-time bank fraud is frustrating and hard to understand."<sup>449</sup>

DOJ's decisions to forgo indictments against HSBC and UBS provide compelling evidence that federal officials are unwilling to impose criminal sanctions against global SIFIs. It is perhaps not a coincidence

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agreement in 2009 for conspiring to defraud the United States of tax revenue by creating more than 17,000 secret Swiss accounts for United States taxpayers who failed to declare income and committed tax fraud . . . UBS agreed to pay \$780 million in fines and penalties and disclose the identities of many of its United States clients."); U.S. Dept. of Justice, Press Release, UBS AG Admits to Anticompetitive Conduct by Former Employees in the Municipal Bond Investments Market and Agrees to Pay \$160 Million to Federal and State Agencies (May 4, 2011), *available at* <http://www.justice.gov/opa/pr/2011/May/11-at-567.html> (announcing that UBS entered into a non-prosecution agreement and agreed to pay \$160 million to settle charges that former UBS employees "entered into unlawful agreements to manipulate the bidding process and rig bids on municipal investment contracts").

446. Eaglesham & Perez, *supra* note 442; Fortado et al., *supra* note 441.

447. Jonathan Weil, *Let Justice Be Done, Though a Huge Bank Falls*, BLOOMBERG (Dec. 20, 2012), <http://www.bloomberg.com/news/2012-12-20/let-justice-be-done-though-a-huge-bank-falls.html> (paraphrasing Mr. Breuer's remarks to reporters).

448. *Id.* (quoting Mr. Breuer). In sharp contrast to its decision not to file criminal charges against UBS, DOJ imposed harsh criminal sanctions on a small Swiss private bank, Wegelin & Co., for engaging in tax evasion activities similar to UBS's misconduct. Two weeks after announcing its settlement of Libor-rigging charges against UBS, DOJ forced Wegelin to plead guilty to criminal conspiracy with U.S. clients to evade U.S. taxes. Wegelin's tax evasion work for U.S. clients was comparable to the misconduct that resulted in UBS's deferred prosecution agreement with DOJ on similar tax evasion charges in 2009. In addition to Wegelin's guilty plea, Wegelin paid fines and forfeitures totaling \$74 million, equal to almost one-tenth of the \$780 million penalty paid by UBS under its 2009 settlement. Bob Van Voris & David Voreacos, *Swiss Bank Wegelin & Co. Pleads Guilty in U.S. Tax Probe*, BLOOMBERG (Jan. 4, 2013), <http://www.bloomberg.com/news/2013-01-03/swiss-bank-wegelin-co-to-plead-guilty-in-u-s-tax-case.html>. Yet Wegelin, with \$25 billion of assets, *id.*, was only one-sixtieth the size of UBS, which had \$1.5 billion of assets at the end of 2011. Andrew Cunningham, *Annual Survey: World's Biggest Banks: The Big Get Bigger*, GLOBAL FIN. MAG., Oct. 2012, at 44. Like the stunningly disparate penalties assessed against HSBC and G&A Check Cashing for money laundering (*see supra* notes 434-40 and accompanying text), the strikingly different sanctions imposed on UBS and Wegelin for tax evasion show that DOJ has followed a much more lenient enforcement policy for TBTF banks.

449. Eaglesham & Perez, *supra* note 442 (quoting Sen. Grassley); *see also* Barofsky, *supra* note 433 (criticizing DOJ's settlement with UBS, and noting that "a significant amount of the illegal [Libor-rigging] activity took place at the parent company level" within UBS); Weil, *supra* note 447 ("The reality is UBS's punishment was anything but strict.").



that DOJ adopted new guidelines encouraging the use of deferred prosecution agreements, as a preferable alternative for dealing with serious misconduct at large corporations, during the summer of 2008, just as “the financial storm brewed . . . and [Wall Street] institutions feared for their survival.”<sup>450</sup> A major Wall Street law firm advised its clients that DOJ’s 2008 guidelines represented “an important step away from the more aggressive prosecutorial practices seen in some cases under their predecessors.”<sup>451</sup> Similarly, a former federal prosecutor recently remarked that large companies facing criminal charges “are happy to enter into these deferred prosecution agreements because it’s become so commonplace now . . . . The stock markets don’t even seem to punish them.”<sup>452</sup>

In defending the lack of criminal prosecutions against major banks and their top executives, federal prosecutors and SEC enforcement director Robert Khuzami asserted that such cases are difficult to prove and the SEC has only limited funding to pursue such cases. The validity of those assertions is impossible to evaluate in the absence of even a single prosecution of a major financial institution or its senior managers for misconduct during the financial crisis.<sup>453</sup> It is noteworthy, however, that federal prosecutors and SEC officials have sued more than 400 people and have won 70 criminal convictions for insider trading in the past few years, while devoting extensive resources to those cases.<sup>454</sup> A top SEC enforcement official recently described insider-trading investigations as “incredibly labor-intensive” efforts that require “doggedness, creative thinking, and meticulous analysis of the facts”<sup>455</sup>—a description that would apply equally well to complex financial fraud cases.

The prosecutorial fervor that the SEC and DOJ have shown in pursuing insider-trading cases is nowhere to be found when it comes to financial misconduct by Wall Street firms, which involved the sale of

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450. Morgenson & Story, *supra* note 418.

451. *Id.* (quoting memo to clients issued by Sullivan & Cromwell in Sept. 2008).

452. Douglas, *supra* note 415 (quoting Michael Clark).

453. John J. Curran & Jesse Hamilton, *Schapiro’s SEC Seen Ineffectual As Republicans Race to Scuttle Dodd–Frank*, BLOOMBERG (Mar. 31, 2011); Finkle, *supra* note 440; Joshua Gallo & Robert Schmidt, *Schapiro SEC Reign Nears End With Rescue Mission Not Done*, BLOOMBERG (Oct. 19, 2012); Taibbi, *supra* note 415.

454. William D. Cohan, *Is This Big Fish Worth Catching?*, BLOOMBERG BUSINESSWEEK, Dec. 3–10, 2012, at 6; David Voreacos, *Wall Street’s Insider Trading Tricks Spread Across U.S.*, BLOOMBERG (Dec. 21, 2012) (reporting that more than 400 people were sued by the SEC or prosecuted by DOJ for insider trading between 2009 and 2012, and describing the extensive personnel and other assets devoted by the SEC, DOJ and FBI to those cases).

455. Sheelah Kolhatkar, *The Dangling Man: On the Trail of SAC Capital’s Steven Cohen*, BLOOMBERG BUSINESSWEEK, Jan. 14–20, 2013, at 46, 51 (quoting Sanjay Wadhwa, senior associate director for enforcement in the SEC’s New York regional office).

hundreds of billions of dollars of toxic mortgage-backed securities and CDOs with inadequate or misleading disclosures.<sup>456</sup> After examining DOJ's lack of criminal prosecutions against large financial institutions and their senior officers, journalist Matt Taibbi concluded that "the shocking pattern of nonenforcement with regard to Wall Street is so deeply engrained in Washington that it raises a profound and difficult question about the very nature of our society: whether we have created a class of people whose misdeeds are no longer perceived as crimes, . . . [a] nonjailable class."<sup>457</sup> Similarly, Senator Sherrod Brown (D-OH) declared in January 2013 that "Wall Street megabanks aren't just too big to fail, they're increasingly too big to jail."<sup>458</sup> Two months later, as discussed below, Attorney General Eric Holder essentially conceded during a Senate committee hearing that DOJ viewed global SIFIs as too big to prosecute.<sup>459</sup>

*b. Ineffective Civil Enforcement Measures Against Large Banks and Their Senior Officers*

The federal government's record of civil enforcement against major

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456. Cohan, *supra* note 454; FCIC Report, *supra* note 36, at 169-70. Moreover, the SEC has shown much less appetite for pursuing insider trading cases in recent years when those cases involved major Wall Street firms or their executives. For example, in 2005 the SEC fired Gary Aguirre, an agency enforcement lawyer, after he complained that his superiors refused to allow him to depose John Mack for possible involvement in alleged insider trading by Pequot Capital Management, a large hedge fund. At that time, Mack was being considered for appointment as chairman of Morgan Stanley, and Morgan Stanley's outside counsel, Mary Jo White, contacted SEC enforcement director Linda Thomsen to discuss the SEC's investigation of Mack. Two Senate committees reviewed that incident and strongly criticized the SEC, stating that "[b]y allowing the perception that 'going over the head' of S.E.C. staff attorneys yields results, the S.E.C. undermines public confidence in the integrity of its investigations and exacerbates the problems associated with 'regulatory capture.'" Gretchen Morgenson & Walt Bogdanich, *S.E.C. Erred On Pequot, Report Says*, N.Y. TIMES, Aug. 4, 2007, at C1 (quoting joint report issued by the Senate Finance and Judiciary Committees); Taibbi, *supra* note 415 (discussing the circumstances surrounding Aguirre's firing by the SEC). The SEC subsequently paid Aguirre \$775,000 to settle his claim for wrongful termination. Phyllis Diamond, *SEC, Whistleblower Aguirre Settle Lawsuit Over His Termination for \$775K*, 42 SEC. REG. & L. REP. (BNA) 1283 (July 5, 2010). In addition, the SEC failed to take action after receiving information from Ted Parmigiani, a Lehman analyst, indicating that Lehman's research managers frequently gave advance tips to Lehman's proprietary trading desk and Lehman's hedge fund customers about upcoming changes in stock ratings by Lehman's analysts. After reviewing Mr. Parmigiani's evidence, Senator Charles Grassley (R-IA) declared that the SEC's failure to take action against Lehman or its managers raised "serious questions about the S.E.C.'s culture of deference to Wall Street and big players going back a long time." Gretchen Morgenson, *Is Insider Trading Part of the Fabric?*, N.Y. TIMES, May 20, 2012, § BU, at 1 (quoting Sen. Grassley).

457. Taibbi, *supra* note 415.

458. Jeff Bater, *Enforcement: Senators Question Justice Department's Handling of Wrongdoing by Big Banks*, 100 BNA'S BANKING REP. 244 (Feb. 5, 2013); *see also* Barofsky, *supra* note 433 (contending that DOJ has adopted a "two-tiered system of justice" that treats major global banks as "still too big to fail—and . . . still to big to jail").

459. *See infra* notes 716-20 and accompanying text (reviewing Mr. Holder's testimony).

institutions and their top executives has been only marginally better than the complete lack of criminal enforcement. The SEC has entered into several settlements with major banks in which the banks paid relatively modest penalties and neither admitted nor denied liability for the violations alleged by the SEC. As indicated above, Goldman, JPMorgan and Citigroup collectively agreed to pay about \$1 billion to settle civil fraud charges arising out of their marketing of three CDOs to investors.<sup>460</sup> However, the SEC did not attempt to hold Goldman and Citigroup accountable for marketing additional CDOs under similar circumstances nor did the SEC sue Deutsche, a major promoter of CDOs during the credit boom.<sup>461</sup>

The SEC entered into two similar consent judgments based on alleged securities disclosure violations by BofA and Citigroup. The SEC alleged that BofA's proxy statement soliciting shareholder approval for BofA's acquisition of Merrill in December 2008 did not disclose that (i) BofA had agreed "to let Merrill pay its executives and certain other employees \$5.8 billion in bonuses at a time when Merrill was suffering huge losses;" and (ii) "Merrill was suffering historically great losses during the fourth quarter of 2008 (ultimately amounting to a net loss of \$15.3 billion, the largest quarterly loss in the firm's history) and . . . Merrill had nonetheless accelerated the payment to certain executives and other employees of more than \$3.6 billion in bonuses."<sup>462</sup>

BofA agreed to pay \$150 million to settle the SEC's charges after District Judge Jed Rakoff refused to approve the \$33 million fine originally proposed by the SEC.<sup>463</sup> Judge Rakoff described the revised \$150 million fine as "paltry," and he also observed that the fine "penalizes the shareholders for what was, in effect if not in intent, a

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460. See *supra* notes 279–80 and accompanying text.

461. Ben Hallman, *Federal Investigators Punt on Goldman Sachs Prosecutions*, HUFFINGTONPOST.COM (Aug. 10, 2012), [http://www.huffingtonpost.com/2012/08/10/investigation-goldman-sachs\\_n\\_1765368.html](http://www.huffingtonpost.com/2012/08/10/investigation-goldman-sachs_n_1765368.html); see also Yves Smith, *Why Robert Khuzami Would Be a Terrible Choice to Head the SEC* (Nov. 29, 2012), <http://www.economonitor.com/blog/2012/11/why-robert-khuzami-would-be-a-terrible-choice-to-head-the-sec/> (noting that SEC General Counsel Robert Khuzami was General Counsel for the Americas for Deutsche from 2004 to 2009, when Deutsche was actively engaged in packaging and marketing CDOs, and asserting that "Khuzami simply can't afford to dig too deeply in this toxic terrain; questions would be correctly raised as to why Deutsche was not being scrutinized similarly."); FCIC Report, *supra* note 36, at 129–33, 137–46, 192–99, 235–38, 256 (discussing major roles of Goldman and Citigroup in creating and marketing CDOs); U.S. Senate, Permanent Subcommittee on Investigations, *Wall Street and The Financial Crisis: Anatomy of a Financial Collapse: Majority and Minority Staff Report* 7–11, 318–625 (April 13, 2011), available at [http://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI\\_WallStreetCrisis\\_041311.pdf](http://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf) [hereinafter *Senate Wall Street Crisis Report*] (describing leading roles of Goldman and Deutsche in creating and marketing CDOs).

462. SEC v. Bank of America Corp., 2010 WL 624581, at 1 (S.D.N.Y. Feb. 22, 2010) (summarizing the SEC's charges against BofA).

463. *Id.* at 4.

fraud by management on the shareholders.”<sup>464</sup> Judge Rakoff further criticized the consent judgment because it did not impose any sanctions on “the specific individuals responsible for [BofA’s] nondisclosures,” but he reluctantly approved the settlement while calling it “half-baked justice at best.”<sup>465</sup>

Similarly, the SEC alleged that Citigroup misled investors on several occasions between July and November 2007 by stating that its exposure to subprime mortgage-related securities was \$13 billion or less when in fact its exposure exceeded \$50 billion. Citigroup agreed to pay \$75 million to settle the SEC’s charges.<sup>466</sup> The SEC also charged former Citigroup chief financial officer (CFO) Gary Crittenden and former Citigroup head of investor relations Arthur Tildesley with participating in Citigroup’s disclosure violations. Like Citigroup, Crittenden and Tildesley entered into consent judgments (without admitting or denying liability), and Crittenden paid \$100,000 while Tildesley paid \$80,000.<sup>467</sup>

As Judge Rakoff had done with regard to the BofA settlement, journalist Andrew Ross Sorkin criticized the Citigroup consent judgment for requiring Citigroup’s shareholders to bear the cost of a corporate penalty even though they “were arguably defrauded by [Citigroup’s] failure to disclose its exposure to subprime mortgages in the first place.”<sup>468</sup> Mr. Sorkin also pointed out that the \$100,000 fine paid by Mr. Crittenden paled in comparison with the \$32 million of compensation he received “during 2007 and 2008, even as [Citigroup] was foundering.”<sup>469</sup> Mr. Sorkin questioned the fairness of “a system that is supposed to hold the financial industry accountable and instead seems

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464. *Id.* at 4, 5. In contrast to the SEC’s decision not to sue any of BofA’s senior officers, Judge Rakoff noted that New York Attorney General Andrew Cuomo filed civil charges under New York law against BofA’s former chief executive officer, Kenneth Lewis, and its former chief financial officer, Joseph Price, “accusing them of masterminding a massive fraud and manipulation.” *Id.* at 2. In September 2012, BofA paid \$2.43 billion to settle a shareholder suit based on the same alleged proxy disclosure violations, while New York’s charges against Lewis and Price remained outstanding. Jessica Silver-Greenberg & Susanne Craig, *Bank of America Settles Suit Over Merrill for \$2.43 Billion*, N.Y. TIMES, Sept. 28, 2012, at A1.

465. *Bank of America Corp.*, 2010 WL 624581 at 5; *see also id.* at 6 (stating that the Court would have rejected the settlement as “inadequate and misguided” if it had reviewed the agreement “solely on the merits,” but the Court felt obliged to accept the settlement based on considerations of “substantial deference” and “judicial restraint”).

466. SEC *Litigation Release No. 21605*, July 29, 2010, available at <http://www.sec.gov/litigation/litreleases/2010/lr21605.htm>.

467. SEC *Administrative Release No. 34-62593*, July 29, 2010, available at <http://www.sec.gov/litigation/admin/2010/34-62593.pdf>.

468. Andrew Ross Sorkin, *Punishing Citi, or Its Shareholders?*, N.Y. TIMES, Aug. 3, 2010, at B1.

469. *Id.* In August 2012, Citigroup paid \$590 million to settle a shareholder suit based on the same alleged disclosure violations. Jessica Silver-Greenberg, *Citigroup in \$590 Million Settlement of Subprime Lawsuit*, N.Y. TIMES, Aug. 30, 2012, at B4.

to leave shareholders with the bill.”<sup>470</sup> In John Coffee’s view, the SEC’s enforcement actions against major banks indicated that the agency was following a deliberate policy of seeking “quick, publicity-generating settlements” from banks while forgoing “individual actions against executives who would be unlikely to settle.”<sup>471</sup>

In 2011 and 2012, federal and state officials filed civil cases against major banks alleging that the banks committed fraud while selling mortgage loans and mortgage-backed securities to Fannie Mae, Freddie Mac and federal agencies. Those cases have produced additional settlements requiring payments by banks, but they have not resulted in the assessment of penalties against any senior executives of those banks.<sup>472</sup> It is doubtful whether sanctions imposed on banks are effective in deterring future misconduct by their senior executives, because executives are likely to conclude that they can keep most of their personal gains from financial fraud even if their companies are ultimately forced to pay fines.<sup>473</sup>

Federal agencies did file civil lawsuits against top executives of Countrywide and WaMu, two of the largest and most aggressive nonprime lenders during the housing boom.<sup>474</sup> However, both cases demonstrate that federal regulators have not acted forcefully in pursuing charges of serious misconduct against senior managers of major banks.

In 2009 the SEC filed a civil suit for securities fraud against former Countrywide chairman Angelo Mozilo, former Countrywide president

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470. *Id.*

471. Coffee, *supra* note 415 (explaining that the SEC “knows that suits against senior executives will often drag on [and] consume considerable resources” while “major financial institutions almost always settle with the SEC at an early point . . . to avoid reputational damage”); see also Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 654 (2007) (“It is easier to get a board of directors to accept a penalty against the company than it is to get individuals to agree to painful personal sanctions . . . [C]ompany sanctions are the path of least resistance; the SEC can claim its victory” by settling with the company and forgoing individual claims against executives).

472. Rick Rothacker & Tanya Agrawal, *BofA Reaches \$11.6 Billion Settlement with Fannie Mae*, REUTERS (Jan. 7, 2013), <http://www.foxbusiness.com/news/2013/01/07/bofa-reaches-116-billion-settlement-with-fannie-mae/>; Jessica Silver-Greenberg, *Mortgage Crisis Presents a New Reckoning to Banks*, N.Y. TIMES, Dec. 10, 2012, at A1; David McLaughlin, *JPMorgan Rivals Face Billions in Damages After MBS Case*, BLOOMBERG (Oct. 3, 2012), <http://www.bloomberg.com/news/2012-10-02/jpmorgan-rivals-face-billions-in-damages-after-mbs-case.html>; see also Ben Protess, *U.S. Accuses Bank of America of a ‘Brazen’ Mortgage Fraud*, N.Y. TIMES, Oct. 25, 2012, at A1 (reporting that “[f]ew cases have taken aim at top executives” and “in the latest [civil] case [filed by federal prosecutors] against Bank of America, no company officials were sued as part of the complaint.”).

473. See Langevoort, *supra* note 471, at 632, 635–36, 660–61 (questioning the effectiveness of corporate penalties in deterring wrongdoing by senior officers).

474. See ENGEL & MCCOY, *supra* note 19, at 178–79, 200–02 (describing the reckless lending strategies pursued by WaMu and Countrywide).

David Sambol, and former Countrywide CFO Eric Sieracki.<sup>475</sup> Mozilo caused Countrywide to become the largest U.S. mortgage lender in 2005 and 2006 by aggressively expanding the firm's menu of mortgage products to include high-risk subprime and "Pay-Option ARM" mortgage loans.<sup>476</sup> During the same period, Mozilo and Sieracki signed Countrywide's annual reports to shareholders, which stated that Countrywide's mortgage lending policies "ensure our ongoing access to the secondary mortgage market by consistently producing quality mortgages."<sup>477</sup> Moreover, at an investor conference in May 2006 Mozilo declared that "Countrywide views the [Pay-Option ARM] product as a sound investment for our Bank and a sound financial management tool for customers."<sup>478</sup>

While giving these public assurances, Mozilo acknowledged in internal email messages to Countrywide managers that Countrywide's subprime loans were "dangerous" and "toxic" and that Countrywide was "flying blind" with respect to the risks posed by its Pay-Option ARMs.<sup>479</sup> In 2006 and early 2007, Mozilo exercised stock options and executed trading plans to sell almost 7 million shares of Countrywide stock, from which he realized trading profits of \$140 million.<sup>480</sup>

After Countrywide suffered crippling losses due to its large exposure

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475. SEC v. Mozilo, 2009 WL 3807124 (C.D. Cal., Nov. 3, 2009), at 1–2 [hereinafter *Mozilo I*] (summarizing the SEC's claims against Mozilo, Sambol, and Sieracki).

476. *Id.* at 2–3. For example, Countrywide offered an "80/20" piggyback subprime mortgage program that enabled borrowers to finance 100% of the purchase price for their homes by taking out simultaneous first and second lien subprime loans (which typically covered 80% and 20% of the purchase price, respectively). Countrywide's "Pay-Option ARM" loans allowed borrowers to make very low minimum payments on their mortgages, which resulted in negative amortization until the principal balance (including unpaid interest) reached 115% of the original principal amount, at which point the borrowers would be required to make much larger payments for the remainder of the loan term. Countrywide also originated many subprime or Pay-Option ARM loans with little or no documentation of the borrowers' income or net worth. *Id.* at 2–6.

477. SEC v. Mozilo, 2010 WL 3656068 (C.D. Cal., Sept. 16, 2010), at 10 [hereinafter *Mozilo II*] (quoting from Countrywide's 2005 Form 10-K annual report and stating that "[a] nearly identical representation appears in Countrywide's 2006 Form 10-K").

478. *Id.* at 12 (quoting Mozilo's remark during an investor conference on May 31, 2006).

479. In a Mar. 2006 internal email, Mozilo acknowledged that Countrywide's 80/20 subprime mortgage was "the most dangerous product in existence and there can be nothing more toxic," and in an April 2006 internal e-mail he stated, "I consider that product line to be the poison of [our business]." *Id.* at 17 (quoting emails sent by Mozilo on Mar. 27 and April 13, 2006). In a September 2006 internal email, Mozilo admitted that "[w]e have no way, with any reasonable certainty, to assess the real risk of holding [Pay-Option] loans on our balance sheet . . . [W]e are flying blind on how these loans will perform in a stressed environment of higher unemployment, reduced values and slowing home sales." *Id.* at 13 (quoting Sept. 26, 2006 email).

480. *Id.* at 20. The SEC alleged that Mozilo violated SEC Rule 10b-5 by engaging in insider trading while in possession of material, nonpublic information. *Id.* Countrywide president Sambol exercised Countrywide stock options and sold the underlying shares for total profits of \$40 million from 2005 through 2007. *Mozilo I*, *supra* note 475, at 1. However, the SEC did not sue Sambol for unlawful insider trading.

to high-risk loans, Mozilo arranged an emergency sale of Countrywide to BofA in early 2008.<sup>481</sup> The Countrywide deal later inflicted huge losses on BofA and was a significant factor (along with BofA's subsequent acquisition of Merrill Lynch) in compelling BofA to seek a costly federal bailout during the peak of the financial crisis.<sup>482</sup>

The SEC sought civil penalties and disgorgement from Mozilo, Sambol and Sieracki. A federal district court denied motions to dismiss and motions for summary judgment by the defendants.<sup>483</sup> Despite its success on those motions, the SEC entered into a settlement with Mozilo in which he did not admit or deny liability but agreed to pay \$67.5 million in penalties and disgorgement and to be permanently barred from serving as a public company officer or director.<sup>484</sup> Mozilo personally paid only \$22.5 million of that settlement, while Countrywide's insurance carriers and BofA paid the remaining \$45 million. As a result, Mozilo was allowed to keep about \$500 million of the compensation he received from Countrywide between 2000 and 2008.<sup>485</sup> Sambol and Sieracki also settled the SEC's charges while making combined out-of-pocket payments of only \$650,000.<sup>486</sup>

The FDIC's civil action against WaMu chairman Kerry Killinger

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481. Gretchen Morgenson, *How Countrywide Covered the Cracks*, N.Y. TIMES, Oct. 17, 2010, § BU, at 1; Valerie Bauerlein & James R. Hagerty, *Behind Bank of America's Big Gamble*, WALL ST. J., Jan. 12, 2008, at A1.

482. Paul M. Barrett & Dawn Kopecki, *Can Brian Moynihan Save Bank of America?*, BLOOMBERG BUSINESSWEEK, Sept. 12–18, 2011, at 60, 62–64; Steve Mufson, *A Fateful Step for a Banking Giant*, WASH. POST, Dec. 5, 2010, at G1; *see also* Jessica Silver-Greenberg & Susanne Craig, *Bank of America Settles Suit Over Merrill for \$2.43 Billion*, N.Y. TIMES, Sept. 29, 2012, at A1 (reporting that BofA's \$2.43 billion settlement of a shareholder suit “underscores how two deals in 2008—the Merrill acquisition and the purchase of [Countrywide] earlier that year—have weighed on the bank,” with the Countrywide deal costing BofA “more than \$40 billion in losses on real estate, legal costs and settlements”).

483. *Mozilo I*, *supra* note 475; *Mozilo II*, *supra* note 477. The district court did grant Mozilo's and Sieracki's motion for partial summary judgment with respect to the SEC's claim that they violated SEC Rule 13a-14 by certifying Countrywide's false and misleading public securities filings. *See Mozilo II*, *supra* note 477, at 21 (holding that “a false Sarbanes–Oxley certification does not state an independent violation of the securities laws”).

484. *Antifraud: Countrywide's Mozilo Agrees to Pay Record \$22.5M Fine to Settle SEC Charges*, 42 SECURITIES REGULATION & L. REP. (BNA) 2015 (Oct. 25, 2010); *see also* Gretchen Morgenson, *Lending Magnate Settles Charges For \$67 Million*, N.Y. TIMES, Oct. 16, 2010, at A1 (noting that “Mr. Mozilo and his colleagues neither admitted nor denied the government's charges” in their settlement with the SEC).

485. Michael Hiltzik, *Getting Tough on Crimes by Firms*, L.A. TIMES, Jan. 6, 2013, at B1 (reporting that “\$45 million [of Mozilo's settlement] was covered by insurance companies and Countrywide's new owner, Bank of America”); Morgenson, *supra* note 484 (reporting Mozilo received \$521.5 million of compensation from Countrywide between 2000 and 2008).

486. Morgenson, *supra* note 484 (reporting that Sambol agreed to a lifetime ban on serving as a public company officer or director and to pay \$5 million in disgorgement and a \$520,000 million penalty, but also explaining that “Countrywide is paying for all of Mr. Sambol's disgorged funds,” while Sieracki agreed to pay only a \$130,000 penalty).

produced similarly unimpressive results. As Mozilo did with Countrywide, Killinger caused WaMu to aggressively expand its offerings of pay-option ARM, subprime and home equity loans. Killinger initiated this high-risk strategy in mid-2004, declaring that he wanted to increase WaMu's assets "by at least 10% per year" while achieving "average ROE [return on equity] of at least 18% and average EPS [earnings per share] growth of at least 13%."<sup>487</sup> Killinger proclaimed that "[i]t is important that [WaMu] focus on growth initiatives and risk taking. Above average creation of shareholder value requires significant risk taking."<sup>488</sup>

Killinger pursued his high-risk strategy even though he acknowledged in June 2005 that the U.S. was experiencing a "speculative" housing boom:

We are currently experiencing the most speculative housing market we have seen in many decades . . . . Whatever the exact outcome, it is highly likely that housing will not be a stimulant to the economy and could easily become a significant drag on consumer confidence and consumer spending.<sup>489</sup>

In mid-2006 Killinger further admitted that "[t]he housing market is now showing signs of slowing" and "[w]e expect the housing market to be weak for quite some time as we unwind the speculative bubble . . . . A collapse of the housing market would significantly increase our credit costs."<sup>490</sup> Nevertheless, Killinger continued to press forward with WaMu's high-risk lending strategy.<sup>491</sup> By the time WaMu collapsed in September 2008—thereby becoming the largest bank failure in U.S. history—WaMu had reported huge losses and held more than \$100

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487. Complaint ¶ 22, *FDIC v. Killinger et al.*, 2011 WL 910099 (W.D. Wash. Mar. 16, 2011) [hereinafter *FDIC WaMu Complaint*] (quoting Killinger's June 2004 Strategic Direction memorandum).

488. *Id.* ¶ 25 (quoting Killinger's June 2004 Strategic Direction memorandum).

489. *Id.* ¶ 40 (quoting Killinger's June 1, 2005 Strategic Direction memorandum). Similarly, in March 2005 Killinger told WaMu's chief risk officer, "I have never seen such a high risk housing market as market after market thinks they are unique and for whatever reason are not likely to experience price declines. This typically signifies a bubble." *Id.* ¶ 41 (quoting Mar. 2005 email from Killinger).

490. *Id.* ¶ 53 (quoting Killinger's June 12, 2006 Strategic Direction memorandum).

491. In mid-2007, Killinger conceded that the "bursting of the housing bubble" that he had predicted for two years "has now turned into a reality." *Id.* ¶ 64 (quoting Killinger's June 18, 2007 Strategic Direction memorandum). Even so, in August 2007, Killinger told the *American Banker* that WaMu would continue to expand its "non-conforming hybrid adjustable-rate mortgages, payment-option ARMs, multifamily loans, and home equity loans." The following month, he told the *Seattle Times* that, despite the ongoing decline in the U.S. housing market, "this, frankly, may be one of the best times I've ever seen for taking on new loans into our portfolio." *Id.* ¶ 71 (quoting from Killinger's newspaper interviews). Large percentages of WaMu's loans were concentrated in California, Florida and other states with speculative housing markets, and many of WaMu's loans contained additional high-risk features like "no or low documentation and high loan-to-value ('LTV') and debt-to-income ('DTI') ratios." *Id.* ¶¶ 143 (quote), 157–62.



billion of high-risk pay-option ARM and home equity loans on its balance sheet.<sup>492</sup>

The FDIC alleged that Killinger—along with WaMu’s former chief operating officer Stephen Rotella and former home loans president David Schneider—caused WaMu “to take extreme and historically unprecedented risks . . . . They focused on short term gains to increase their own compensation, with reckless disregard for WaMu’s longer term safety and soundness.”<sup>493</sup> Nevertheless, the FDIC agreed to a settlement in which Killinger paid just \$275,000 in cash and surrendered \$7.5 million of dubious claims for retirement benefits against WaMu’s bankrupt parent holding company.<sup>494</sup> The FDIC obtained similar settlements (including modest cash payments) from Rotella and Schneider.<sup>495</sup>

In view of WaMu’s payment of \$88 million of compensation to Killinger between 2001 and 2007, the FDIC’s settlement was viewed as “a pittance” by journalist Gretchen Morgenson<sup>496</sup> and as “[p]retty soft” by Senator Carl Levin (D-MI).<sup>497</sup> Moreover, despite strong evidence that Mozilo, Killinger and other top executives of Countrywide and WaMu consciously pursued reckless lending strategies that inflicted

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492. *Id.* ¶¶ 2–11, 137, 142, 150, 178.

493. *Id.* ¶ 1 (summarizing FDIC’s claims against Killinger, Rotella and Schneider). From 2005 through 2008, while WaMu pursued its high-risk lending strategy, Killinger received \$65.9 million in compensation, while Rotella and Schneider received \$23.4 million and \$5.9 million, respectively. *Id.* ¶¶ 14–16. The FDIC, as receiver for WaMu, sued the three defendants under 12 U.S.C. § 1821(k) for gross negligence, ordinary negligence and breach of fiduciary duty. *Id.* ¶¶ 12, 181–95. The FDIC allegations included claims that Killinger, Rotella and Schneider ignored repeated warnings in 2005 and 2006 from WaMu’s risk managers that WaMu’s high-risk lending strategy exposed the bank to a high probability of disastrous losses if housing markets weakened and housing prices began to decline. *Id.* ¶¶ 26–58, 119–35; *see also* KIRSTEN GRIND, *THE LOST BANK: THE STORY OF WASHINGTON MUTUAL—THE BIGGEST BANK FAILURE IN AMERICAN HISTORY* 123–24, 133–35, 149–54, 161–63 (2012) (describing how Killinger disregarded numerous warnings from colleagues about the dangers of WaMu’s high-risk lending strategy).

494. Gretchen Morgenson, *Slapped Wrists at WaMu*, N.Y. TIMES, Dec. 18, 2011, § BU, at 1.

495. Rotella paid \$100,000 and gave up a doubtful bankruptcy claim against WaMu’s parent holding company for \$11.5 million in compensation, while Schneider paid \$50,000 and surrendered a similar bankruptcy claim for \$5.8 million in compensation. The FDIC also received \$39.6 million from WaMu’s insurance carriers and \$125 million from the bankruptcy estate of WaMu’s parent company. *See id.*; *FDIC Announces Settlement with Washington Mutual Directors and Officers* (Dec. 15, 2011) (including *Settlement Summary—Fact Sheet*) [hereinafter *FDIC WaMu Press Release*], available at <http://www.fdic.gov/news/news/press/2011/pr11192.html>. Thus, as was true for the SEC’s settlements with BofA and Citigroup (*see supra* notes 462–70 and accompanying text), most of the payments received by the FDIC in the WaMu case were extracted from the shareholders and creditors of WaMu’s parent company, not from the senior executives responsible for WaMu’s failure.

496. Morgenson, *supra* note 494.

497. *Id.* (quoting Sen. Levin, and noting that his “dismay over the settlement probably arises from his deep knowledge of WaMu and its practices” as a result of the extensive investigation of WaMu by the Senate Permanent Subcommittee on Investigations, which he chaired); *see also Senate Wall Street Crisis Report*, *supra* note 461, at 48–242 (presenting results of the investigation of WaMu’s collapse by Sen. Levin’s subcommittee).

enormous harm on the banking industry and financial markets, federal prosecutors decided not to bring criminal charges against any of those individuals.<sup>498</sup>

The settlements described above with eight senior executives of Citigroup, Countrywide and WaMu exhibit a disturbing pattern. All eight officers avoided any admission of personal wrongdoing and escaped further civil or criminal liability while paying amounts that were a tiny fraction of the compensation they received.<sup>499</sup> Even more disturbing is the fact that those settlements evidently represent the *only* public enforcement actions brought by federal authorities against senior managers of major banks.

Perhaps most remarkably, federal officials have not brought any criminal charges—and have filed only a “handful” of civil claims—against senior officers of financial companies for falsely certifying their companies’ public reports.<sup>500</sup> Sections 302 and 906 of the Sarbanes-Oxley Act impose civil and criminal penalties on senior officers for false certifications of annual and quarterly reports.<sup>501</sup> Sections 302 and 906 were key components of the Sarbanes-Oxley Act’s effort to hold corporate executives accountable by ensuring that “their actions will be scrutinized, with the threat of real penalties for violations of their legal responsibilities.”<sup>502</sup>

The SEC adopted Rule 13a-14 to implement the civil-liability

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498. Hiltzik, *supra* note 485; Morgenson, *supra* note 484; Morgenson, *supra* note 494. Peter S. Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1.

499. *See supra* notes 466–69, 484–86, 493–98 (describing the SEC’s settlements with Citigroup and Countrywide executives and the FDIC’s settlement with WaMu officers, and noting the lack of any admission of liability and the relatively small penalties paid by those individuals in comparison with their highly lucrative compensation). In settling with WaMu’s executives, the FDIC agreed not to bring any enforcement actions against them or to make any “disparaging comments” about them. *FDIC WaMu Press Release (Settlement Summary, Part II)*, *supra* note 495.

500. Michael Rapoport, *Global Finance: Law’s Big Weapon Sits Idle—Sarbanes-Oxley’s Jail-Time Threat Hasn’t Been Applied in Crisis-Related Cases*, WALL ST. J., July 30, 2012, at C3 (reporting that federal prosecutors “haven’t brought any criminal cases for false certification related to the crisis” while “[t]he SEC says it has brought civil false-certification charges against . . . executives at companies involved in the crisis like Fannie Mae, Freddie Mac and Countrywide”).

501. Joris M. Hogan, *The Enron Legacy: Corporate Governance Requirements for a New Era*, 31 SEC. REG. LAW J. 142, 143–44 (2003) (discussing Section 302 of the Sarbanes Oxley Act and SEC Rule 13a-14).

502. 148 CONG. REC. E1451 (daily ed. July 25, 2002) (extension of remarks) (statement by Rep. Sununu); *see also* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 955–56 (2003) (explaining that Sections 302 and 906 potentially provide “the sharpest governance teeth” in Sarbanes-Oxley because they “prevent CEOs and CFOs from hiding behind the defense of ignorance”); Allison List, *The Lax Enforcement of Section 304 of Sarbanes-Oxley: Why is the SEC Ignoring Its Greatest Asset in the Fight Against Corporate Misconduct*, 70 OHIO ST. L.J. 195, 198–99 (2009) (explaining that Sections 302 and 906 are intended to protect investors by “attaching liability to company executives responsible for financial disclosure”).

provisions of Section 302.<sup>503</sup> However, the SEC filed civil claims against bank officers for violating Rule 13a-14 in only two cases: the SEC's lawsuit against Angelo Mozilo and Eric Sieracki of Countrywide and a similar suit against Alan Levan, chairman of BankAtlantic (a relatively small Florida bank).<sup>504</sup> Notably, the SEC has not brought enforcement actions under Rule 13a-14 "against executives from any of the major banks suspected of misleading the public about their finances during the crisis," despite evidence indicating that senior executives of Bear, Citigroup and Lehman certified public reports containing material misstatements.<sup>505</sup>

The SEC did file civil suits including Rule 13a-14 claims against Daniel Mudd and Richard Syron, the former CEOs of Fannie Mae and Freddie Mac. The SEC's complaints alleged that Mudd and Syron signed public disclosure documents that materially understated the exposures of the GSEs to subprime and Alt-A mortgages. The SEC's

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503. Certification of Disclosure in Companies' Quarterly and Annual Reports, 67 Fed. Reg. 57,276 (Sept. 9, 2002).

504. See *supra* note 483 (discussing the SEC's claims under Rule 13a-14 against Mozilo and Sieracki for falsely certifying Countrywide's public reports); SEC v. BankAtlantic Bancorp, Inc., 2012 WL 1936112 (S.D. Fla. May 29, 2012) (discussing the SEC's claim under Rule 13a-14 against Alan Levan for falsely certifying BankAtlantic's public reports); see also Rachel Witkowski, *SEC Files Lawsuit Alleging Fraud at BankAtlantic*, AM. BANKER (Jan. 19, 2012) [http://www.americanbanker.com/issues/177\\_12/bankatlantic-fraud-lawsuit-1045848-1.html](http://www.americanbanker.com/issues/177_12/bankatlantic-fraud-lawsuit-1045848-1.html) (reporting that BankAtlantic had \$3.7 billion of assets). A federal district court dismissed the SEC's claims under Rule 13a-14 against Mozilo and Sieracki, concluding that "a false Sarbanes-Oxley certification does not state an independent violation of the securities laws." *Mozilo II*, *supra* note 477, at 21. However, another federal district court upheld the validity of the SEC's claim under Rule 13a-14 against Levan in the *BankAtlantic* case, and most other recent decisions have similarly concluded that the SEC has authority to bring civil enforcement actions for violations of Rule 13a-14. *BankAtlantic*, 2012 WL 1936112 *supra*, at 23 & n.5; see also, e.g., SEC v. Brown, 878 F. Supp. 2d 109, 118 & n.4 (D.D.C. July 19, 2012) (reviewing relevant decisions).

505. Rapoport, *supra* note 500 (reporting that former chairman James Cayne and other Bear executives paid \$275 million to settle shareholder litigation that included "allegations that Mr. Cayne falsely certified Bear's financial reports," while a report by Lehman's bankruptcy examiner concluded "there was enough evidence to support claims that Richard Fuld failed to ensure the firm's quarterly reports were accurate"); see also William D. Cohan, *Obama Keeps the SEC in Pocket of Wall Street*, BLOOMBERG (Dec. 2, 2012), <http://www.bloomberg.com/news/2012-12-02/sec-trades-one-wall-street-lapdog-for-another.html> (criticizing the SEC for not filing an enforcement action against Fuld "despite the solid evidence of indictable offenses itemized in the post mortem done on [Lehman] by court-appointed examiner Anton Valukas"); William D. Cohan, *Why Does the SEC Protect Banks' Dirty Secrets?*, BLOOMBERG (Oct. 28, 2012), <http://www.bloomberg.com/news/2012-10-28/why-does-the-sec-protect-banks-dirty-secrets-.html> (criticizing the SEC for ignoring whistleblower claims filed by former Citigroup executive Richard Bowen, including the fact that Bowen sent an "urgent" email message in November 2007 to Citigroup CFO Gary Crittenden and Robert Rubin, chairman of Citigroup's executive committee, warning them about "breakdowns in internal controls and resulting significant but possibly unrecognized financial losses existing within our organization"); Taibbi, *supra* note 415 (criticizing the SEC for ignoring whistleblower complaints filed by Oliver Budde, a former Lehman attorney, in which Budde alleged that Lehman significantly understated Fuld's compensation in Lehman's public disclosure reports).

Rule 13a-14 claims survived motions to dismiss and are still pending.<sup>506</sup> Given the SEC's success to date in pursuing Rule 13a-14 claims against Mudd and Syron, the agency's decision not to file similar claims against senior executives of big Wall Street firms is more than puzzling

Unfortunately, the SEC's decision to forgo Rule 13a-14 claims against top Wall Street officials is consistent with the preferential treatment given by the SEC to big Wall Street firms and their officials who were accused of misconduct prior to the financial crisis. A recent study of SEC enforcement actions in 1998 and from 2005 through early 2007 concluded that the SEC gave significantly more favorable treatment to big broker-dealers and their staff compared to small broker-dealers and their employees.<sup>507</sup> The SEC's preferential treatment was manifested in three ways: (i) "SEC actions against big firms were more likely to involve corporate liability exclusively, with no individuals subject to any regulatory action," (ii) "big-firm defendants were more likely to end up in administrative rather than court proceedings, controlling for types of violation and levels of harm to investors," and (iii) "within administrative proceedings, big-firm employees were more likely to receive lower sanctions."<sup>508</sup>

The shocking inadequacy of federal enforcement efforts against major banks was vividly illustrated at a Senate committee hearing in February 2013. During that hearing, Senator Elizabeth Warren (D-MA) asked seven federal financial regulators to specify "the last few times you've taken the biggest financial institutions all the way to trial."<sup>509</sup> She observed that if major banks "can break the law and drag in billions in profits, and then turn around and settle, paying out of those profits, they don't have much incentive to follow the law."<sup>510</sup> After the seven regulators failed to cite even one instance in which they had taken a major bank to trial, Senator Warren responded, "I'm really concerned

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506. SEC v. Mudd, 885 F. Supp. 2d 654, 657-67 (S.D.N.Y. 2012); SEC v. Syron, 2013 WL 1285572, at \*3-\*18 (S.D.N.Y. Mar. 28, 2013).

507. Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAWYER 679, 692-94 (2012) (describing SEC enforcement actions included in the study, and explaining that proceedings from 1998 were included in the study "to allow for variation in SEC enforcement policies under Democratic and Republican administrations").

508. *Id.* at 679 (abstract); *see also id.* at 728 (restating same conclusions).

509. David Uberti, *Warren Rips Deals with Big Banks*, BOS. GLOBE (Feb. 15, 2013), <http://www.bostonglobe.com/news/nation/2013/02/14/senator-elizabeth-warren-grills-regulators-ending-quiet-first-month-office/rWy4b0VnwoFozpkQhZ8mGM/story.html> (quoting Sen. Warren's remarks during a Senate Banking Committee hearing on Feb. 14, 2013); *see also* Victoria Finkle, *Warren Takes Center Stage in Grilling Regulators on Bank Prosecutions*, AM. BANKER (Feb. 15, 2013), [http://www.americanbanker.com/issues/178\\_32/warren-takes-center-stage-in-grilling-regulators-on-bank-prosecutions-1056811-1.html](http://www.americanbanker.com/issues/178_32/warren-takes-center-stage-in-grilling-regulators-on-bank-prosecutions-1056811-1.html) (reporting on Sen. Warren's statements to regulators during the hearing).

510. Finkle, *supra* note 509 (quoting Sen. Warren).

that ‘too big to fail’ has become ‘too big for trial.’ That just seems wrong to me.”<sup>511</sup>

*B. Large Financial Institutions Have Used Regulatory Arbitrage and Capture to Undermine Supervisory Restrictions on Their Activities*

Large financial institutions have skillfully employed arbitrage and capture techniques to weaken the effectiveness of regulation. Both before and during the financial crisis, leading banks exploited flawed incentives and governance structures in regulatory agencies to encourage regulators to cater to their interests. The financial industry also took advantage of “cultural capture”—fostered in part by the “revolving door” between industry and government service—to persuade regulators to adopt policies consistent with the industry’s preferences.

1. Competition Among Domestic and Foreign Regulators Has Encouraged Regulatory Arbitrage

Financial regulators competed aggressively during the 1990s and 2000s, both within and across national borders, to attract and retain the allegiance of major financial institutions. Regulatory competition—which the financial industry actively promoted—pushed agencies to adopt policies that would please their existing constituents and attract new ones. The result was regulatory arbitrage, in both domestic and global arenas, which undermined the ability and willingness of regulators to apply rigorous supervisory policies.

*a. Domestic Competition for Regulatory Charters*

During the 1990s and 2000s, the OCC and OTS actively competed for charters by issuing rulings that aggressively preempted state consumer protection laws. The OCC’s and OTS’s preemption rulings induced many large state-chartered institutions to convert into national banks or federal thrifts.<sup>512</sup> Similarly, the FRB, OCC and OTS sought to persuade

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511. *Id.* (quoting Sen. Warren, and noting that her statements triggered “an unusual smattering of applause from the audience at the hearing”).

512. *See supra* notes 251–55 and accompanying text (discussing preemption initiatives by OCC and OTS); BAIR, *supra* note 290, at 51 (explaining that “by expanding the scope of state preemption, the OCC hoped that large, state-regulated banks such as JPMorgan Chase would ‘flip’ their charters and become national banks,” and after the OCC issued sweeping preemption rules in 2004, “JPMorgan Chase switched from being chartered by New York State to being OCC-regulated”); BETHANY MCLEAN & JOE NOCERA, *ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS* 147 (2010) (describing how preemption became a “recruiting tool” that the OCC and OTS used “to expand

leading financial institutions to operate within their respective jurisdictions by approving new activities and reducing regulatory requirements.<sup>513</sup> In one particularly egregious example of regulatory competition, OTS persuaded Countrywide to convert from a national bank to a federal thrift in early 2007 by promising to give Countrywide and its parent holding company more lenient supervisory treatment than they were receiving at that time from the OCC and FRB.<sup>514</sup>

The OTS attracted the most severe criticism from Congress for its regulatory lapses, and Congress decided to abolish OTS when it passed Dodd–Frank.<sup>515</sup> Congressional and Treasury investigators rebuked OTS for lax and ineffective regulation that contributed to the collapse of WaMu and three other large thrifts (IndyMac, Downey Federal and BankUnited).<sup>516</sup> Investigators also condemned OTS for allowing IndyMac and BankUnited to backdate contributions of capital made by their parent holding companies in 2008. Those backdated capital contributions enabled IndyMac and BankUnited to report that they remained “well capitalized” (and therefore eligible to continue collecting high-cost brokered deposits)—a false representation that delayed their subsequent failures and likely increased the FDIC’s resolution costs.<sup>517</sup> Investigators also blamed OTS for its very weak

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their own empires”); Wilmarth, *supra* note 211, at 915–16 (explaining how OCC and OTS used their preemptive rulings to encourage state-chartered institutions to switch to federal charters).

513. Wilmarth, *supra* note 193, at 265, 265 n.150, 276–77, 277 n.203; RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 61–67, 465–67, 490–94 (4th ed. 2009) (describing competition between OCC and FRB during the 1990s to maintain the loyalty of the largest banks, which could choose between status as national banks or as state Fed member banks); *FCIC Report*, *supra* note 36, at 151–54 (describing how OTS and SEC competed to encourage the largest securities firms to organize nonbank holding companies under their oversight rather than forming bank holding companies that would be subject to FRB supervision).

514. ENGEL & MCCOY, *supra* note 19, at 159–60, 201–02; Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Upstream*, 26 *YALE J. ON REG.* 143, 160 (2009).

515. S. Rep. No. 111-176, at 25–26 (2010); *see also* ENGEL & MCCOY, *supra* note 19, at 157–84 (discussing regulatory failures by OTS); Binyamin Appelbaum & Ellen Nakashima, *Banking Regulator Played Advocate Over Enforcer: Agency Let Lenders Grow Out of Control, Then Fail*, *WASH. POST*, Nov. 23, 2008, at A1 (same).

516. ENGEL & MCCOY, *supra* note 19, at 176–81; *Senate Wall Street Crisis Report*, *supra* note 461, at 161–65, 209–35; Joe Adler, *OTS Faulted in BankUnited Failure*, *AM. BANKER*, June 25, 2010, at 3; Appelbaum & Nakashima, *supra* note 515; Louise Story & Gretchen Morgenson, *Finger-Pointing Turns to Regulators*, *N. Y. TIMES*, Nov. 23, 2011, at A1.

517. Adler, *supra* note 516; Binyamin Appelbaum & Ellen Nakashima, *Regulator Let IndyMac Bank Falsify Report*, *WASH. POST*, Dec. 23, 2008, at A01; Story & Morgenson, *supra* note 516. The Treasury Department’s inspector general reportedly made a criminal referral to the Justice Department with respect to OTS regional director Darrel Dochow’s approval of IndyMac’s backdated capital contribution. However, the Justice Department did not take any action against Mr. Dochow, and he retired from OTS in 2009 with a full government pension. Story & Morgenson, *supra* note 516. Mr. Dochow had previously been demoted by OTS in the early 1990s after “federal investigators found that he had delayed and impeded proper regulation of Charles Keating’s failed Lincoln Savings and Loan.” Appelbaum & Nakashima, *supra*; *see also* Black, *supra* note 412, at 188–205, 209–11 (describing

oversight of thrift holding companies, which contributed to the collapse of AIG and Lehman as well as Merrill's near-failure.<sup>518</sup>

The FRB and OCC bore shared responsibility, along with OTS, for the near-collapse of Countrywide.<sup>519</sup> In addition, the FRB and OCC were jointly at fault for not taking strong regulatory measures that might have prevented (i) the near-failures and massive bailouts of Citigroup and BofA, (ii) the failure and emergency sale of Wachovia to Wells Fargo in a federally-assisted transaction, and (iii) the near-collapse and forced sale of National City to PNC in another federally-assisted deal.<sup>520</sup> The failures and bailouts of so many leading financial institutions made it "painfully obvious" that the OTS, FRB and OCC had allowed the largest thrifts and banks to become "deeply implicated in the origination and securitization of bad mortgage loans."<sup>521</sup> The competition among federal agencies for charters was an important factor that contributed to those regulatory failures, because it encouraged agencies to offer "a bigger menu of legally permissible banking activities and gentler regulation" in order to meet the demand by financial institutions for "the easiest regulators and laws."<sup>522</sup>

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Dochow's role in obstructing attempts by other regulators to take strong measures against Keating and Lincoln in the late 1980s). Dochow regained his regional director's position in 2007 after he played "a leading role in persuading Countrywide to move under OTS supervision, a major coup for the agency." Appelbaum & Nakashima, *supra*; see also Appelbaum & Nakashima, *supra* note 515 (reporting that Dochow and other OTS officials offered to provide "more lenient" treatment to Countrywide than it was currently receiving from the FRB and OCC) (quoting an unnamed Countrywide executive).

518. *FCIC Report*, *supra* note 36, at 151–54, 177–78, 200–04, 346, 351–54; ENGEL & MCCOY, *supra* note 19, at 221–23.

519. *FCIC Report*, *supra* note 36, at 20, 105, 172, 248–50; ENGEL & MCCOY, *supra* note 19, at 159–60, 200–02; MCLEAN & NOCERA, *supra* note 512, at 138–49, 214–16, 219–33, 300–05; Wilmarth, *supra* note 15, at 1018, 1045.

520. *FCIC Report*, *supra* note 36, at 20–23, 111–13, 170–74, 195–200, 263, 302–08, 366–71, 379–86; ENGEL & MCCOY, *supra* note 19, at 158–71, 200–03; Wilmarth, *supra* note 12, at 978 n.105, 984–85; Arthur E. Wilmarth, Jr., *Cuomo v. Clearing House: The Supreme Court Responds to the Subprime Financial Crisis and Delivers a Major Victory for the Dual Banking System and Consumer Protection* (Geo. Wash. U. Pub. L. & Leg. Theory Working Paper No. 479, 2010), at 26–31, available at <http://ssrn.com/abstract=1499216>; Binyamin Appelbaum & David Cho, *Fed's approach to regulation left banks exposed to crisis*, WASHINGTON POST, Dec. 21, 2009, at A01. The Treasury Department facilitated Wells Fargo's emergency acquisition of Wachovia and PNC's comparable takeover of National City by issuing an extraordinary ruling, which declared that purchasing banks could use losses from acquired banks to reduce taxes on their future income. That ruling reportedly provided tax benefits worth \$25 billion to Wells Fargo and \$5 billion to PNC. Cheryl Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 218–19 (2010); Amit R. Paley, *A Quiet Windfall For U.S. Banks*, WASHINGTON POST, Nov. 10, 2008, at A01; see also BAIR, *supra* note 290, at 103–04 (stating that Wells Fargo CEO Dick Kovacevich referred to "a recent tax ruling that made the economics of the [Wachovia] deal work better"). Congress repudiated the Treasury's tax ruling in a subsequent statute but "included a 'grandfather' clause, giving the benefit of the [ruling] to existing contracts—the Wells Fargo transaction, in particular." Block, *supra*, at 219.

521. ENGEL & MCCOY, *supra* note 19, at 204.

522. *Id.* at 158, 159; see also *id.* at 166 (contending that regulatory competition "encouraged lenders to shop for legal regimes and charters," resulting in a "downward spiral in lending standards").

*b. International Regulatory Competition for the Allegiance of Large Financial Institutions*

A similar regulatory competition took place across national borders, especially between the world's two leading financial centers—New York and London. During the global credit boom that preceded the financial crisis, federal regulators worried that any attempt to impose stricter supervision on large U.S. financial institutions might cause those institutions to shift more of their operations to London or other foreign locations that offered “light touch” regulation.<sup>523</sup> Federal officials therefore repeatedly offered regulatory accommodations in order to persuade major banks to keep more of their activities in the U.S.<sup>524</sup>

Federal regulators were not mistaken in fearing that large financial institutions might shift operations and assets to foreign jurisdictions with more accommodating regulatory schemes. A recent study found that, between 1996 and 2007, global banks headquartered in 26 developed countries were more likely to open branches and subsidiaries in other nations, and to transfer capital to their foreign operations, if the destination countries (i) imposed fewer activity restrictions, lower capital requirements, weaker disclosure rules and looser auditing standards, and (ii) followed more lenient supervisory policies.<sup>525</sup>

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523. ANAT ADMATI & MARTIN HELLWIG, *THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT* 9–10, 96, 192–95, 199 (2013); Dariusz Wójcik, *The Dark Side of NY-LON: Financial Centres and the Global Financial Crisis* (University of Oxford Employment, Work and Finance Working Paper No. 11-12, July 20, 2011), at 7, available at <http://ssrn.com/abstract=1890644>; see also *infra* notes 526–43 (discussing the fierce competition between New York and London). For discussions of international regulatory arbitrage and its impact on supervisory policies, see Viral V. Acharya, Paul Wachtel & Ingo Walter, *International Alignment of Financial Sector Regulation*, in *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 365, 366–71 (Viral A. Acharya & Matthew Richardson eds., 2009); HEIDI MANDANIS SCHOONER & MICHAEL W. TAYLOR, *GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES* 283–84, 292–93 (2010); John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 716–17, 721 (2009); Cristie L. Ford, *Macro and Micro Level Effects on Responsive Financial Regulation*, 44 U.B.C. L. REV. 589, 608, 610–11 (2011).

524. Wójcik, *supra* note 523, at 7; Ford, *supra* note 523, at 608, 611. For example, during the quarter century leading up to the financial crisis, U.S. banking regulators sought to avoid imposing capital requirements on large U.S. banks that would place them at a competitive disadvantage compared to foreign banks. DANIEL K. TARULLO, *BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION* 45–64, 84–85, 210–14 (2008); see also BAIR, *supra* note 290, at 31–33 (stating that the FRB and OCC strongly supported Basel II's internal risk-based capital standards—which would have allowed big banks to operate with lower capital levels—because the FRB and OCC wanted to “maintain the competitiveness of the U.S. financial system” with Europe). Similarly, as described above, in 2004 federal regulators adopted an interagency rule setting a very low capital charge for banks that provided backup lines of credit to their sponsored off-balance-sheet conduits. See *supra* notes 224–28 and accompanying text (discussing adoption of the 2004 interagency rule). In adopting that very lenient rule, federal regulators rejected a proposed higher capital charge because that proposal “would put U.S. banks at a competitive disadvantage relative to foreign banks.” Risk-Based Capital Guidelines, 44 Fed. Reg. 44,908, 44,910 (July 28, 2004).

525. Joel F. Houston, Chen Lin & Yue Ma, *Regulatory Arbitrage and International Bank Flows*



The U.K. has long been the most prominent and attractive foreign destination for large U.S. financial institutions. For example, AIG Financial Products—which sold massive volumes of credit default swaps that destroyed its parent company—carried on most of its activities in London.<sup>526</sup> Similarly, JPMorgan’s Chief Investment Office (CIO) conducted its “London Whale” trading operations—which inflicted a \$6 billion loss on the bank in 2012—from the CIO’s London office.<sup>527</sup>

U.K. government leaders actively promoted London as the most business-friendly venue for global financial institutions. U.K. politicians pressured the Financial Services Authority (FSA) to adopt and follow “light touch” supervisory policies for major financial firms.<sup>528</sup> The financial industry applauded the U.K.’s embrace of “light touch” and “principles-based regulation,” and the industry pushed officials to maintain the U.K.’s lenient approach to supervision throughout the credit boom of the 2000s.<sup>529</sup>

In October 2006, FSA enforcement director Margaret Cole boasted—

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(J. FIN., *forthcoming*, Aug. 26, 2011), at 2–5, 17–19, 24–29, available at <http://ssrn.com/abstract=1525895>.

526. ENGEL & MCCOY, *supra* note 19, at 221–23; *FCIC Report*, *supra* note 36, at 139–42, 200–02; Wójcik, *supra* note 523, at 7.

527. *Jamie Dimon on the Line*, VANITY FAIR (Nov. 2012), <http://www.vanityfair.com/business/2012/11/jamie-dimon-tom-brady-hang-in-there> (text under heading “Killer Whale”).

528. U.K. Financial Services Authority, *The Failure of the Royal Bank of Scotland* § 3.1.3, ¶ 686, at 261 [hereinafter *FSA RBS Report*], available at <http://www.fsa.gov.uk/static/pubs/other/rbs.pdf>. In a press release issued by the U.K. Treasury on May 24, 2005, Chancellor of the Exchequer Gordon Brown declared that he wanted “[n]ot just a light touch but a limited touch” from the FSA in order to improve “London’s competitive position” as well as “the ‘competitiveness’ of the U.K. financial services sector.” *Id.* at 261–62 (material quoted from the press release in italics). Similarly, in June 2006 a senior U.K. Treasury official proclaimed that “we must keep the UK’s regulatory system at the cutting edge—the best in the world . . . nothing should be done to put at risk a light-touch, risk-based regulatory regime.” *Id.* at 262 n.746 (quoting speech on June 14, 2006, by Economic Secretary to the Treasury Ed Balls, MP).

529. Gonzalo Vina & Robert Hutton, *Brown Says He Was Wrong Not to Toughen Bank Regulation as Finance Minister* BLOOMBERG, April 14, 2010 (quoting U.K. Prime Minister Gordon Brown, who stated that he was under “a huge amount of pressure” from the financial-services industry to maintain “light touch” regulatory policies); Stephanie Baker et al., *Brown’s “Churchill” Moment Masks Failure of Regulator He Built*, BLOOMBERG (Nov. 26, 2008) <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=auS77akg6dq0> (explaining that Mr. Brown, as Chancellor of the Exchequer, “created the FSA” in 1997 and “held up principles-based regulation as a model” because he believed that “Britain needed to take measures to remain competitive in an era of globalization”); see also Howard Davies, Comments on Ross Levine’s paper “The Governance of Financial Regulation: Reform Lessons from the Recent Crisis,” (BIS Working Papers No. 329, Nov. 2010), at 15, 16–17 (comment by former FSA chairman, stating that “the political climate in which [U.K.] regulators were operating . . . was highly unfavourable to tight regulation” before the global financial crisis began in 2007, because “the City of London was seen as a goose that lays golden eggs, which should on no account be frightened into flapping its wings and flying away”), available at <http://www.bis.org/publ/work329.pdf>.

in a speech delivered in New York—that “London’s philosophy of ‘light touch’ regulation has helped it in becoming the world’s leading centre for mobile capital.”<sup>530</sup> She declared that “[t]he FSA is firmly of the view that regulators must be very wary of the damaging effects they can have on creativity, innovation and competition.”<sup>531</sup> She further claimed that “[t]he benefits of this light touch approach to regulation are borne out by the figures,” and she cited data showing that London was attracting more stock offerings than New York.<sup>532</sup>

Two weeks later, Senator Charles Schumer (D-NY) and New York Mayor Michael Bloomberg published an op-ed in the *Wall Street Journal* and announced that they had commissioned a report by McKinsey and Company on the competitiveness of U.S. financial markets.<sup>533</sup> Senator Schumer’s and Mayor Bloomberg’s op-ed warned that “we risk allowing New York to lose its pre-eminence in the global financial-services sector,” and they called for legal reforms to remedy “overregulation” and “frivolous litigation” in the U.S.<sup>534</sup> They criticized U.S. regulators for “often competing to be the toughest cop on the street,” while they praised the FSA for being “more collaborative and solutions-oriented.”<sup>535</sup> Shortly thereafter, Treasury Secretary Henry Paulson delivered a speech declaring that the op-ed by Senator Schumer and Mayor Bloomberg was “right on target.”<sup>536</sup>

Senator Schumer and Mayor Bloomberg issued the McKinsey report in January 2007, and they again warned that “New York could lose its status as a global financial market” if U.S. financial markets continued to be “stifled by stringent regulations and high litigation risks.”<sup>537</sup> The

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530. The UK FSA: Nobody does it better?, Speech by Margaret Cole, FSA Director of Enforcement, at Fordham Law School, Oct. 17, 2006, available at [http://www.fsa.gov.uk/library/communication/speeches/2006/1017\\_mc.shtml](http://www.fsa.gov.uk/library/communication/speeches/2006/1017_mc.shtml).

531. *Id.*

532. *Id.*; see also Vina & Hutton, *supra* note 529 (reporting that “[i]n 2005, London surpassed the U.S. as the No. 1 choice for stock listings by foreign companies, especially those from emerging markets such as India and Russia”).

533. Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn from London*, Wall St. J., Nov. 1, 2006, at A18; see also BAIR, *supra* note 290, at 37 (referring to the McKinsey study commissioned by Sen. Schumer and Mayor Bloomberg).

534. Schumer & Bloomberg, *supra* note 533.

535. *Id.*

536. Remarks by Treasury Secretary Henry M. Paulson before the Economic Club of New York, “On the Competitiveness of U.S. Capital Markets” (Nov. 20, 2006) [hereinafter Paulson Nov. 20, 2006 Speech], available at <http://www.treasury.gov/press-center/press-releases/Pages/hp174.aspx>. In the same speech, Secretary Paulson criticized a “broken tort system [that] is an Achilles heel for our economy,” as well as a regulatory enforcement approach that “can appear confusing and threatening” to financial institutions and other business firms. *Id.*

537. Press Release, Bloomberg/Schumer Report, NY in Danger of Losing Status as World Financial Center Within 10 Years Without Major Shift in Regulation and Policy, Jan. 22, 2007, available at <http://www.nyc.gov/cgi-bin/misc/pfprinter.cgi?action=print&sitename=OM&p=13621848>

McKinsey report called upon U.S. financial regulators to adopt a “principles-based” system of regulation and a “measured approach to enforcement” similar to the FSA’s policies, which senior financial executives described as “easier to deal with” and “responsive to their business needs.”<sup>538</sup> The McKinsey report also urged U.S. regulators to implement the Basel II international risk-based capital accord—and to abandon a U.S. interagency proposal for tougher capital requirements—in order to “place U.S. financial institutions on an equal footing with their international competitors.”<sup>539</sup>

Similarly, Treasury Secretary Paulson’s speech in November 2006 endorsed a “principles-based system” of regulation that would be “more agile and responsive” and thereby “maintain the competitiveness of our capital markets.”<sup>540</sup> The Bloomberg–Schumer report and the Paulson speech reflected the intense political pressures exerted on U.S. financial regulators to conform their policies to the FSA’s “light touch” approach and to the more accommodating Basel II capital standards.<sup>541</sup> Those

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538. Mayor Michael R. Bloomberg & Sen. Charles E. Schumer, *Sustaining New York’s and the US’ Global Financial Services Leadership* (Jan. 2007), at 17, 81, available at [http://www.nyc.gov/html/om/pdf/ny\\_report\\_final.pdf](http://www.nyc.gov/html/om/pdf/ny_report_final.pdf). As evidence of the FSA’s “measured” enforcement approach, the report quoted an unnamed CEO of a U.S. securities firm, who stated, “The FSA is open to discussing issues constructively and *resolving problems quietly*.” *Id.* at 84 (emphasis added).

539. *Id.* at 88, 112 (quotes). The McKinsey report quoted unnamed “CEOs and other thought leaders” who criticized the federal banking agencies for issuing a joint proposal for new capital requirements that would (i) include “a leverage ratio, which could require banks to hold more capital than would be required under a [Basel II] risk-based system,” (ii) require banks to hold more capital “if the aggregate capital under the [Basel II] regime falls by 10 percent for the industry as a whole” and (iii) reject provisions of Basel II that would allow capital requirements to “decline” in “a strong economic environment.” *Id.* at 88. The McKinsey report noted that Citigroup, JPMorgan, Wachovia and WaMu had formed a working group to recommend an “alternative” to the agencies’ proposal, and their “alternative approach [was] endorsed” by the major banking trade associations. *Id.* at 88, 112. As discussed above, Citigroup subsequently needed a huge federal bailout to avoid failure, while Wachovia and WaMu both failed in 2008. See *supra* notes 110, 231, 290, 520 and accompanying text.

540. Paulson Nov. 20, 2006 Speech, *supra* note 536. The “principles-based” objectives set forth in Secretary Paulson’s speech were subsequently incorporated in the Treasury Department’s *Blueprint for a Modernized Financial Regulatory Structure* (Mar. 2008), which he strongly advocated. Baker et al., *supra* note 529; see also Damian Paelitta et al., *Paulson Plan Begins Battle Over How to Police Market*, WALL ST. J., Mar. 31, 2008, at A1 (describing Secretary Paulson’s support for proposals to “streamline bureaucracy” contained in the Treasury’s *Blueprint*, and noting that the Bush Administration “has long been working on reducing regulation that, it argues, has hurt U.S. financial institutions in competition with overseas centers such as London and Hong Kong”). Due to the financial crisis, Secretary Paulson’s *Blueprint* was never implemented and was superseded by the Obama Administration’s proposals that provided the foundation for the Dodd–Frank Act. HAL S. SCOTT & ANNA GELPERN, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION* 335 (19th ed. 2012); Damian Paletta, *U.S. to Toughen Finance Rules*, WALL ST. J., Mar. 16, 2009, at A1.

541. See, e.g., BAIR, *supra* note 290, at 24, 27 (explaining that, in 2006, most federal bank regulators “were still moving in the direction of less regulation, at least for larger institutions,” and noting that “[a]dding fuel to the fire was the fact that some of our foreign competitors, particularly in Europe, were taking industry self-regulation to new extremes [through] ‘principles-based’ regulation,

pressures eased only when the global financial crisis revealed that the Basel II standards were woefully inadequate,<sup>542</sup> and when the FSA was “thoroughly discredited” after U.K. authorities were forced to bail out four of the nine largest U.K. banks.<sup>543</sup>

As the financial crisis has receded in the public’s memory, major U.S. banks and their allies in Congress have once again invoked the need for international “competitiveness” and “level playing fields” as a reason to avoid rigorous implementation of Dodd–Frank’s financial reforms.<sup>544</sup> For example, major bank trade associations attacked the FRB’s proposals to adopt higher capital standards and other enhanced prudential requirements for SIFIs because the proposed requirements “may place U.S. banks at an unwarranted competitive disadvantage compared to those countries that have not implemented a comparable approach.”<sup>545</sup> Similarly, big banks and their political allies have used

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which, in my view, meant articulating high-level standards but then leaving it to the banks themselves to interpret and enforce those standards”); *id.* at 30–39 (describing how FDIC chairman Bair successfully resisted intense lobbying by the FRB, OCC and OTS, as well as Senators Schumer and Mike Crapo (R-ID), to abandon the U.S. leverage capital requirement and conform U.S. capital requirements to the weaker Basel II standards as implemented by the U.K., Europe and Japan).

542. ADMATI & HELMWIG, *supra* note 523, at 96 (describing how European banks and U.S. investment banks “found many creative ways to have very high leverage and evade the [Basel II] requirements by shifting risks to others or hiding them behind flawed risk models or misleading credit ratings”); *id.* at 183 (“[T]he financial crisis showed that Basel II was flawed.”); BAIR, *supra* note 290, at 257 (“Europe was to pay dearly for its ill-advised implementation of Basel II and failure to impose a leverage ratio.”); *id.* at 40 (explaining that, due to the financial crisis, “the weight of market opinion had swung our way” by the end of 2007, and the Dodd–Frank Act “essentially killed Basel II as a means of reducing big bank capital”).

543. BAIR, *supra* note 290, at 192 (describing the FSA as “weak and a captive of the industry it regulated”); *see also* Eilis Ferran, *The Break-Up of the Financial Services Authority* (Univ. of Cambridge Faculty of Law Res. Paper Ser. No. 10/04, Oct. 11, 2010), at 2–5 (discussing the “dramatic fall from grace for the FSA” and its abolition by Parliament, but suggesting that “there was not a clear-cut case for outright abolition of the FSA and . . . fixing it was a solid option”), available at <http://ssrn.com/abstract=1690523>; Patrick Jenkins & Brooke Masters, *Finance: London’s Precarious Position*, FT.COM, July 29, 2012 (reporting that the “FSA’s old reputation for light-touch regulation comes in for blame repeatedly as enforcement cases lay bare the excesses of the past”); Kevin Crowley & Ambereen Choudhury, *Made-in-London Scandals Risk City Reputation as Money Center*, BLOOMBERG, July 6, 2012 (referring to the U.K.’s bailouts of four of its largest nine banks, “costing the country more money than any other project in history outside of world wars”); Ali Quassim, *International Banking: U.K.’s Chancellor Osborne to Abolish ‘Failed’ Financial Services Authority Started by Brown*, 94 BNA’S BANKING REP. 1237 (June 22, 2010) (describing plans by the Conservative-Liberal coalition government to abolish the “failed” FSA and replace it with three separate agencies that would assume responsibility for regulating banks, protecting consumers and combating serious economic crimes).

544. ADMATI & HELMWIG, *supra* note 523, at 1–3, 10, 194–95, 199; Donna Boark, *Three Years On, Fears of Flight from U.S. Regs.*, AM. BANKER, June 17, 2011, at 1 (reporting that members of Congress “appear consumed again with a very precisis topic: Is overregulation driving financial institutions overseas?”); and quoting, as an example of that concern, a statement by Rep. Shelley Moore Capito (R-WV) that “failing to examine the aggregate cost of compliance with Dodd–Frank could lead to job losses and, in the worst case, a downgrade in the United States as a financial center”).

545. Big Bank Systemic Risk Comment Letter, *supra* note 44, at 9; *see also id.* at 4 (warning that

the same global “competitiveness” rationale to block efforts by federal regulators to implement the Volcker Rule and Dodd–Frank’s derivatives reforms.<sup>546</sup>

The financial industry’s repeated calls for international “level playing fields” seek to reduce regulatory standards for global banks to the “lowest common denominator” followed by any major financial center.<sup>547</sup> As a practical matter, that approach would “allow foreign nations with the *weakest* systems of financial regulation to set the *maximum* level of supervisory constraints on global SIFIs.”<sup>548</sup> The industry’s “level playing field” arguments must be rejected in view of the disastrous role played by international regulatory arbitrage in undermining financial supervision in the U.S., U.K. and Europe prior to the financial crisis.<sup>549</sup>

## 2. Structural Flaws and Conflicts of Interest in U.S. Financial Agencies Have Increased Their Vulnerability to Industry Influence and Regulatory Arbitrage

Structural flaws and conflicts of interest within U.S. financial agencies further weakened the effectiveness of financial regulation both before and after the financial crisis. As shown above in Part IV(B)(1)(a), the OCC, OTS and FRB actively competed to persuade financial institutions to operate within their respective jurisdictions. The OCC and OTS had particularly strong financial incentives to adopt lax policies that would encourage large depository institutions to operate as national banks or federal thrifts. Assessments paid by federally-chartered banks and thrifts funded virtually all of the OCC’s and OTS’s

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“excessive limitations on the ability of U.S. banks to take controlled risks will reduce the role of the United States as a leader in the global financial system”).

546. Cheyenne Hopkins et al., *U.S. Volcker Rule Faces Harsh Critics*, BLOOMBERG, Feb. 14, 2012 (citing financial industry arguments that the Volcker Rule would hurt the “competitiveness” of U.S. banks); Kevin Wack, *Regulators: We Don’t Have all the Answers on Volcker Rule*, AM. BANKER, Jan. 19, 2012, at 1 (reporting on claims by House Republicans that “the Volcker Rule will put the United States at a disadvantage internationally”); Michael J. Moore, *Citigroup Says Dodd–Frank Drives Off Overseas Clients*, BLOOMBERG, Mar. 1, 2013 (describing argument by Citigroup that new derivatives rules mandated by Dodd–Frank could cause the bank to “lose clients to non-U.S. financial institutions that are not subject to the same compliance regime”); Gregory Meyer & Aline van Duyn, *US Banks Plead to Limit Range of Swap Rules*, REUTERS, Mar. 16, 2011 (citing arguments by BofA, Citigroup and JPMorgan that proposed derivatives rules could “damage . . . their competitiveness in foreign markets”).

547. ADMATI & HELLWIG, *supra* note 523, at 10, 94–95; *see also* Wilmarth, *supra* note 109 (Part II), at 7 (referring to the financial industry’s argument that the U.S. “should not implement fundamental financial reforms until all other major developed nations have agreed to do so”).

548. Wilmarth, *supra* note 109 (Part II), at 7.

549. ADMATI & HELLWIG, *supra* note 523, at 96, 177, 187; BAIR, *supra* note 290, at 27–38; 192, 257; Wilmarth, *supra* note 109 (Part II), at 7.

budgets.<sup>550</sup>

For example, the fees paid by WaMu covered about one-seventh of the OTS's total budget, and OTS Director John Reich referred to WaMu as "my largest constituent."<sup>551</sup> OTS examiners uncovered "more than 500 serious operational deficiencies" at WaMu between 2004 and 2008, but the OTS continued to rate WaMu as "fundamentally sound" until February 2008 and failed to take any public enforcement action before WaMu failed in September 2008.<sup>552</sup> A Senate investigation concluded that the OTS's forbearance toward WaMu "reflected an OTS culture of deference to bank management" as well as the OTS's likely "recognition of [WaMu's] unique importance to the agency's finances."<sup>553</sup>

Congress abolished OTS for its regulatory failings.<sup>554</sup> However, the OCC continues to have "strong budgetary incentives" to please large national banks that fund most of the agency's operations.<sup>555</sup> The OCC is "widely viewed as the most committed regulatory champion for the interests of major banks," and it has consistently acted to "retain [their] allegiance."<sup>556</sup> In addition to its aggressive preemption of state consumer protection laws, the OCC "issued dozens of rulings that greatly expanded the permissible activities of national banks in areas such as data processing, derivatives, equipment leasing, insurance sales, real estate investments and securities activities."<sup>557</sup> In 2005, Acting Comptroller of the Currency Julie Williams assured a group of bankers that (i) the OCC's supervisory approach provided "a spacious framework, designed to accommodate change," and (ii) the agency's personnel were "advocates on the national stage [for] measures designed to make regulation more efficient, *and* less costly, less intrusive, less complex, and less demanding on [bankers] and [their] resources."<sup>558</sup>

During the debates over Dodd–Frank, the OCC joined major banks

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550. ENGEL & MCCOY, *supra* note 19, at 158–61; Oren Bar-Gill & Elizabeth Warren, "Making Credit Safer," 157 U. PA. L. REV. 1, 81–83, 91–94 (2008); Wilmarth, *supra* note 211, at 915–16; *see also* BAIR, *supra* note 290, at 41, 79, 192, 339–40 (criticizing the conflicts of interest created by the OCC's and OTS's charter-based funding).

551. *Senate Wall Street Crisis Report*, *supra* note 461, at 165, 210 (quoting May 2, 2007 email from Mr. Reich to an OTS colleague), 230.

552. *Senate Wall Street Crisis Report*, *supra* note 461, at 209, 161–62, 177, 228–30.

553. *Id.* at 209–11; *see also supra* notes 516–18 and accompanying text (citing additional OTS missteps that contributed to the failures of IndyMac, Downey Federal, BankUnited and AIG).

554. Wilmarth, *supra* note 211, at 918.

555. Wilmarth, *supra* note 19, at 912.

556. *Id.*

557. *Id.* at 912–13 (quote); *see also supra* notes 251–551, 513 (discussing the OCC's preemption of state laws); Saule Omarova, *The Quiet Metamorphosis: How Derivatives Changed the 'Business of Banking'*, 63 U. MIAMI L. REV. 1041, 1051–99 (2009) (describing how the OCC greatly expanded the powers of national banks, especially with regard to derivatives activities, by issuing rulings that adopted an ever-expanding definition of "the business of banking").

558. Wilmarth, *supra* note 211, at 905 (quoting speech by Ms. Williams on May 27, 2005).

and their trade associations in opposing many of the statute's key reforms.<sup>559</sup> After Dodd–Frank's enactment, the OCC continued to align itself with large financial institutions by resisting significant increases in capital requirements for bank SIFIs, by opposing the Volcker Rule, and by refusing to make significant reductions in the scope of the OCC's 2004 preemption rules.<sup>560</sup> In June 2011, Acting Comptroller of the Currency John Walsh appeared to question the need for fundamental financial reform when he warned that “in the frenzy of the moment, we can overreact in response to crisis . . . [W]e are in danger of trying to squeeze too much risk and complexity out of banking.”<sup>561</sup>

Democrats on Capitol Hill strongly criticized Mr. Walsh, and President Obama replaced him with Thomas Curry, a former state banking commissioner and FDIC board member.<sup>562</sup> After taking office in April 2012, Comptroller Curry declared that one of his “goals” was to “eliminate [the] perception” that “the OCC is too cozy with the banks it regulates.”<sup>563</sup> He apologized for several OCC mistakes that were revealed shortly after he took office, including the OCC's failures to prevent (i) widespread foreclosure abuses by national banks, (ii) JPMorgan's \$6.2 billion loss from its “London Whale” trading operation, and (iii) massive money laundering violations by HSBC.<sup>564</sup>

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559. Wilmarth, *supra* note 19, at 913 (discussing the OCC's opposition during the drafting of Dodd–Frank to reforms that would give greater protections to consumers, require national banks to retain a substantial portion of the risk of loans they sell for securitization, and impose greater restrictions on executive pay).

560. *Id.* at 913–15.

561. *Id.* at 914 (quoting speech by Mr. Walsh on June 21, 2011). Mr. Walsh did not change his views after he was replaced by Thomas Curry in April 2012. In a subsequent interview, Mr. Walsh repeated his concern that “policymakers are trying to wring too much risk and complexity out of the financial system.” He also cautioned that “[w]e can go too far in the direction of safety” and thereby restrict economic growth. Barbara A. Rehm, *What Ex-Comptroller Walsh Really Thinks About the State of Banking*, AM. BANKER, Aug. 31, 2012, at 3 (summarizing and quoting Mr. Walsh's views).

562. Wilmarth, *supra* note 19, at 915–16; Kate Davidson, *Curry's Tricky Balancing Act at OCC*, POLITICO.COM, Feb. 27, 2013 (available on Lexis).

563. Victoria McGrane, *Comptroller Got 'Whale' of an Intro*, WALL ST. J., July 2, 2012, at C9 (quoting from an interview with Mr. Curry); see also Rob Blackwell & Rachel Witkowski, *OCC's Curry on Big Bank Breakup, Basel and Preemption*, AM. BANKER, Jan. 22, 2013, 2013 WLNR 1420945 (quoting Mr. Curry's view that the OCC should act as “the cop on the beat” and should have “a good dose of healthy skepticism” toward the banks it regulates).

564. Joe Adler, *Watchdog Blames OCC Supervision for Failure to Catch 'Robo-Signing' Scandal*, AM. BANKER, June 4, 2012 (describing the Treasury inspector general's criticism of the OCC for failing to prevent abusive foreclosure practices by national banks, and reporting that Mr. Curry “generally agreed with the watchdog's recommendations”); Ben Protess, *U.S. Regulator Concedes Oversight Lapse in JPMorgan Loss*, N.Y. TIMES, June 7, 2012, at B5 (reporting that Mr. Curry “conceded . . . that his agency stumbled” by failing to identify flawed risk management practices at JPMorgan that led to a “multibillion dollar trading loss”); Joe Adler, *Comptroller Curry Vows Tougher Enforcement, Higher Ethics at OCC*, AM. BANKER, July 18, 2012 (describing the Senate Permanent Subcommittee on Investigation's criticism of the OCC for “feeble enforcement” of anti-money laundering (AML) laws against HSBC, and reporting that “Curry acknowledged his agency acted too slowly in addressing the

Mr. Curry also developed a plan to “strengthen” the OCC by giving a stronger voice to the agency’s examiners and by “diversifying funding so the agency doesn’t have to rely solely on assessments from the banks it regulates.”<sup>565</sup> However, Mr. Curry’s efforts to change the OCC’s culture—including his appointment of former FDIC colleagues to fill leadership positions at the OCC—provoked criticism from bank executives and OCC staff members. As a result, some analysts expressed doubts whether Mr. Curry could successfully transform the OCC into a strong and independent regulator.<sup>566</sup>

The Fed is not subject to the same budgetary pressures as the OCC, because the Fed independently finances its operations by “drawing on earnings from [its] portfolio of Treasury securities and other debt instruments.”<sup>567</sup> However, the banking industry exerts significant influence over the Fed through the “unique governance structure” of the Fed’s twelve regional Federal Reserve Banks (Reserve Banks).<sup>568</sup> Member banks in each Fed district elect six of the nine directors of that district’s Reserve Bank, and three of those bank-elected directors vote (along with three additional directors appointed by the FRB) to select the Reserve Bank’s president.<sup>569</sup>

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bank’s problems”); see also *Senate HSBC Report*, *supra* note 434, at 8–11, 283–335 (criticizing the OCC’s failure to enforce AML laws against HSBC, stating that “[d]espite the many AML problems identified by its examiners, OCC supervisors took no formal or informal enforcement actions [from 2005 until 2010], allowing the bank’s AML problems to fester,” *id.* at 283); Jesse Hamilton, *Bank-Friendly Regulator Shifts to Revamp Reputation*, BLOOMBERG, Oct. 8, 2012 (reporting on initiatives taken by Mr. Curry to make the OCC “a regulator for the public, not a regulator that views itself as protecting banks”) (quoting former FDIC chairman Sheila Bair, who worked with Mr. Curry at the FDIC).

565. Davidson, *supra* note 562.

566. *Id.*; Hamilton, *supra* note 564; see also BAIR, *supra* note 290, at 341 (noting that Mr. Curry would be “fighting an uphill battle” in trying to “change the regulatory culture of the OCC and refocus it on protecting the public interest, not the banks” because “the OCC’s decline as a regulator has been ongoing for many years”); Victoria Finkle, *If CFPB Needs a Commission, Why Not OCC?*, AM. BANKER, Feb. 13, 2013 (reporting on a proposal by Sen. Mike Crapo (R-ID) to replace the OCC’s single-director model of governance with a bipartisan commission, and citing analyst Edward Mills’ view that Senator Crapo’s proposal might “reflect dissatisfaction with the new regime at the OCC,” including Mr. Curry’s efforts “to distance the agency from the perception that it is too lenient on banks. If the agency gets tougher on the industry, that may prompt more calls to change its structure” in order to give Republican legislators and the banking industry “more control over Curry than they currently have”).

567. Wilmarth, *supra* note 19, at 941.

568. *Id.*; see also ALLAN H. MELTZER, 1 A HISTORY OF THE FEDERAL RESERVE, 1913–1951, at 65–67, 483–86 (2003) (explaining that the Fed’s governance structure, which was established in 1913 and modified in 1935, represented a “compromise” between those who wanted a “central bank . . . under political control”—as reflected in the President’s appointment of the FRB’s governors—and those who wanted a “central bank . . . run by bankers,” as reflected in the election of two-thirds of each Reserve Bank’s directors by member banks); BARTH, CAPRIO & LEVINE, *supra* note 19, at 151 (discussing the “many compromises” that produced the “unique . . . private-public nature of the Fed, as well as its centralized-decentralized structure”).

569. Wilmarth, *supra* note 19, at 941–42 (explaining that (i) member banks elect three Class A



Five Reserve Bank presidents are voting members of the Federal Open Market Committee (FOMC)—which determines the nation’s monetary policy—along with the FRB’s seven governors.<sup>570</sup> All twelve Reserve Bank presidents participate in the FOMC’s meetings, and each Reserve Bank president has shared responsibility (together with the FRB) for supervising member banks and bank holding companies headquartered in that Reserve Bank’s district. Thus, Reserve Bank presidents—who are subject to substantial influence from member banks in their districts—“play significant roles in determining the Fed’s monetary policy and bank supervisory policies.”<sup>571</sup>

Boards of directors of Reserve Banks have “typically been dominated by senior executives of major banks, large [nonbank] financial firms and leading nonfinancial corporations that are customers of the biggest banks.”<sup>572</sup> Many of the same banks and nonbank firms received federal support during the financial crisis. For example, during the peak of the crisis between 2007 and 2009, the New York Fed’s board of directors included JPMorgan chairman Jamie Dimon, Lehman chairman Richard Fuld, General Electric chairman Jeffrey Immelt, and Goldman director and former chairman Stephen Friedman.<sup>573</sup> Mr. Friedman’s service as a Class C director of the New York Fed provoked substantial public controversy because the FRB granted a waiver that allowed him to continue serving in that role after Goldman converted to a bank holding company in September 2008.<sup>574</sup>

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and three Class B directors for each Reserve Bank, while the FRB appoints three Class C directors, and (ii) Class B and Class C directors jointly vote to select the Reserve Bank’s president).

570. *Id.* at 942 (explaining that the president of the Federal Reserve Bank of New York (New York Fed) serves as a permanent voting member of the FOMC, while four additional FOMC voting seats rotate among the other eleven Reserve Bank presidents).

571. *Id.*; see also BARTH, CAPRIO & LEVINE, *supra* note 19, at 89 (stating that the Fed “is not independent of private banks” because “private banks are intimately intertwined with [Fed officials] charged with regulating the nation’s major banks”).

572. Wilmarth, *supra* note 19, at 943; see also Jonathan Reiss, *The Regional Feds Need More Independence*, BLOOMBERG, June 13, 2012 (pointing out that six of the nine directors of each Reserve Bank are elected by the banking industry, and also noting that the New York Fed’s three current Class C directors were appointed by the FRB but were also leaders of “nonprofit corporations that rely on contributions from financial corporations or their executives”).

573. Wilmarth, *supra* note 19, at 943; see also U.S. Senator Bernard Sanders (I-VT), *Jamie Dimon Is Not Alone*, June 12, 2012 (identifying 18 former and current Reserve Bank directors who worked in banks and corporations that received Fed liquidity assistance during the financial crisis), available at <http://www.sanders.senate.gov/imo/media/doc/061212DimonIsNotAlone.pdf>; William Alden, *Dimon Leaves New York Fed Board as His Term Ends*, N.Y. TIMES BLOGS (DEALBOOK), Jan. 8, 2013 (available on Lexis) (reporting that Mr. Dimon left the New York Fed’s board in December 2012 after completing two three-year terms).

574. Wilmarth, *supra* note 19, at 944–45 (explaining that (i) “[w]ithout the FRB’s waiver, Friedman would have been disqualified from serving as a Class C director unless he resigned his Goldman directorship and divested his Goldman stock,” and (ii) “Friedman purchased 37,000 additional shares of Goldman stock while his waiver was pending, and during that period the New York Fed

Dimon, Fuld, Immelt, Friedman and fourteen other Reserve Bank directors worked at institutions that received massive amounts of emergency liquidity assistance from the Fed during the crisis.<sup>575</sup> In addition, academic studies have shown that (i) “banks were significantly more likely to receive capital assistance under [TARP] if their executives served as directors of either Reserve Banks or Reserve Bank branches,”<sup>576</sup> and (ii) banks whose executives served as Reserve Bank Class A directors between 1990 and 2009 “experienced significant abnormal gains in their stock market values” and “were significantly less likely to fail (compared with other banks).”<sup>577</sup>

During the past two decades the FRB has actively competed with the OCC to attract the loyalty of major banks by (A) issuing rulings that expanded the securities and derivatives activities of bank holding companies, (B) granting exemptions that loosened restraints on transactions between major banks and their affiliates, and (C) advocating the adoption of less demanding capital requirements for the largest banks under the Basel II capital accord.<sup>578</sup> Both the FRB and the OCC advocated an aggressive bailout policy for leading banks during the financial crisis, and they also supported giving lenient terms to major banks that wanted “to exit the TARP capital assistance program by repurchasing the preferred stock they had sold to Treasury.”<sup>579</sup>

The foregoing evidence indicates that “large financial institutions have exerted substantial influence on Fed policies” as well as those of the OCC.<sup>580</sup> The nature and extent of the financial industry’s influence on the Fed and the OCC become even clearer when one considers the

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directed AIG to pay \$14 billion to Goldman, representing full payment of AIG’s obligations to Goldman”).

575. Wilmarth, *supra* note 19, at 945–46; *see also* Sanders, *supra* note 573, at 1 (stating that “at least 18 former and current directors from Federal Reserve Banks worked in banks and corporations that collectively received over \$4 trillion in low-interest loans from the Federal Reserve”).

576. Wilmarth, *supra* note 19, at 946 (citing a study by Ran Duchin and Denis Sosyura and another study by Lei Li).

577. *Id.* at 946–47 (citing a study by Renee Adams).

578. Saule Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities* (Nov. 24, 2012), at 12–14, 33–42 (discussing OCC and FRB rulings that greatly expanded the securities and derivatives activities of national banks and bank holding companies), available at <http://ssrn.com/abstract=2180647>; Saule Omarova, *From Gramm–Leach–Bliley to Dodd–Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1702–03, 1706–55 (2011) (detailing the generous exemptions that the FRB granted to large banking organizations from rules limiting affiliate transactions, both before and during the financial crisis); BAIR, *supra* note 290, at 31–39 (stating that FRB and OCC officials worked together to promote more lenient capital standards for large U.S. banks under Basel II); Wilmarth, *supra* note 19, at 948 (same).

579. Wilmarth, *supra* note 19, at 948–50; *see also* BAIR, *supra* note 290, at 95–129, 165–74, 207 (describing the FRB’s and OCC’s strong support for bailouts of large troubled banks and their willingness to allow lenient terms for major banks that wanted to leave the TARP program).

580. Wilmarth, *supra* note 19, at 947, 950.

contrasting record of the FDIC. As I explained in a previous article, the FDIC “has demonstrated a significantly higher degree of independence from industry influence” by virtue of its “clearly defined mission” as well as its “assured source of funding.”<sup>581</sup> The FDIC’s twin purposes are to protect bank depositors and preserve the Deposit Insurance Fund (DIF), and both goals encourage the FDIC to consider the broader public interest and not just the financial industry’s self-interest.<sup>582</sup> In addition, the FDIC funds its operations by collecting premiums from FDIC-insured banks. Because FDIC insurance is a practical necessity for all banks that accept deposits from the public, the FDIC—unlike the OCC—is not vulnerable to industry influence through “charter competition.”<sup>583</sup>

The FDIC’s “guaranteed funding source” also means that the agency is not subject to congressional domination through the appropriations process.<sup>584</sup> As I previously pointed out, “Congress has frequently undermined the effectiveness of CFTC and SEC over the past two decades by frequently failing to provide those agencies with adequate funds.”<sup>585</sup> Two former chairmen of the CFTC and SEC recently declared that both agencies “need a robust—and dependable—source of funding” that is not subject to deep cuts imposed by congressional appropriators.<sup>586</sup> As both former chairmen explained, an independent funding source “insulates [agencies] from political pressure exerted by the deep-pocketed institutions they regulate” and allows agencies to “implement strategic decisions to adapt to changing markets and build

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581. *Id.* at 947.

582. *Id.*; see also BAIR, *supra* note 290, at 8, 12–13, 21–24, 43–47, 81–82, 192–93, 226, 340 (describing the FDIC’s strong commitments to protect depositors and preserve the DIF as well as the FDIC’s relative independence from the financial industry); Brendan Greeley, *Ditch Basel Rules, Just Raise Capital*, VITTER SAYS, BLOOMBERG BUSINESSWEEK (May 1, 2013) (stating that the FDIC has followed “more conservative” supervisory policies because of its dual role as “both a regulator and an insurer”), <http://www.businessweek.com/articles/2013-05-01/ditch-basel-bank-rules-just-raise-capital-vitter-says>.

583. Wilmarth, *supra* note 19, at 947; see also BAIR, *supra* note 290, at 340 (stating that the FDIC “has repeatedly proven itself to be significantly more independent of the big banks than the OCC” because the FDIC “does not have to rely on fees from the nation’s biggest banks to fund itself, as does the OCC”).

584. Wilmarth, *supra* note 19, at 947.

585. *Id.* at 951–53; see also *supra* notes 87–89, 160–62 (describing successful efforts by the financial industry and its congressional allies to cut or freeze the budgets of the CFTC and SEC and thereby constrain the ability of both agencies to implement Dodd–Frank’s reforms); BAIR, *supra* note 290, at 342–43 (stating that “industry lobbyists have found that the best way to harass the SEC and CFTC and block efforts at financial reform is through convincing appropriations committees to restrict how these agencies can use their money,” and contending that the “effectiveness [of the SEC and CFTC] will not be improved if their senior staff and chairmen have to spend time and resources on the Hill constantly battling industry lobbyists for enough money to operate”).

586. Brooksley Born & William Donaldson, *Self-Funding of Regulators Would Help Fiscal Mess*, POLITICO.COM, Mar. 10, 2013.

needed information technology . . . all of which require multiyear budget certainty.”<sup>587</sup>

Because of the FDIC’s well-defined public interest mission and its assured funding, the FDIC has demonstrated a much higher degree of independence from the financial industry than the FRB, OCC, CFTC or SEC. During the period leading up to the financial crisis, the FDIC (i) generally took a tougher position against subprime mortgage lending,<sup>588</sup> and (ii) “fought hard to maintain tougher capital rules for U.S. banks (including leverage capital requirements) during international negotiations over the Basel II capital accord.”<sup>589</sup> The FDIC also pushed the Basel Committee on Bank Supervision to adopt stronger capital standards—including a leverage requirement—in the post-crisis Basel III accord,<sup>590</sup> although Basel III did not go far enough.<sup>591</sup> The FDIC prevailed (over the opposition of New York Fed and Treasury officials) in deciding that WaMu’s bondholders would *not* be bailed out when WaMu failed in September 2008.<sup>592</sup> The FDIC achieved partial success—again despite the contrary views of Fed and OCC officials—when it pressured the largest banks to satisfy tougher capital-raising requirements in order to exit the TARP capital assistance program.<sup>593</sup>

Sheila Bair, who served as FDIC chairman from 2006 to 2011, deserves much of the credit for the FDIC’s comparatively better performance during those years. However, the FDIC’s public interest mission and its structural independence from the banking industry also appear to be key factors. An example of that independence is shown by the fact that, over the past three decades, industry insiders have repeatedly attacked the FDIC for seeking to impose stronger capital standards and higher deposit insurance premiums to reduce bank failures and protect the DIF.<sup>594</sup> Industry critics have frequently mocked the FDIC’s acronym as standing for “Forever Demanding Increased Capital.”<sup>595</sup> An appropriate response to that mockery might be, “Isn’t that the FDIC’s job?”

587. *Id.*

588. BAIR, *supra* note 290, at 43–49, 57–58.

589. Wilmarth, *supra* note 19, at 947–48; *see also* BAIR, *supra* note 290, at 30–40.

590. BAIR, *supra* note 290, at 257–72.

591. *See* ADMATI AND HELLWIG, *supra* note 516, at 96, 169–70, 176–88 (showing that Basel III is inadequate to ensure that large global banks can withstand future shocks similar to the financial crisis of 2007–09).

592. BAIR, *supra* note 290, at 90–94, 99–100; *see also* Wilmarth, *supra* note 19, at 948–49, 949 n.283 (explaining that then-New York Fed president Timothy Geithner and Treasury officials strongly favored protecting WaMu’s bondholders).

593. BAIR, *supra* note 290, at 201–07; Wilmarth, *supra* note 19, at 949–50.

594. BAIR, *supra* note 290, at 22–25; Wilmarth, *supra* note 19, at 947.

595. Wilmarth, *supra* note 19, at 947, 947–48 n.279.

### 3. The “Revolving Door” and “Cultural Capture” Provide Important Sources of Regulatory Influence for the Financial Industry

The far-reaching deregulation of the U.S. financial services industry after 1980 and the resulting proliferation of new financial activities and products promoted rapid growth in the industry’s size, profitability and compensation.<sup>596</sup> For example, U.S. financial-sector assets (including assets under financial management) mushroomed from \$15.06 trillion (254% of GDP) in 1991 to \$37.71 trillion (360% of GDP) in 2002 and \$55.62 trillion (420% of GDP) in 2006.<sup>597</sup> Similarly, U.S. financial-sector debt rose from 40% of GDP in 1988 to 70% of GDP in 1998 and 120% of GDP in 2006.<sup>598</sup> U.S. financial-sector profits experienced a comparable growth curve, rising from 13% of total pretax domestic profits in 1980 to 27% of such profits in 2007.<sup>599</sup> Stocks of financial firms included in the S&P 500 index accounted for the highest aggregate market value of any industry sector from 1995 to 1998 and again from 2002 to 2007.<sup>600</sup>

Compensation in the U.S. financial industry steadily moved upward

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596. JOHNSON & KWAK, *supra* note 15, at 70–87, 104–09, 120–44; Wilmarth, *supra* note 15, at 972–97, 1002–15; *see also* Thomas Philippon & Ariell Reshef, *Wages and Human Capital in the U.S. Financial Industry: 1909–2006*, Nat’l Bur. Econ. Res. Working Paper No. 14644 (Jan. 2009), at 3–4, 16–22, 30 (finding that the two most important factors behind the significant rise in financial sector compensation between 1980 and 2006 were (i) deregulation of banking and financial operations and (ii) expansion of corporate finance activities linked to IPOs and credit risk management), available at <http://www.nber.org/papers/w14644>.

597. For the U.S. financial industry’s assets in 1991, see Bd. of Governors of Fed. Res. Sys., *Flow of Funds Accounts of the United States*, 4th Qtr. 1996 (Statistical Rel. Z.1), at 68, 72–79 (line 1 of tbls. L.109, L.114, L.115, L. 116, L.117, L.118, L.119, L.120, L.121, L.122, L.123, L.124, L.125, L.126), available at <http://www.federalreserve.gov/releases/z1/19970314/z1.pdf>. For GDP in 1991, see Bd. of Governors of the Fed. Res. Sys., *Flow of Funds Accounts of the United States*, 3d Qtr. 1996 (Statistical Rel. Z.1), at 12 (tbl.F.6, line 1), available at <http://www.federalreserve.gov/releases/z1/19961211/z1.pdf>. For the financial industry’s assets in 2002 and 2006, see Ins. Co. Instit. & Fin. Serv. Roundtable, *The Financial Services Fact Book 2008*, at 2. For GDP in 2002 and 2006, see Bd. of Governors of Fed. Res. Sys., *Flow of Funds Accounts of the United States*, 4th Qtr. 2006 (Statistical Rel. Z.1.), at 12 (tbl.F.6, line 1). *See also* Steven M. Kaplan & Joshua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, (Nat’l Bur. Econ. Res. Working Paper 13270, July 2007), at 18 (noting that the global capital of the top 50 U.S. securities firms grew by more than 20 times between 1987 and 2004, while total assets under management at U.S. mutual funds rose from \$135 billion to \$8.9 trillion between 1980 and 2005), available at <http://www.nber.org/papers/w13270>.

598. *The gods strike back: A special report on financial risk*, ECONOMIST, Feb. 13, 2010, at 3 (Borrowed time chart 1).

599. Justin Lahart, *Has the Financial Industry’s Heyday Come and Gone?*, WALL ST. J., April 28, 2008, at A2.

600. Elizabeth Stanton, *Bank Stocks Cede Biggest S&P Weighting to Technology (Update 1)*, BLOOMBERG, May 21, 2008; *see also* Tom Lauricella, *Crumbling Profit Center: Financial Sector Showing Life, but Don’t Bank on Long-Term Revival*, WALL ST. J., Mar. 24, 2008, at C1 (reporting that financial stocks accounted for 22.3% of the total market value of all stocks included in the S&P 500 index at the end of 2006, “up from just 13% at the end of 1995”).

in tandem with the dramatic growth in the industry's size and profits after 1980. Wages in the financial sector were approximately the same as average wages in the rest of the U.S. economy in 1980. However, relative wages in the financial sector increased rapidly thereafter and were seventy percent higher than average wages in the rest of the U.S. economy by 2006.<sup>601</sup> The peak reached in 2006 for relative compensation in the financial industry matched a similarly high level recorded in the early 1930s, which also marked the end of a long period of aggressive deregulation and rapid growth in the financial sector.<sup>602</sup>

The remarkable expansion of the financial industry's size, profits and compensation over the past three decades produced a parallel growth in the industry's political clout. As described above, the financial sector's lobbying expenditures and campaign contributions increased dramatically after 1990.<sup>603</sup> Wall Street's ability to wield great political influence and to offer highly-compensated employment also created powerful incentives for a rapidly spinning "revolving door" between leadership positions in financial regulatory agencies and senior positions at Wall Street firms and their law firms, accounting firms and trade associations.<sup>604</sup> As shown below, the "revolving door" and the related problem of "cultural" or "cognitive" capture provide additional explanations for Wall Street's continued ability to shape Washington's financial policies.

*a. The Impact of the "Revolving Door" in Magnifying the Financial Industry's Influence in Washington*

The "revolving door" between government service and Wall Street-related employment has undoubtedly played a major role—along with political contributions and lobbying—in helping to foster a pro-industry

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601. Philippon & Reshef, *supra* note 596, at 3–4, 8 & fig. 1; *see also* JOHNSON & KWAK, *supra* note 15, at 113–14, 252 n.77 (discussing the study by Philippon & Reshef and noting that the "excess relative wage" paid to financial industry workers over other workers—representing "the difference between [higher] average finance wages and what one would predict based on educational differences—reaches a peak of around 40 percentage points in the 2000s"); Kaplan & Rauh, *supra* note 597, at 2–6, 32–34, 37–40, tbl.8a (concluding that executives of U.S. securities firms, hedge funds, private equity funds, venture capital funds and mutual funds accounted for more than half of the most highly-compensated American individuals in 2004).

602. Philippon & Reshef, *supra* note 596, at 3–4, 8, 16–17 (describing the impact of deregulation and the growth of IPOs and other corporate finance activities between 1900 and 1930 and again between 1980 and 2007).

603. *See supra* Part IV(A)(1); JOHNSON & KWAK, *supra* note 15, at 90–92.

604. JOHNSON & KWAK, *supra* note 15, at 92–105, 113–19; *see also* BARTH, CAPRO & LEVINE, *supra* note 19, at 89, 209–10 (stating that "[t]he revolving door spins often and rapidly" between financial regulatory agencies and Wall Street and noting that "regulatory officials often raise their salaries by a factor of ten, if not more, by moving from their regulatory offices to financial firms").

outlook among many members of Congress, senior Executive Branch officials and financial regulators.<sup>605</sup> A former senior legislative aide and lawyer-lobbyist recently declared, “Money is the basis of almost all relationships in [Washington,] DC . . . . [O]ur political campaign system and DC’s mushrooming Permanent Class—who alternate between government jobs and lawyering, influence-peddling and finance—mean Wall Street always wins.”<sup>606</sup>

In recent years the financial industry has employed hundreds of former members of Congress, legislative staffers, senior regulators and agency staffers as lobbyists and advisers. In 2009 and 2010, as noted above, (i) the financial industry hired more than 1,400 lobbyists who were former federal employees, including 73 former members of Congress and two former Comptrollers of the Currency, and (ii) the six largest U.S. banks employed more than 240 lobbyists who were former government insiders.<sup>607</sup> Financial industry trade groups frequently appoint former politicians as their leaders.<sup>608</sup> For example, the National Association of Insurance Commissioners (NAIC) recently named former Senator Ben Nelson (D-NE) as its CEO. In announcing Senator Nelson’s appointment, the president of NAIC declared, “We needed the gravitas, the phone calls returned, to go to Capitol Hill, to tell our story, defend our turf . . . . I think all the way up to and including President Obama would return Senator Nelson’s phone calls.”<sup>609</sup>

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605. JOHNSON & KWAK, *supra* note 15, at 92–93 (contending that the “constant flow of people from Washington to Wall Street and back ensured that important decisions were made by officials who had absorbed the financial sector’s view of the world and its perspective on government policy, and who often saw their future careers on Wall Street, not in Washington”); *see also* BARTH, CAPRIO & LEVINE, *supra* note 19, at 7, 89, 209–10 (agreeing that the “revolving door” contributes to a situation in which “regulators are not completely independent of private financial institutions”); ADMATI & HELLWIG, *supra* note 523, at 204–05, 325–26 n.56 (reaching a similar conclusion).

606. CONNAUGHTON, *supra* note 367, at 11.

607. *See supra* notes 389–90 and accompanying text; *see also supra* note 375 and accompanying text (citing study finding that the financial industry employed 3,000 lobbyists in 2007, including many former government insiders).

608. SIFMA, Wall Street’s preeminent trade association, recently hired former Senator Judd Gregg (R-NH) as its CEO while retaining former congressman Kenneth Bentsen (D-TX) as its president. Stephen Joyce, *Financial Services: SIFMA Names New Leadership, Says Focus Shifting Away From 2008 Crisis*, 45 SEC. REG. & L. REP. (BNA) 980 (May 27, 2013). The Financial Services Roundtable, which represents most of the 100 largest U.S. financial institutions, hired former Minnesota Governor and Republican Presidential candidate Tim Pawlenty in September 2012 to replace former Texas Republican congressman Steve Bartlett. Barbara Rehm, *Roundtable’s Pawlenty: A Blunt Boss Set for Long Haul*, AM. BANKER, Dec. 6, 2012. Similarly, the American Bankers Association appointed former Republican Oklahoma Governor Frank Keating as its president in 2011. Stacy Kaper, *Next Leader of ABA Vows to Put Aside His Politics*, AM. BANKER, Nov. 24, 2010, at 1, 2010 WLNR 23356127.

609. Zachary Tracer & Alex Nussbaum, *Ex-Senator Nelson to Run Insurer Watchdog Group*, BLOOMBERG, Jan. 22, 2013 (quoting NAIC president Jim Donelson, and noting that former Senator Nelson had previously served as Nebraska’s insurance commissioner and Governor).

JPMorgan chairman Jamie Dimon confirmed the crucial importance of political influence in shaping financial policy when he described government relations as JPMorgan's "seventh line of business."<sup>610</sup> JPMorgan has hired a large number of executives and in-house lobbyists who formerly worked as top government officials or senior congressional staffers.<sup>611</sup> Citigroup has employed a similar array of former government heavyweights, including former Treasury Secretary Robert Rubin from 1999 to 2009,<sup>612</sup> as well as former Office of Management and Budget (OMB) Director and current Treasury Secretary Jacob Lew from 2006 to 2008, and former OMB Director Peter Orszag since 2010.<sup>613</sup>

Goldman Sachs is probably the best-known participant in the revolving-door phenomenon. Indeed, the firm is often referred to as "Government Sachs," due to the steady flow of senior personnel between the firm and government agencies.<sup>614</sup> Two former Treasury Secretaries—Robert Rubin (1995–99) and Henry Paulson (2006–09)—were chairmen of Goldman Sachs before their government service, and Henry Fowler joined Goldman Sachs as a partner after his term as Treasury Secretary ended in 1968.<sup>615</sup> Fowler introduced Rubin to

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610. Jackie Calmes & Louise Story, *In Washington, One Bank Chief Still Holds Sway*, N.Y. TIMES, July 19, 2009, at A1.

611. John McCormick et al., *The Administration: Fixing the Things the Chicago Way*, BLOOMBERG BUSINESSWEEK, Jan. 17–23, 2011, at 25 (reporting that President Obama appointed William Daley as his chief of staff after Mr. Daley—a former Secretary of Commerce under President Clinton—worked for JPMorgan for seven years as the bank's "political coordinator") (quoting Leo Melamed); Robert Schmidt, *JPMorgan Drafts Republicans for Damage Control*, BLOOMBERG, June 12, 2013 (reporting that JPMorgan employed former Senator Mel Martinez (R-FL) as a regional chairman and Peter Scher, a former Clinton Administration official, as the bank's head of global government relations); Kevin Wack, *JPMorgan Builds Vast Web of Staff, Money Connections to Lawmakers*, AM. BANKER, June 13, 2012 (explaining that, in addition to giving large political contributions to key members of the Senate and House banking committees, JPMorgan employed 11 in-house lobbyists who were former staffers on Capitol Hill, including six who worked for Democrats and five who worked for Republicans).

612. William D. Cohan, *Rethinking Rubin*, BLOOMBERG BUSINESSWEEK, Sept. 24–30, 2012, at 60; see also Michael Hirsh, *In Bob We Trust*, NATIONAL JOURNAL, Jan. 19, 2013, at 12, 17–18 (reporting that Rubin advocated legislation to repeal Glass–Steagall as Treasury Secretary, and Citigroup CEO Sandy Weill hired Rubin in 1999 "to secure a 'highly visible public endorsement' for the repeal of Glass–Steagall later that year"); Wilmarth, *supra* note 206, at 220–21, 306–07 (explaining that the passage of GLBA, which repealed Glass–Steagall, was necessary to enable Citigroup to continue to operate as a diversified financial conglomerate).

613. Eric Lipton, *Advisers' Citigroup Ties Raise Questions*, N. Y. TIMES, Feb. 11, 2009, at A21; Jonathan Weil, *Citigroup's Man Goes to the Treasury Department*, BLOOMBERG, Feb. 21, 2013; Zachary Goldfarb, *Regulators see chance to cash in*, WASH. POST, Dec. 30, 2010, at A11; David Griffin, *Citigroup's Orszag to Oversee Strategy Unit as Chiefs Picked*, BLOOMBERG, Feb. 25, 2013.

614. See, e.g., Julie Creswell & Ben White, *The Guys from 'Government Sachs'*, N.Y. TIMES, Oct. 19, 2008, § BU, at 1; Michael Hirsh, *'Government Sachs,' Italian Style*, NATIONAL JOURNAL, Nov. 10, 2011 (available on Lexis); Michael J. De La Merced, *Bank of England's New Leader a Member of the 'Government Sachs' Club*, NEW YORK TIMES BLOGS (DEALBOOK), Nov. 26, 2012 (available on Lexis).

615. JOHNSON & KWAK, *supra* note 15, at 93–95; Joseph Weber, *The Leadership Factory*,



Democratic “powerbroker” Robert Strauss in 1971, a step that launched Rubin’s active involvement in politics and government.<sup>616</sup> Both Rubin and Paulson appointed several of their Goldman colleagues to senior Treasury posts during their respective tenures as Treasury Secretary.<sup>617</sup>

Many other former Goldman partners have served in senior federal government positions since World War II.<sup>618</sup> As noted above, former Goldman chairman Stephen Friedman had a controversial tenure as a Class C director of the New York Fed, and he was also chair of the search committee that nominated William Dudley, Goldman’s former chief economist, as the new President of the New York Fed in 2009.<sup>619</sup> Goldman’s alumni also include two leading international central bankers—Mario Draghi (former head of the Bank of Italy and current head of the European Central Bank), and Mark Carney (former head of the Bank of Canada and current head of the Bank of England).<sup>620</sup>

Robert Rubin’s career—including his ability to secure top-level government and private-sector positions for his acolytes—provides a striking illustration of the revolving door’s powerful impact.<sup>621</sup> After being mentored by Henry Fowler and Robert Strauss, Rubin was appointed by President Clinton as head of the National Economic Council in 1993 and as Treasury Secretary in 1995. Rubin received widespread praise for “his handling of the Asian financial crisis and the bailout of Long-Term Capital Management” in 1998.<sup>622</sup> Along with FRB chairman Alan Greenspan and Deputy Treasury Secretary Lawrence Summers, Rubin “was lionized on the cover of *Time*, which dubbed the troika the ‘Committee to Save the World.’”<sup>623</sup> Rubin helped to arrange the appointments of many of his mentees to senior positions in the federal government, including (i) Lawrence Summers as Treasury Secretary in 1999 and as chief economic adviser to President Obama in

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BUSINESSWEEK, June 12, 2006, at 60.

616. William D. Cohan, *Bob Rubin’s Washington Reign Reaches 20 Years*, BLOOMBERG, Jan. 20, 2013.

617. JOHNSON & KWAK, *supra* note 15, at 93–100; Creswell & White, *supra* note 614.

618. Weber, *supra* note 615 (noting, inter alia, that former Goldman chairman Jon Corzine served as a U.S. Senator and Governor of New Jersey, while former Goldman chairman Stephen Friedman served as a senior advisor to President George W. Bush).

619. See *supra* note 574 and accompanying text; Wilmarth, *supra* note 19, at 944–45.

620. Hirsh, *supra* note 612; Landon Thomas Jr. & Jack Ewing, *Can Super Mario Savie the Day for Europe*, N.Y. TIMES, Oct. 30, 2011, § BU, at 4; Landon Thomas Jr. & Julia Werdigier, *Britain Selects a Canadian to Lead the Bank of England*, N.Y. TIMES, Nov. 27, 2012, at B1; De La Merced, *supra* note 614.

621. Gabriel Sherman, *Revolver*, NEW YORK MAGAZINE, April 18, 2011 (“More than anyone else, it was Bob Rubin who made the Democratic revolving door work as smoothly as it has.”) (available on Lexis).

622. *Id.*

623. *Id.*

2009, (ii) Timothy Geithner as President of the New York Fed in 2003 and as Treasury Secretary in 2009, (iii) Peter Orszag as OMB Director in 2009, and (iv) Jacob (Jack) Lew as Treasury Secretary in 2013.<sup>624</sup>

Three recent Comptrollers of the Currency provide further prominent examples of the revolving door between the private sector and government service. Eugene Ludwig practiced law at Covington & Burling, served as Comptroller from 1993 to 1998 and was a vice chairman at Bankers Trust before he founded Promontory Financial Group—"a consulting firm that has built a reputation as a shadow regulator by hiring scores of former government officials"—in 2001.<sup>625</sup> John D. Hawke, Jr., served as the FRB's General Counsel from 1975 to 1978, practiced law at Arnold & Porter and worked as a top Treasury official from 1995 to 1998, after which he served as Comptroller from 1998 to 2004 and then returned to Arnold & Porter.<sup>626</sup> John C. Dugan was a senior House banking committee counsel, worked as a senior Treasury official and practiced law at Covington & Burling before serving as Comptroller from 2005 to 2010, when he returned to Covington & Burling.<sup>627</sup>

As three economists recently observed, "The speed of the revolving door at the SEC makes one's head spin."<sup>628</sup> Between 2001 and 2010,

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624. JOHNSON & KWAK, *supra* note 15, at 93–100; Jackie Calmes, *Rubinomics Recalculated*, NEW YORK TIMES, Nov. 24, 2008, at A1; Cohan, *supra* note 612; Hirsh, *supra* note 612; Eamon Javers, *Robert Rubin returns*, POLITICO.COM, April 8, 2010 (available on Lexis).

625. Jean Eaglesham, *SEC Ex-Chief Lands at Consultant—Schapiro Is Latest Former U.S. Regulator to Join Promontory Financial*, WALL ST. J., April 2, 2013, at C1 (reporting that Promontory hired former SEC chairman Mary Schapiro to lead the firm's "governance and markets practice and advis[e] clients on risk management and compliance" and noting that "[m]ore than one-fourth of Promontory's nearly 400 full-time employees are former regulators"); *see also* Jeff Horwitz & Maria Aspan, *How Ludwig's Promontory Became a Regulatory Braintrust*, AM. BANKER, April 2013 (describing Ludwig's career and his success in building Promontory as an "ex-regulator omnibus, capable of forecasting, mimicking and occasionally even substituting for the financial industry's supervisors"), available at <http://www.promontory.com/uploadedFiles/Articles/News/How%20Ludwigs%20Promontory%20Became%20a%20Regulatory%20Braintrust%20%20April%202013.pdf>; Ludwig: *21st Century Spells Challenge, Change*, BANK INVESTMENT SERVICES REP., Mar. 15, 1999, at 1 (discussing Ludwig's career) (available on Lexis).

626. Arnold & Porter LLP, firm biography of John D. Hawke, Jr., available at <http://www.arnoldporter.com/professionals.cfm?u=HawkeJohnDJr&action=view&id=716>.

627. Covington & Burling, firm biography of John C. Dugan, available at <http://www.cov.com/jdugan/>; JOHNSON & KWAK, *supra* note 15, at 95 (explaining that Dugan served as "a Treasury official during the George H.W. Bush administration, [where] he led a study that advocated the repeal of interstate banking restrictions and of the Glass–Steagall Act; as a lawyer advising the American Bankers Association, he helped steer [GLBA] through Congress"); *see also* U.S. Dept. of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* xviii, 5–8, 49–61 (Feb. 1991) (stating that Dugan was "Study Director" for the Treasury study, which recommended legislation that would authorize nationwide banking and branching and would also repeal the Glass–Steagall Act).

628. BARTH, CAPRIO & LEVINE, *supra* note 19, at 209–10. The revolving door also spins rapidly at the CFTC. According to one news story, "fully three-quarters of those who had served as CFTC

more than 400 SEC alumni filed nearly 2,000 requests to represent clients before the SEC within two years after they had left the agency.<sup>629</sup> Former SEC officials have helped Wall Street clients to obtain hundreds of special waivers from the agency since 2001. Those waivers have allowed Wall Street firms to continue selling securities in public offerings as “well-known seasoned issuers,” and to sell securities in exempt private offerings, even though the firms previously settled SEC charges for securities law violations.<sup>630</sup> In addition, former SEC employees obtained dozens of no-action letters that allowed their Wall Street clients to provide financial support to sponsored money market mutual funds (MMMFs) during the financial crisis.<sup>631</sup> SEC alumni also actively participated in the mutual fund industry’s lobbying campaign that successfully blocked SEC chairman Mary Schapiro’s efforts to impose stronger regulations on MMMFs in 2012.<sup>632</sup>

The powerful impact of the revolving door is confirmed not only by those who enter it but also by those who refuse to enter or decide to leave it. In his recent memoir, Neil Barofsky recounts a meeting in April 2010 with Herbert Allison, a senior Treasury official and former Wall Street executive. After first praising Barofsky as “very talented, with a bright future,” Allison warned Barofsky that he was causing himself “real harm” by issuing reports (in his capacity as Special Inspector General for TARP) that sharply criticized Treasury’s implementation of TARP.<sup>633</sup> Allison advised Barofsky that “[a]ll you really have to do is to change your tone, just a bit, and things can really

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commissioners over the past decade are among the noisy crowd of lobbyists beseeching [CFTC chairman Gary Gensler] to soften the proposed derivatives rules, delay their implementation or simply chuck them out altogether.” Rivlin, *supra* note 7.

629. Project on Government Oversight, *Dangerous Liaisons: Revolving Door at SEC Creates Risk of Regulatory Capture* 8 (Feb. 11, 2013) [hereinafter POGO SEC Revolving Door Report], available at <http://www.pogo.org/our-work/reports/2013/dangerous-liaisons-revolving-door-at-sec.html?print=t>; see also U.S. Gov’t Accountability Off., *Securities and Exchange Commission: Existing Post-Employment Controls Could Be Further Strengthened*, GAO-11-654, at 5,10 (July 2011) (finding that, between 2005 and 2010, 224 SEC alumni filed 825 requests to represent clients before the SEC within two years after those former employees left the agency) [hereinafter GAO SEC Revolving Door Study].

630. POGO SEC Revolving Door Report, *supra* note 629, at 8–10; Edward Wyatt, *S.E.C. Is Avoiding Tough Sanctions for Large Banks*, N.Y. TIMES, Feb. 3, 2012, at A1. In many cases the SEC granted the requested waivers even though the requesting firms had entered into more than one settlement with the SEC. *Id.*

631. POGO SEC Revolving Door Report, *supra* note 629, at 14.

632. *Id.* at 3–6.

633. BAROFSKY, *supra* note 337, at xii–xiii; see also *supra* notes 337–40, 344–49 and accompanying text (discussing Barofsky’s critique of Treasury’s implementation of HAMP); Gretchen Morgenson, *TARP’s Watchdog: A Tough Act to Follow*, N.Y. TIMES, Mar. 20, 2011, § BU, at 1 (explaining that Barofsky criticized Treasury’s implementation of several TARP programs, and noting that Barofsky’s reports “often put him at odds with the Treasury officials whose work he [was] charged with overseeing”).

change for you. Including with the White House.”<sup>634</sup> Allison further suggested that the Obama Administration might be willing to offer Barofsky “[s]omething else in government” or a “judgeship,” but Barofsky politely declined to follow Allison’s advice, and he continued to criticize Treasury’s implementation of TARP in subsequent reports.<sup>635</sup> Of course, Barofsky did not receive any offers of senior government positions or Wall Street partnerships when he completed his government service in 2011.<sup>636</sup>

While Barofsky’s experience indicates the consequences of refusing to enter the revolving door, Gary Gensler’s career reveals the likely costs of exiting that door. After working at Goldman Sachs from 1979 to 1997, Gensler served as a senior Treasury official under Rubin and Summers during the Clinton Administration and later helped Senator Paul Sarbanes to draft the Sarbanes–Oxley Act in 2002.<sup>637</sup> Although viewed as a champion of financial deregulation during his Treasury service, Gensler adopted a very different approach after he was appointed as CFTC’s chairman in 2009. Gensler became the leading government champion for enacting and implementing Dodd–Frank’s new regime for regulating derivatives markets.<sup>638</sup> He also became the “driving force” for prosecuting large U.S. and foreign banks for having manipulated Libor, in sharp contrast to other U.S. and U.K. financial regulators who largely ignored evidence of widespread Libor manipulation in 2007 and 2008.<sup>639</sup>

Gensler publicly declared his independence from Wall Street in early 2010, while he actively negotiated Dodd–Frank’s derivatives reforms. He stated in an interview that he could “take on the banks . . . because they are part of his past, not his future.”<sup>640</sup> As Gensler explained, “I don’t see myself going back to Wall Street . . . . That’s very liberating.”<sup>641</sup>

In response to Gensler’s vigorous reform efforts, Wall Street and its

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634. BAROFSKY, *supra* note 337, at xiv.

635. *Id.* at xiv–xvi; 200–25.

636. *Id.* at 225 (explaining that Barofsky accepted an offer to teach at New York University Law School); *see also* Morgenson, *supra* note 633 (reporting that “comments by unnamed Treasury officials deriding Mr. Barofsky and his work often appeared in news articles after he published his reports. In mid-February [2011], when he announced his retirement, an unidentified Treasury source told The Washington Post that the news was ‘a nice valentine to us.’”).

637. Fana Foroohar, *The Money Cop*, TIME, Dec. 24, 2012, at 36, 40; Foroohar, *supra* note 71; Ian Katz & Robert Schmidt, *Gensler Turns Back on Wall Street to Push Derivatives Overhaul*, BLOOMBERG, Feb. 12, 2010.

638. *See* authorities cited *supra* in note 637.

639. Foroohar, *supra* note 637, at 36, 39–40; Liam Vaughan & Gavin Finch, “Secret Libor Transcripts Expose Trader Rate Manipulation,” BLOOMBERG, Dec. 13, 2012.

640. Katz & Schmidt, *supra* note 637 (paraphrasing Mr. Gensler).

641. *Id.* (quoting Mr. Gensler).

legislative allies blocked his requests for increases in the CFTC's budget and used both lobbying and litigation to obstruct the CFTC's rulemaking efforts.<sup>642</sup> Gensler's term as CFTC chairman expired in April 2012, although he could potentially remain in that position until the end of 2013.<sup>643</sup> As of mid-2013, the Obama Administration had not nominated Gensler for a second term, and efforts by reform advocates to elevate Gensler to a more influential position as Treasury Secretary or SEC chairman went nowhere.<sup>644</sup> In June, industry lobbyists began to spread rumors that President Obama would nominate a replacement for Gensler "as soon as July."<sup>645</sup> Analysts explained the absence of any new appointment for Gensler—despite his "brave and lonely battle" to implement Dodd-Frank's reforms—by pointing out that Wall Street strongly opposed any such appointment.<sup>646</sup>

While bypassing Gensler, the Obama Administration received widespread praise from the financial industry when President Obama appointed two veterans of Wall Street—Jacob (Jack) Lew and Mary Jo White—as Treasury Secretary and SEC chairman in early 2013.<sup>647</sup> From 2006 to 2008 Lew worked as a senior executive at Citigroup,

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642. Foroohar, *supra* note 71; *see also supra* notes 73–89, 95–99, 160–62 and accompanying text (discussing the financial industry's use of lobbying and litigation to cut the CFTC's budget and obstruct the agency's rulemaking).

643. Silla Brush, *Gensler Said to Discuss Chance of Second Term at CFTC*, BLOOMBERG, Mar. 5, 2013.

644. *Id.*; Hirsh, *supra* note 612, at 15; Simon Johnson, *My Top Five Choices for a New Treasury Secretary*, BLOOMBERG, Nov. 11, 2012.

645. Gregory Meyer, *Commodity Futures Trading Commission faces top-level shake-up*, FT.COM (June 18, 2013).

646. Hirsh, *supra* note 612, at 15; *see also* Faroohar, *supra* note 637 (reporting that "some insiders speculate that if Gensler hadn't made so many enemies in finance in the past few years, he might be a contender for a bigger gig, like head of the SEC or Treasury"); Ben Protess & Jessica Silver-Greenberg, *With an Obama Victory, Wall Street Pivots to Plan B*, NY TIMES BLOG, Nov. 7, 2012, 2012 WLNR 23715366 (reporting that "lobbyists at several New York banks" were working to prevent any reappointment of Mr. Gensler as CFTC chairman). The financial industry's ability to block the reappointment of a regulator who is a fearless proponent of strong supervisory policies is not a phenomenon limited to the U.S. In the U.K., leading banks reportedly helped to persuade Chancellor of the Exchequer George Osborne to reject Robert Jenkins' application for a second term on the Bank of England's Financial Policy Committee. The banks opposed Jenkins' reappointment because of his outspoken advocacy for higher bank capital requirements as well as stricter limits on executive compensation paid by systemically important banks. Ben Chu, *How George Osborne threw our guardian angel overboard*, THE INDEPENDENT (London, U.K.), April 5, 2013 (available on Lexis); Iain Dey, *Treasury to shake up bank watchdog: Two of City's fiercest critics may be axed from regulator set up after financial crisis*, THE SUNDAY TIMES (London, U.K.), Mar. 24, 2013, § Bus., at 2 (available on Lexis); *see also* Meera Louis, *Banks Should Defer Bonuses for Up to 10 Years, Jenkins Says*, BLOOMBERG, Feb. 8, 2012 (reporting on Robert Jenkins' proposal that "[b]ankers' bonuses should be deferred for as long as 10 years to hold executives accountable for risks," and noting that Jenkins also "called for higher capital requirements and said 'too-big-to-fail, too-big-to-bail and too-big-to-jail' institutions remain a challenge for regulation").

647. Hirsh, *supra* note 612, at 15–17; William D. Cohan, *Mary Jo White Spins the SEC's Revolving Door*, BLOOMBERG, Mar. 17, 2013.

which hired him on Robert Rubin's recommendation.<sup>648</sup> Citigroup paid Lew a bonus of nearly \$1 million in late 2008, one day after the federal government provided a huge TARP bailout to Citigroup.<sup>649</sup> In addition, Lew's employment contract with Citigroup gave him a stock-based payout worth up to \$500,000 when he left the bank to join the Obama Administration in 2009.<sup>650</sup> Given Lew's strong connections with Citigroup and Rubin, as well as his past support for financial deregulation,<sup>651</sup> it is hardly surprising that Wall Street warmly praised his nomination.<sup>652</sup>

Mary Jo White also attracted strong support from Wall Street when President Obama nominated her as SEC chairman.<sup>653</sup> White served as U.S. Attorney for the Southern District of New York from 1993 to 2002, and during her tenure she pioneered the use of deferred prosecution agreements instead of indictments to resolve criminal charges against large corporations.<sup>654</sup> White then spent more than a decade defending

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648. Jonathan Weil, *Citigroup's Man Goes to the Treasury Department*, BLOOMBERG, Feb. 21, 2013; Jia Lynn Yang, *Treasury pick faced a storm at Citigroup*, WASH. POST, Jan. 25, 2013, at A01.

649. Victoria Finkle, *Lew Defends Citi Experience, Outlines Banking Views*, AM. BANKER, Feb. 14, 2013, 2013 WLNR 3623822; Yang, *supra* note 648.

650. Weil, *supra* note 648; Jonathan Weil, *Is NYU a Charity? Another Question Orrin Hatch Should Ask Jack Lew*, BLOOMBERG, Feb. 25, 2013. As shown by Citigroup's payout to Lew, major Wall Street firms have promoted revolving-door behavior by allowing their senior executives to collect deferred compensation and cash out their stock option awards when they enter government service. Susanne Craig, *Financial Windfalls for Wall St. Executives Taking Government Jobs*, N.Y. TIMES, Mar. 21, 2013, at B5; Project on Government Oversight, *Big Businesses Offer Revolving Door Rewards*, Mar. 21, 2013, available at <http://www.pogo.org/blog/2013/03/big-businesses-offer-revolving-door-rewards.html>.

651. Hirsh, *supra* note 612, at 15, 17 (noting Lew's close connection to Rubin and reporting that (i) during his confirmation hearing for OMB Director in 2010, Lew stated, "I don't believe that deregulation was the proximate cause" of the financial crisis, and (ii) during Lew's earlier service as OMB Director between 1998 and 2001, the OMB cleared both GLBA and CFMA); Finkle, *supra* note 649 (reporting that, during Lew's confirmation hearing for Treasury Secretary in 2013, he disagreed with the view that Congress made a mistake when it repealed Glass-Steagall in 1999).

652. Hirsh, *supra* note 612, at 17 (quoting an unnamed financial-industry lobbyist who said that "Lew's appointment is a huge relief precisely because Wall Street executives believe they'll get something close to another Geithner, or someone even more pliable"); Jim Kuhnenn, *Obama picks Lew for Treasury as fiscal issues loom*, ASSOCIATED PRESS FINANCIAL WIRE, Jan. 10, 2013 (quoting praise for Lew's appointment from Thomas Donohue, head of the Chamber of Commerce, and Rob Nichols, head of the Financial Services Forum); "Forum Statement on Senate Confirmation of Jack Lew," Feb. 27, 2013 (press release by the Financial Services Forum, an organization "comprising the CEOs of 19 of the largest and most diversified financial services institutions doing business in the United States," which praised Lew as having "a unique understanding of the important role the financial sector plays in our economy"), available at <http://www.financialservicesforum.org/index.php/news/press-releases/1403-forum-statement-on-senate-confirmation-of-jack-lew>.

653. Jessica Holzer, *SEC Nominee Signals Shift*, WALL STREET JOURNAL, Jan. 25, 2013, at (quoting Kenneth E. Bentsen, Jr., a "top official" at SIFMA, "Wall Street's main trade group," who called White "a solid choice"); *ICI Statement on Nominee for SEC Chair*, Jan. 24, 2013 (press release by Investment Company Institute, praising White's "record of extraordinary accomplishment" and "applaud[ing] her nomination"), available at [http://www.ici.org/pressroom/news/13\\_secchair\\_nominee](http://www.ici.org/pressroom/news/13_secchair_nominee).

654. Dave Michaels, *Obama's SEC Pick Wary of Zealous Wall Street Prosecutions*, BLOOMBERG,

Wall Street firms and their executives as a partner at Debevoise & Plimpton.<sup>655</sup> She declared in 2003 that she feared a “feeding frenzy of enforcement” after the Enron and WorldCom scandals, and she expressed similar concerns in 2012, when she urged prosecutors to “distinguish what is actually criminal and what is just mistaken behavior, what is even reckless risk-taking, and not bow to the frenzy.”<sup>656</sup> In 2005, White made a controversial intervention on behalf of a Wall Street client in an SEC insider trading investigation, and an SEC lawyer involved in that investigation later called her “Wall Street’s protector-in-chief.”<sup>657</sup>

Given White’s past defense of Wall Street interests and the fact that her husband is also a prominent lawyer representing Wall Street clients, some analysts warned that the SEC’s conflict of interest rules and her

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Feb. 27, 2013 (discussing Mary Jo White’s career and describing her “invention of corporate probation, or deferred prosecution” in 1994 as a method for resolving criminal charges against Prudential Securities for “fraudulently marketing \$8 billion in ruinous energy partnerships to small investors”); Kurt Eichenwald, *Brokerage Firm Admits Crimes in Energy Deals*, N.Y. TIMES, Oct. 28, 1994, at A1 (quoting White’s explanation that she approved the deferred prosecution agreement with Prudential Securities to avoid “crippling collateral consequences to thousands of innocent employees” that could have occurred if the firm had been indicted”); see also Peter Spivak & Sujit Raman, *Regulating the ‘New Regulators’: Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 164 (2008) (stating that the Prudential Securities settlement was “the first deferred prosecution agreement involving a major company”). For criticisms of the use of deferred prosecution agreements for settling criminal charges against large financial firms, see *supra* notes 434–49 and accompanying text (discussing the public outcry against recent deferred prosecution agreements with HSBC and UBS); Michaels, *supra* (quoting former Treasury official Jimmy Gurulé’s charge that “resolving complex cases pursuant to deferred-prosecution agreements is creating a culture of impunity within the financial services community”).

655. Michaels, *supra* note 654 (reporting that Mary Jo White’s clients as a “Wall Street defense lawyer” at Debevoise & Plimpton included JPMorgan Chase, Morgan Stanley, UBS and Bank of America CEO Ken Lewis).

656. *Id.* (quoting White’s statement during a Bloomberg Radio interview in 2003); Roger Runnigen & Joshua Gallu, *Obama Will Name Former Prosecutor Mary Jo White SEC Chairman*, BLOOMBERG, Jan. 24, 2013 (quoting White’s statement at a New York University School of Law event in Feb. 2012); see also *Talks of the Campus, New York University School of Law*, THE LAW SCHOOL MAGAZINE 84 (2012) (quoting White as criticizing President Obama’s creation of a federal-state financial fraud task force during a program at NYU Law School on Feb. 8, 2012, because “[i]t gets back to my frenzy concern. You don’t want that kind of pressure in the system. You don’t want the search for scalps to be the metric for success. Politics doesn’t belong in this space at all.”), available at <http://issuu.com/nyulaw/docs/2012mag?mode=embed&layout=http%3A%2F%2Fskin.issuu.com%2Fv%2Fflight%2Flayout.xml&showFlipBtn=true>.

657. Jean Eaglesham & Liz Rappaport, *The Six Degrees of Mary Jo White*, WALL ST. J., Jan. 26, 2013, at B1 (quoting Gary Aguirre, “a former SEC investigator and whistleblower”). As discussed *supra* in note 456, White contacted SEC enforcement director Linda Thomsen on behalf of Morgan Stanley to inquire whether John Mack was implicated in an SEC insider trading investigation involving Pequot Capital. At the time, Morgan Stanley was considering appointing Mack as its CEO. The SEC fired Aguirre after he sought to depose Mack, and the agency took no action against Mack. A Senate joint committee report and an SEC’s inspector general report criticized the SEC for responding to White’s inquiry and for creating the impression that White might have influenced the agency’s investigation. Morgenson & Bogdanovitch, *supra* note 456; Runnigen & Gallu, *supra* note 656.

personal inclinations could discourage her from pursuing strong regulatory and enforcement policies against Wall Street firms and their executives.<sup>658</sup> In any event, the career paths of Robert Rubin, Peter Orszag, Jack Lew, Mary Jo White, Neil Barofsky and Gary Gensler indicate that the revolving door spins quickly and lucratively for those who sympathize with Wall Street but repels those who criticize Wall Street.

*b. The Impact of “Cultural” and “Cognitive” Capture” in Undermining the Effectiveness of Financial Regulation*

In addition to the revolving door between government service and the financial industry, extensive professional and social contacts encourage regulators to align themselves with the outlook of industry officials, a phenomenon that analysts have described as “cultural capture” and “cognitive capture.”<sup>659</sup> As James Kwak has explained, “‘cultural capture’ . . . operates through a set of shared but not explicitly stated understandings” leading to “regulatory actions that serve the ends of industry.”<sup>660</sup> Similarly, Willem Buiters has argued that “cognitive regulatory capture” occurs when regulators “internalis[e], as if by osmosis, the objectives, interests and perception of reality of the vested interest they are meant to regulate and supervise in the public interest.”<sup>661</sup> The likelihood of cultural capture increases when (i) financial regulators feel part of an “in-group” with industry executives due to close professional contacts and shared “social networks,” and (ii)

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658. William D. Cohan, *Mary Jo White Spins the SEC’s Revolving Door*, BLOOMBERG, Mar. 17, 2013; Andrew Ross Sorkin, *Nominee for ‘Sheriff’ Has Worn Banks’ Hat*, N.Y. TIMES, Jan. 29, 2013, at B1 (noting, inter alia, that John W. White “is a corporate partner at Cravath, Swaine & Moore” and “counts JPMorgan Chase, Credit Suisse and UBS as clients”); Jonathan Weil, *Mary Jo White’s Latest Conflict of Interest*, BLOOMBERG, Feb. 14, 2013; David Zeiler, *Mary Jo White: SEC Pick Compromised by Links to Wall Street*, MONEY MORNING (Jan. 28, 2013), <http://moneymorning.com/2013/01/28/mary-jo-white-sec-pick-compromised-by-links-to-wall-street/>.

659. See Lawrence G. Baxter, *‘Capture’ in Financial Regulation: Can We Channel It Toward the Common Good?*, 21 *Cornell J.L. & Pub. Pol’y* 175, 183–86 (2011) (explaining that “cultural” and “social” capture arise when “the language of regulation is shaped by the common backgrounds, education, experience and intermingling of the more powerful players [in government and industry] in the policy formation process” and noting the impact of “the very visible revolving doors between the SEC and other financial regulators and industry”) (footnotes omitted).

660. James Kwak, “Cultural Capture and the Financial Crisis,” at 9, in *Preventing Capture: Special Interest Influence on Regulation, and How to Limit It* (Daniel Carpenter & David Moss., eds.) (Cambridge Univ. Press, 2013) (forthcoming), chapter manuscript available at <http://www.tobinproject.org/sites/tobinproject.org/files/assets/Kwak%20Cultural%20Capture%20%281.16.13%29.pdf>.

661. Willem H. Buiters, *Central Banks and Financial Crises*, in *Maintaining Stability in a Changing Financial System: Proceedings of the 2008 Economic Policy Symposium* 495, 601 (Fed. Res. Bank of Kansas City, MO, Aug. 21–23, 2008), available at <http://www.kansascityfed.org/publicat/sympos/2008/Buiters.03.12.09.pdf>.



regulators view industry insiders as occupying a “higher status” based on wealth, intellectual achievement and social prominence.<sup>662</sup>

Regulators and bankers maintain close working relationships through frequent supervisory meetings as well as policy discussions about regulatory initiatives.<sup>663</sup> Banking agencies maintain continuous contacts with megabanks by virtue of their “permanent resident teams of bank examiners at the largest banks.”<sup>664</sup> In addition, financial regulators are inclined to identify with the views and experiences of industry officials because (i) regulators “operate within a relatively narrow, insulated and expertise-based” field of work that they share with “sophisticated repeat players” in the financial industry, and (ii) regulators and industry officials frequently have similar educational and professional backgrounds and are therefore “likely to share social, educational, or experiential ties.”<sup>665</sup>

The New York Fed calls its on-site examination teams “relationship management teams,”<sup>666</sup> a term that suggests a very close and symbiotic connection between on-site regulators and the institutions they regulate. The New York Fed’s self-study of supervisory failures during the financial crisis determined that on-site examiners often lacked sufficient independence from the banks they regulated. The study found that “the Relationship teams [often] become gate-keepers at *their* banks, seeking to control access [by other regulators] to *their* institutions.”<sup>667</sup> In addition, “relationship managers were too deferential to bank management and too dependent on the bank’s goodwill and [management information systems] to gain information”<sup>668</sup> Bank examiners complained that they often did not “receive sufficient support from senior management when banks complain about supervisory

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662. Kwak, *supra* note 660, at 11–25.

663. Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 630 (2012).

664. Levitin, *supra* note 514, at 159 (noting that permanent on-site teams of bank examiners bear “an uncanny resemblance to [the teams] of outside accountants at Enron and WorldCom, who abdicated their regulatory role to become enablers”).

665. Ford, *supra* note 523, at 614–15.

666. Caroline Salas & Bradley Keoun, *New York Fed’s Dahlgren Overhauls Bank Supervision to Beef Up Oversight*, BLOOMBERG, Mar. 21, 2011.

667. Federal Reserve Bank of New York, “Report on Systemic Risk and Bank Supervision” (“Discussion Draft” of Aug. 18, 2009 [rev1]), at 11 (emphasis added), FRBNY-FCIC-General10080241 [hereinafter FRBNY Systemic Risk Report], available at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-docs/2009-09-10%20FRBNY%20Report%20on%20Systemic%20Risk%20and%20Bank%20Supervision%20draft.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2009-09-10%20FRBNY%20Report%20on%20Systemic%20Risk%20and%20Bank%20Supervision%20draft.pdf).

668. *Id.* at 19, FRBNY-FCIC-General10080249; see also *id.* at 8, FRBNY-FCIC-General10080238 (“Banks inherently have an information advantage over supervisors . . . . Getting good, timely information is therefore dependent on the willingness and enthusiasm of bank staff in providing that information. Supervisors . . . believe that a non-confrontational style will enhance that process.”).

intrusion,” and one examiner admitted, “Within three weeks on the job, I saw the capture set in.”<sup>669</sup>

The precarious position of on-site bank examiners is part of a larger context in which politicians and industry leaders have pushed financial regulators to treat banks as their “customers.”<sup>670</sup> The Clinton–Gore Administration promulgated a “Reinventing Government Initiative” that described “government as being in the ‘customer service’ business with regulatees as the ‘customers.’”<sup>671</sup> Frank Keating, head of the American Bankers Association (ABA) and a former Oklahoma Governor, expressed a similar view of the role of regulators. When asked by a journalist why the ABA’s members gave a “less than friendly reception” to FDIC chairman Sheila Bair at a 2011 conference, Keating criticized Bair’s “aggressive” remarks and stated that regulators are “servants of the served” while bankers are “regulated people who pay [Bair’s] salary.”<sup>672</sup> In contrast to Bair’s strong personal commitment to independence from the industry she regulated,<sup>673</sup> some bank regulators have accepted the industry’s view that they should treat financial institutions as their “constituents.”<sup>674</sup>

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669. *Id.* at 8 n.2, FRBNY-FCIC-General 10080238.

670. *See supra* notes 528–43 and accompanying text (describing intense political pressures on U.K. and U.S. regulators to adopt industry-friendly policies during the 2000s).

671. Levitin, *supra* note 514, at 159 n.65; *see also* National Partnership for Reinventing Government, *Our Vision for the Future: America @ Our Best*, (stating a goal of achieving “customer satisfaction with federal services equal to or better than the business service sector” and declaring, “We provide our customers with products and information they want and need”), *available at* <http://govinfo.library.unt.edu/npr/library/vision2000.html>.

672. Barbara A. Rehm, *Editor at Large: How Keating Got to ABA and Where He’ll Take It*, AM. BANKER, May 26, 2011, at 1, 2011 WLNR 10443141; *see also* BAIR, *supra* note 290, at 312–16 (describing the “combative heckling” she received at the ABA conference in 2011 after delivering a speech in which she called for stronger regulation of banks (including tighter restrictions on bank overdraft fees) and also suggested that “the success of the financial sector is not an end in itself, but a means to an end—which is to support the vitality of the real economy and the livelihood of the American people”).

673. BAIR, *supra* note 290, at 316 (describing Keating’s remarks as “[f]rightening, but that is how a lot of industry lobbyists see the role of regulators. We do not have our jobs to serve the public. The banks pay our salary, so we work for them”); *id.* at 8, 41 (declaring that Bair based her regulatory decisions on “common sense,” including support for “stronger capital and better lending standards,” as well as “independence, doing the right thing for the general public, and ignoring the special interests”).

674. *See supra* note 551 and accompanying text (referring to OTS Director John Reich’s description of WaMu as “my largest constituent”); *see also supra* note 517 (discussing Darrel Dochow’s controversial career at OTS, during which he was criticized for helping Lincoln Savings, Countrywide and IndyMac avoid regulatory constraints); Levitin, *supra* note 514, at 159–60 (stating that Dochow’s career “indicates that at least some bank regulatory agencies view themselves as a business in which supervised institutions are customers”); Jess Bravin & Paul Beckett, *Friendly Watchdog: Federal Regulator Often Helps Banks Fighting Consumers*, WALL ST. J., Jan. 28, 2002, at A1 (reporting that Comptroller of the Currency John D. Hawke, Jr. appeared in a 1999 OCC video, which described “how the OCC and a national bank charter can help banking organizations achieve their goals,” and also quoting Hawke’s statement that the OCC’s preemption of state consumer protection laws was “one of the advantages of a national bank charter, and I’m not the least bit ashamed to promote it”).

Beyond the deferential supervisory attitudes produced by a “customer service” view of regulation, the revolving door between government and the financial industry creates additional pressures for regulatory acquiescence. The revolving door encourages a similarity of views between regulators and financial executives because (i) “regulators and the representatives of financial institutions are [frequently] the same people, only at different points in their careers,” and (ii) the continuous movement of senior officials between government and the financial sector promotes “social connections between people on opposite sides of the [revolving] door.”<sup>675</sup> For example, after former SEC Commissioner Annette Nazareth returned to private law practice at Davis Polk & Wardwell in 2008, she maintained close connections with SEC Chairman Mary Schapiro and SEC General Counsel and Senior Policy Director David Becker. Nazareth met frequently with Schapiro and Becker, and she sent them Davis Polk’s memoranda analyzing Dodd–Frank’s provisions as the legislation proceeded through Congress. Nazareth also invited Schapiro and Becker to attend December holiday parties hosted by her and her husband, former FRB Vice Chairman Roger Ferguson. In extending one such invitation, Nazareth noted that “we expect [former FRB Chairman Alan] Greenspan to lead us in a sing-along,”<sup>676</sup>

The perceived socioeconomic and intellectual superiority of Wall Street insiders provides further inducements for regulators to accept the financial industry’s viewpoints. During the 1990s and 2000s, “[f]inancial regulators . . . saw firsthand the vast sums of money being made by Wall Street bankers and traders. And . . . the financial sector was routinely lionized as both an exemplar of the knowledge economy and an engine of economic growth.”<sup>677</sup> Moreover, “as the world of

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675. Kwak, *supra* note 660, at 15, 23; *see also* Omarova, *supra* note 663, at 630 (agreeing that, due to “strong professional and personal relationships” between financial regulators and industry executives, regulators “often come to view their institutional interests or mission as largely congruent with the interests of their regulated industry constituency”).

676. *Top Bank Lawyer’s E-Mails Show Washington’s Inside Game*, BLOOMBERG, Sept. 5, 2012 (noting that (i) Nazareth met with Schapiro 11 times in 2009 and 2010, “twice as many as any single competitor in the law and lobbying business,” and (ii) “[w]ith Nazareth on board, Davis Polk was hired as outside counsel on Dodd–Frank by the six largest U.S. banks and the Securities Industry and Financial Markets Association, the Wall Street trade group”). In her email correspondence with Becker about Dodd–Frank’s draft provisions, Nazareth told Becker that the proposed CFPB made her “feel ill” and she assured Becker that she had urged SIFMA to “trash” the proposed new office of investor advocacy at the SEC after hearing Becker’s strong criticism of that office. *Id.*

677. Kwak, *supra* note 660, at 19; *see also id.* at 20–21 (contending that “as the world of finance became more technical, its academic pedigree became more imposing”; as a result, “subscribing to cutting-edge financial theories” endorsed by “famous economists” offered “perceived status benefits” to regulators); JOHNSON & KWAK, *supra* note 15, at 105 (“Over the past twenty years, finance . . . [became] the glistening centerpiece of the modern American economy . . . . [W]here it mattered most—on elite campuses, in the business and financial media, and in the halls of power in

finance became more complicated and central to the economy, the federal government became more dependent” on Wall Street executives not only as potential candidates for regulatory posts but also as essential sources of information and intelligence about financial institutions and markets.<sup>678</sup> Thus, the standard response by regulators and industry officials to outsiders’ critiques of the revolving door was that only people who worked on Wall Street possessed the necessary expertise to develop enlightened policies for regulating Wall Street.<sup>679</sup>

For all of the above reasons, financial regulators and Wall Street executives developed a “confluence of perspectives and opinions” in which “Wall Street’s positions became the conventional wisdom in Washington.”<sup>680</sup> Regulators increasingly viewed the “well-being and profitability of the financial sector as [a policy] objective in its own right,” regardless of the potential risks of pro-industry policies to the broader economy and consumers.<sup>681</sup> At the same time, regulators “marginalized” the views of consumer advocates and other critics of financial deregulation, because they viewed such critics as “people who simply did not understand the bright new world of modern finance.”<sup>682</sup> In short, cultural and cognitive capture occurred within financial

Washington—banking became the latest chapter in the American Dream, the way to make vast riches by working hard and creating innovative new products that would supposedly improve life for everyone.”).

678. JOHNSON & KWAK, *supra* note 15, at 92–94; *see also id.* at 94 (“[A]s finance became more esoteric and policy questions became more technical, . . . all the people with relevant expertise were Wall Street veterans.”); Rothkopf, *supra* note 5, at 259 (“[T]op financial executives offered to political leaders . . . the ability to understand and communicate with markets that were increasingly seen as vital to the economic success or failure of governments.”).

679. David G. Hilzenrath, *SEC head struggles to turn agency around*, WASH. POST, Oct. 8, 2011, at A1 (“Regulators frequently draw staff members from the industries they regulate, saying it’s impossible to function without industry expertise.”); Sherman, *supra* note 621 (quoting an unnamed former senior Goldman Sachs partner, who argued that it would be “a dangerous and scary thing” to conclude that “someone’s past work on Wall Street disqualifies them from playing a role in something as complex as government,” because in that case “you’ll essentially have people [in government] who have no understanding of how financial markets operate”). Former regulators have justified their post-government work on behalf of financial clients in similar terms. For example, former Comptroller of the Currency Eugene Ludwig defended the former regulators employed by his consulting firm, Promontory Financial Group, by stating that “his firm sells expertise and not access to their former employers and co-workers.” Jesse Hamilton & Cheyenne Hopkins, *Banking Consultant Promontory to Face U.S. Senate Panel*, BLOOMBERG, April 10, 2013 (summarizing interview with Ludwig). Ludwig further explained that “people who dedicated their careers to public service can continue to ensure that regulations are implemented properly.” *Id.* (same).

680. JOHNSON & KWAK, *supra* note 15, at 97.

681. Buiter, *supra* note 661, at 602.

682. JOHNSON & KWAK, *supra* note 15, at 97; *see also id.* at 94 (“Financial policy took on the trappings of a branch of engineering, in which only those with hands-on experience on the cutting edge of innovation were qualified to comment.”); Binyamin Appelbaum, *As Subprime Crisis Unfolded, Watchdog Fed Didn’t Bother Barking*, WASH. POST, Sept. 27, 2009, at A1 (reporting that FRB officials dismissed repeated warnings by consumer advocates about the dangers posed by subprime mortgage lending, because officials believed that those advocates did not have sufficient expertise to provide reliable advice).

agencies as the financial industry persuaded regulators that “deregulation was in the public interest” and “unfettered financial activity is always good for society.”<sup>683</sup>

FRB chairman Alan Greenspan was the best-known advocate for the view that “regulators should seek to minimize any interference with innovation and competition in the financial markets” because “market discipline and private risk management produced better results than government regulation over the longer term.”<sup>684</sup> However, Greenspan was hardly alone in holding that view. During the late 1990s, Treasury Secretary Robert Rubin and his deputy and successor Lawrence Summers actively pursued the same public policy goals of encouraging financial innovation and reducing regulation of financial markets.<sup>685</sup> Rubin and Summers played key roles (along with Greenspan) in passing GLBA, which repealed Glass–Steagall, and also in blocking efforts by CFTC chairman Brooksley Born to regulate OTC derivatives.<sup>686</sup> At the Presidential signing ceremony for GLBA in 1999, Summers thanked Greenspan “for your constant advocacy for modernization of our financial system,” and he also praised “former Secretary of the Treasury Bob Rubin, who worked very hard on this.”<sup>687</sup> Summers lauded GLBA as “the right framework for America’s future financial system,” and he stressed “the crucial role of markets” in the Clinton Administration’s “national economic strategy of which this bill is a part.”<sup>688</sup>

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683. Kwak, *supra* note 660, at 8–9.

684. Wilmarth, *supra* note 211, at 903–04 (summarizing Greenspan’s views); *see also* JOHNSON & KWAK, *supra* note 15, at 100 (stating that there was “no truer believer in the ideology of free markets, financial innovation, and deregulation” than Greenspan); ENGEL & MCCOY, *supra* note 19, at 192 (stating that “Greenspan made it his mission to minimize government oversight by outsourcing risk management to banks”).

685. JOHNSON & KWAK, *supra* note 15, at 99 (stating that Summers “shared Rubin’s opinion that financial innovation and free markets were generally good for America”); Hirsh, *supra* note 612, at 18 (“[Rubin’s] advice always sounded sage: Don’t tamper too much with finance or the flow of capital; keep changes minimal.”); “America’s Role in Global Economic Integration,” Speech by Treasury Deputy Secretary Lawrence Summers at the Brookings conference on “Integrating National Economies: The Next Step” (Jan. 9, 1996 [sic]) (“At Treasury, our most crucial international priority remains the creation of a well-funded, truly global capital market.”), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/pr9701091.aspx>.

686. JOHNSON & KWAK, *supra* note 15, at 8–10, 104, 133–37; Wilmarth, *supra* note 206, at 220–21, 306–07; Cohan, *supra* note 612, at 63–64; Hirsh, *supra* note 612, at 17; *see also* ROTHKOPF, *supra* note 5, at 260 (“Robert Rubin led the Clinton administration to promote an aggressively pro-market agenda, . . . [including] a systematic effort . . . to continue the process of deregulating the American financial community.”).

687. Statement by President Bill Clinton at the Signing of the Financial Modernization Bill, Nov. 12, 1999 (remarks of Treasury Secretary Lawrence Summers) [hereinafter Summers GLBA Remarks], *available at* <http://www.treasury.gov/press-center/press-releases/Pages/ls241.aspx>. Rubin stepped down as Treasury Secretary in July 1999 and joined Citigroup as co-chairman shortly before GLBA’s enactment. Wilmarth, *supra* note 206, at 306; Cohan, *supra* note 612, at 64–65.

688. Summers GLBA Remarks, *supra* note 687. At the same signing ceremony, Senator Phil Gramm (R-TX) declared, “We are here today to repeal Glass–Steagall because we have learned that

Greenspan, Rubin and Summers set the tone for a broader regulatory “mindset” that favored deregulatory policies during the long boom of the 1990s and 2000s. As FRB General Counsel Scott Alvarez later acknowledged, “The mind-set was that there should be no regulation; that the market should take care of policing, unless there already is an identified problem.”<sup>689</sup> Richard Spillenkothen, the FRB’s Director of Bank Supervision from 1991 to 2006, observed in 2010 that regulators had “a high degree of faith that financial markets were largely efficient and self-correcting and, therefore, that counterparty and market discipline were generally more effective ‘regulators’ of risk-taking and improper practices than government rules and supervisors.”<sup>690</sup> The New York Fed’s self-study in 2009 similarly conceded that regulators placed too much faith in the assumption that “[m]arkets will always self-correct.”<sup>691</sup>

This overriding faith in financial innovation and self-correcting markets became part of the “conventional wisdom” among Washington policymakers and regulators as well as Wall Street leaders.<sup>692</sup> The

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government is not the answer. We have learned that freedom and competition are the answers.” *Id.* (remarks of Sen. Gramm). President Clinton agreed with Senator Gramm’s view that GLBA represented “a victory for freedom and free markets,” although President Clinton also claimed that GLBA was “a victory for consumer protection.” *Id.* (remarks of President Clinton). Unfortunately, President Clinton’s second claim proved to be illusory. Federal regulators repeatedly failed to protect consumers during the subprime mortgage boom that led to the financial crisis, and the OCC and OTS preempted efforts by the states to safeguard consumers. Wilmarth, *supra* note 211, at 896–919; *see also supra* Part III(B).

689. FCIC Report, *supra* note 36, at 96 (quoting from an FCIC interview with Alvarez).

690. Richard Spillenkothen, “Notes on the performance of prudential supervision in the years preceding the financial crisis by a former director of banking supervision and regulation at the Federal Reserve Board (1991 to 2006),” May 31, 2010, at 12 [hereinafter Spillenkothen FCIC Memo]; *see also id.* at 27 (stating that “the culture of the Federal Reserve—an agency dominated by professional economists whose mindset and intellectual biases were to enhance the workings of free markets, not to design regulations—was reinforced by a Chairman who had a strong, deep, and abiding philosophical belief that market and counterparty discipline were more effective in controlling risks than governmental regulation and oversight”), available at [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-docs/2010-05-31%20FRB%20Richard%20Spillenkothen%20Paper-%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-05-31%20FRB%20Richard%20Spillenkothen%20Paper-%20Observations%20on%20the%20Performance%20of%20Prudential%20Supervision.pdf).

691. FRBNY Systemic Risk Study, *supra* note 667, at 2, FRBNY-FCIC-General0080232; *see also id.* at 6 (describing “the common expectation [at the New York Fed] that market forces would efficiently price risks and prompt banks to control exposures in a more effective way than regulators . . . . Regulators faced and often shared skepticism that regulators could push for more effective practices than those required by the market for controlling firm risk.”).

692. JOHNSON & KWAK, *supra* note 15, at 105–09 (quotes at 105); *see also id.* at 67–70, 106–07 (explaining how neoclassical economic theories, including the “Efficient Capital Market Hypothesis,” provided “the intellectual justification for financial deregulation. If a free market will always provide fundamentally correct asset prices, then the financial sector can be left to its own devices,” *id.* at 69); JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET* xiii (2009) (explaining that “rational market theory,” including “the efficient market hypothesis,” persuaded many academics and policymakers that “[f]inancial markets possessed a wisdom that individuals, companies, and governments did not.”).

resulting “group-think” among policymakers, regulators and financial executives was “a major reason why the federal government deferred to the interests of Wall Street repeatedly in the 1990s and 2000s.”<sup>693</sup> A similar mindset held sway in the U.K. and at the IMF. Two FSA post-mortem reports on the financial crisis found serious flaws within the “intellectual assumptions on which previous regulatory approaches have been largely built,” including (i) misplaced confidence in “[m]arket discipline . . . as an effective tool in constraining harmful risk-taking” and (ii) the mistaken assumption that “[f]inancial innovation can be assumed to be beneficial since market competition would winnow out any innovations which did not deliver value added.”<sup>694</sup> An IMF post-mortem study similarly concluded that:

IMF’s ability to correctly identify the mounting risks [of a global financial crisis] was hindered by a high degree of groupthink, intellectual capture, [and] a general mindset that a major financial crisis in large advanced economies was unlikely . . . [because] market discipline and self-regulation would be sufficient to stave off serious problems in financial institutions . . . [and] ‘sophisticated’ financial markets could thrive safely with minimal regulation.<sup>695</sup>

Another key component of the mindset shared by Washington and Wall Street was the conviction that large financial conglomerates (universal banks) were essential institutions for meeting the needs of global business corporations and for ensuring the international primacy

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693. JOHNSON & KWAK, *supra* note 15, at 97–104 (quote at 97); *see also* BAIR, *supra* note 290, at 17 (when Sheila Bair began her tenure as FDIC chairman in 2006, she encountered a regulatory “groupthink” based on the assumption that the “golden age of banking was here and would last forever. We didn’t need regulation anymore.”); *id.* at 27, 41 (Bair discovered that the FRB “had acquired a strong antipathy to regulation” under Greenspan’s leadership and “the other bank regulators were still moving in the direction of less regulation, at least for larger institutions”; as a result, “early in my tenure, I frequently found myself isolated in advocating for stronger regulatory standards.”); Spillenkothen FCIC Memo, *supra* note 690, at 8–9 (contending that “the dynamics of group-think” led to widespread confidence by regulators in “a stronger and more resilient financial system” because regulators assumed that “banking organizations’ risk management and measurement capabilities . . . were generally effective and with the right incentives would continue to improve”).

694. Financial Services Authority, *The Turner Review: A regulatory response to the global banking crisis* (Mar. 2009), § 1.4, at 39, available at [http://webarchive.nationalarchives.gov.uk/20090320232158/http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://webarchive.nationalarchives.gov.uk/20090320232158/http://www.fsa.gov.uk/pubs/other/turner_review.pdf); *see also* FSA RBS Report, *supra* note 528, ¶ 3.1.3, at 260 (“A consensus among practitioners and policy-makers across the world . . . confidently assumed that the financial system had been made more stable as a result of the very financial innovation and complexity which we now understand played a significant role in the failure both of the overall system and of [major banks] within it.”).

695. Int’l Monetary Fund, Independent Evaluation Off., *IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07*, ¶¶ 40, 42 at 17 (2011), available at [http://www.ieo-imf.org/ieo/files/completedevaluations/Crisis-%20Main%20Report%20\(without%20Moises%20Signature\).pdf](http://www.ieo-imf.org/ieo/files/completedevaluations/Crisis-%20Main%20Report%20(without%20Moises%20Signature).pdf); *see also id.* at 34 (Annex 7) (“The Fund’s general mindset that markets know best and financial innovation reduces risk would have made it difficult for the staff to see the buildup of systemic risks.”).

of U.S. financial markets. In pushing for GLBA's passage, Greenspan and other advocates maintained that the U.S. must authorize universal banks in order (i) to provide global corporations with "full-service provider[s] that can handle their entire range of financing needs,"<sup>696</sup> and (ii) to enable U.S. financial institutions to preserve their "competitiveness" in foreign markets and thereby ensure "the global dominance of American finance."<sup>697</sup>

Amazingly, the global financial crisis—and the enormous sums spent by the U.S., U.K. and European governments in bailing out failing megabanks—did not shake the confidence of Robert Rubin, Lawrence Summers and Timothy Geithner in the value of giant financial conglomerates as key ingredients for domestic and international economic prosperity. During a 2009 interview, Summers declared, "I don't think we can or want to turn back the clock" to a time when the federal government imposed strong limitations on bank activities.<sup>698</sup> In 2012, Summers dismissed proposals to reestablish Glass–Steagall-type restrictions on banks as "revisionism, warped by hindsight and political convenience," and Rubin similarly declared, "It is a myth that the repeal of Glass–Steagall contributed to the financial crisis."<sup>699</sup>

Summers and Geithner strongly opposed—and helped to defeat—the attempt by Senators Sherrod Brown and Ted Kauffman to amend Dodd–Frank by imposing strict size limits on banks.<sup>700</sup> In separate meetings with Senator Kauffman, Summers argued that breaking up the megabanks "would hurt our ability to serve large companies and hurt the competitiveness of the United States," while Geithner contended that federal regulators could adequately control the risks of megabanks by strengthening Basel's international capital standards, thereby ensuring

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696. Statement by FRB Chairman Alan Greenspan before the House Comm. on Banking and Financial Services, 83 Fed. Res. Bull. 578, 579 (1997) (providing testimony on H.R. 10, one of GLBA's predecessor bills); see also James R. Barth et al., "Policy Watch: The Repeal of Glass–Steagall and the Advent of Broad Banking," 14 *Journal of Economic Perspectives* No. 2 (Spring 2000), at 191, 198–99 (contending that GLBA's authorization for universal banking powers would benefit the U.S. economy by allowing large U.S. banks to provide "one-stop" shopping with improved financing opportunities and "more product and service choices to their customers").

697. Senate Report No. 106-44, at 5 (1999) (quoting Greenspan's testimony).

698. ROTHKOPF, *supra* note 5, at 231–32, 393 (quoting from the author's interview with Summers in 2009); see also *id.* at 18, 260 (noting that the author worked with Rubin, Summers and Geithner during the Clinton Administration).

699. Cohan, *supra* note 612, at 63–64 (quoting statements made by Summers and Rubin in 2012).

700. CONNAUGHTON, *supra* note 371, at 227–44; see also *id.* at 228 (describing the Brown–Kauffman amendment, which would have "impos[ed] a strict 10 percent cap on any bank-holding company's share of the United States' total insured deposits" and "limit[ed] the size of non-deposit liabilities at financial institutions (to 2 percent of GDP for banks, and 3 percent of GDP for non-bank institutions)"); *id.* at 243–44 (explaining that Brown–Kauffman was defeated by a vote of 33–61, and quoting a senior Treasury official who said, "If we'd been for [Brown–Kauffman], it probably would have happened. But we weren't, so it didn't.").



that “U.S. banks wouldn’t be disadvantaged relative to foreign banks.”<sup>701</sup> Indeed, Geithner believed that he couldn’t solve the economic crisis “without keeping the banks intact.”<sup>702</sup>

The most adamant defense of megabanks was offered by Rubin himself. During an interview with David Rothkopf after the financial crisis, Rubin maintained that he and Summers “had advocated the right policies [during the Clinton Administration] and would argue the same things today.”<sup>703</sup> When Rothkopf asked “whether the biggest and most influential financial organizations ought to be broken up, whether being ‘too big to fail’ was a problem to be addressed,” Rubin’s response was immediate and emphatic:

“No, [Rubin] said, ‘don’t you see? Too big to fail isn’t a problem with the system. It *is* the system. You can’t be a competitive global financial institution serving global corporations of scale without having a certain scale yourself. The bigger multinationals get, the bigger financial institutions will have to get.’”<sup>704</sup>

Trade associations for megabanks have echoed Rubin’s arguments in favor of preserving the same universal banking model that precipitated the global financial crisis.<sup>705</sup> For example, five major financial trade associations criticized the FRB’s proposed enhanced prudential supervisory requirements for SIFIs because the FRB’s proposal sought to provide “incentives” for SIFIs “to reduce their systemic footprint.”<sup>706</sup> The trade associations declared that the FRB was “misguided” in suggesting that “big is bad,” and they also asserted, “Banks must mirror the economic system they are designed to serve. In the 21st century,

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701. *Id.* at 234, 236 (describing arguments made by Summers and Geithner during their meetings with Sen. Kaufman).

702. Hirsh, *supra* note 612, at 17; *see also* BAROFSKY, *supra* note 337, at 156–57, 199–200 (maintaining that Geithner administered HAMP and other TARP programs in order to “foam the runway” for large troubled banks and guarantee their survival); JOHNSON & KWAK, *supra* note 15, at 208–09 (noting that Diana Farrell, a member of President Obama’s National Economic Council, rejected proposals to break up big banks and argued that “the genie’s out of the bottle and what we need to do is to manage them and to oversee them, as opposed to hark back to a time that we’re unlikely to ever come back to or want to come back to.”).

703. ROTHKOPF, *supra* note 5, at 266.

704. *Id.*

705. *See, e.g.*, JOHNSON & KWAK, *supra* note 15, at 211 (“A common argument, put forward by [advocates for big banks], is that large corporations require financial services that only large banks can provide. Related to this is the idea that the global competitiveness of U.S. corporations requires that American banks be at least as large as anyone else’s banks.”); Lawrence G. Baxter, *Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance*, 31 *Rev. of Banking & Financial L.* 765, 786–87 (2012) (“Big bank executives insist that . . . modern global banking services require *large-scale capacity* in order to deliver products and innovations that smaller banks could not do effectively . . . [and] that U.S. banks would need to be large enough to be competitive internationally.”).

706. Big Bank Systemic Risk Comment Letter, *supra* note 44, at 16 (quoting FRB Proposed Rule for SIFIs, *supra* note 40, 77 Fed. Reg. at 596).

companies served by international banks compete in a global economic system . . . . [T]hey need banks that are competitive around the world.”<sup>707</sup>

As Simon Johnson and James Kwak have observed, the arguments advanced by advocates for megabanks “suffer from a shortage of empirical evidence.”<sup>708</sup> Most studies indicate that banks larger than \$100 billion do not generate favorable economies of scale or scope after one eliminates the significant funding advantages that megabanks currently enjoy due to their huge explicit and implicit TBTF subsidies.<sup>709</sup> Even before the financial crisis began in 2007, studies confirmed that large financial conglomerates generated “higher levels of systemic risk on both sides of the Atlantic.”<sup>710</sup> Moreover, financial markets did not endorse the universal banking model since they applied a significant “conglomerate discount” to the value of banks that engaged in multiple lines of financial activity.<sup>711</sup>

There is no reason to believe that multinational corporations would fail to obtain adequate financial services in the absence of trillion-dollar financial conglomerates. Large corporations have long relied, both before and after GLBA, on syndicates (groups) of banks and securities firms—not single institutions—for underwriting loans as well as equity and debt securities.<sup>712</sup> Prior to GLBA’s repeal of Glass–Steagall in 1999, large U.S. commercial banks and securities firms were widely viewed as global leaders in efficiency, innovation and profitability. They consistently outperformed European and Japanese universal banks

707. Big Bank Systemic Risk Comment Letter, *supra* note 44, at 17. Similarly, three trade associations representing the largest financial institutions—the Financial Services Forum, the Financial Services Roundtable and SIFMA—issued a joint policy brief in Mar. 2013, which declared, “The value provided by large diversified institutions is particularly important to large, globally active U.S. corporations and the further development of global markets for U.S. goods and services.” Victoria Finkle, *Industry, Lawmakers Clash Over ‘Too Big to Fail’* AM. BANKER (Mar. 12, 2013), 2013 WLNR 6051393 (quoting policy brief).

708. JOHNSON & KWAK, *supra* note 15, at 211.

709. ADMATI & HELLWIG, *supra* note 523, at 89, 136–39, 143–44, 290–91 nn.28–34; Andrew G. Haldane, “On being the right size,” The 2012 Beesley Lecture at the Institute of Directors (London), 25 Oct. 2012, at 12–13, *available at* <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech615.pdf>. As Haldane points out, “Over the period 2002 to 2007, the implied annual subsidy to the world’s [29] largest banks averaged \$70 billion per year using a ratings-based measure . . . . That is roughly 50% of the average post-tax profits of these banks over the period . . . . By 2009, the . . . implied monetary subsidy [for the largest banks increased to] over \$700 billion per year.” *Id.* at 4. For additional evidence of the explicit and implicit TBTF subsidies exploited by megabanks, see Wilmarth, *supra* note 12, at 958–59, 978–84; Wilmarth, *supra* note 109, at 3–5; *supra* notes 112–15 and accompanying text.

710. Wilmarth, *supra* note 15, at 996.

711. Wilmarth, *supra* note 283, at 748–49.

712. JOHNSON & KWAK, *supra* note 15, at 212; Wilmarth, *supra* note 15, at 980–84; Wilmarth, *supra* note 206, at 378–81.

in international financial markets.<sup>713</sup> Indeed, based on the global superiority of U.S. commercial banks and securities firms during the 1980s and 1990s, some analysts concluded that “the decentralized financial industry structure mandated by the Glass–Steagall Act encouraged competition . . . [and] spurred continuing innovation by U.S. banks and securities firms, [giving] them a clear technical superiority over European universal banks.”<sup>714</sup> Large U.S. financial institutions would likely recover the innovative and competitive spirit they exhibited in the 1980s and 1990s if they were obliged to abandon the excessively complex universal banking model along with its bloated TBTF subsidies.<sup>715</sup>

*C. Attorney General Holder’s “Too Big to Jail” Admission and JPMorgan’s “London Whale” Trading Debacle Show that TBTF Banks Continue to Operate Without Effective Control by Federal Regulators*

Two events in March 2013 demonstrated that Wall Street megabanks remain a major unresolved problem for U.S. financial policy in view of their TBTF status and their ability to operate without effective oversight or restraint by federal agencies. First, during a Senate committee hearing, Attorney General Eric Holder acknowledged that DOJ was reluctant to pursue criminal prosecutions against the largest financial institutions because of the potentially destabilizing effect of such proceedings on domestic and global financial systems. Second, a Senate subcommittee’s investigation of the JPMorgan “London Whale” scandal revealed that JPMorgan’s executives and the bank’s primary regulator (the OCC) failed to prevent the bank’s traders from making disastrous bets on high-risk derivatives. Both events provided dramatic confirmation that the largest banks remain too big to fail, manage or

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713. Wilmarth, *supra* note 206, at 440–43, 451–53.

714. *Id.* at 441; *see also id.* (“Several observers have noted that [Glass–Steagall] had an ironic but important effect on competition and experimentation in U.S. financial markets.”); “A Turning Point: Defining the Financial Structure,” Speech by FDIC Vice Chairman Thomas Hoenig, presented at the 22nd Annual Hyman P. Minsky Conference at the Levy Economic Institute of Bard College (New York, NY), April 17, 2013 (“We have a long tradition of financial institutions competing on a global basis and doing so successfully under [a Glass–Steagall] model similar to that proposed here. The largest commercial banks under the umbrella of the safety net would remain mega banks and hold scale capable of offering payments services and loans of any size to firms that operate globally. U.S. broker–dealers and investment banks have long offered specialized capital market services that are competitive and second to none in the world.”) [hereinafter Hoenig April 17, 2013 Speech], *available at* <http://www.fdic.gov/news/news/speeches/spapr1713.html>.

715. *See* “Finance: The fall of the universal bank,” *Economist*, Nov. 21, 2012 (predicting that “the power of universal banks will be eroded by market forces” and stronger regulation, and concluding that “[t]he promise of the cross-selling financial supermarket has long been eclipsed by the destruction of shareholder value after the crash”), *available at* <http://www.economist.com/news/21566439-exit-rock-star-bosses-fall-universal-bank>.

regulate.

### 1. Attorney General Holders' "Too Big to Jail" Testimony Confirms that Federal Agencies Cannot Discipline the Largest Financial Institutions Effectively

During a hearing before the Senate Judiciary Committee on March 6, 2013, Senator Charles Grassley (R-IA) asked Attorney General Eric Holder to comment on DOJ's use of a deferred prosecution agreement to settle HSBC's massive money-laundering violations. Grassley declared he was "concerned we have a mentality of 'too big to jail' in the financial sector," and he also noted the absence of "any high-profile financial convictions [for] either companies or individuals."<sup>716</sup> In response to Grassley's question, Holder admitted that "the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute—if we do bring a criminal charge—it will have a negative impact on the national economy, perhaps even the world economy."<sup>717</sup>

Holder's candid recognition of the "too big to jail" problem was "stunning" and "even more direct" than Assistant Attorney General Lanny Breuer's prior acknowledgments of DOJ's reluctance to prosecute major banks.<sup>718</sup> Holder's statement was also "embarrassingly at odds with the Obama administration's view that too-big-to-fail was fixed by the Dodd–Frank [Act]."<sup>719</sup> In addition, Holder failed to explain why the "too big to jail" status of megabanks prevented DOJ from indicting even one top executive of any of the large financial institutions

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716. Transcript: Attorney General Eric Holder on 'Too Big to Jail', AM. BANKER, Mar. 7, 2013 (quoting statements by Sen. Grassley and Attorney General Holder during the Mar. 6 hearing) [hereinafter Holder Transcript] (available on Lexis); see also *supra* notes 434–38 and accompanying text (discussing DOJ's deferred prosecution agreement with HSBC).

717. Holder Transcript, *supra* note 716 (also conceding that the size of major banks "has an inhibiting influence, impact on our ability to bring resolutions that I think would be more appropriate . . . . The concern you raised is actually one that I share."); see also Rob Blackwell & Victoria Finkle, *How Holder's Surprising 'Too Big to Jail' Admission Changes Debate*, AM. BANKER, Mar. 7, 2013 (describing Holder's "stunning admission" and reporting that his testimony "marked the first time such concerns have been raised by a top member of President Obama's cabinet") (available on Lexis).

718. Blackwell & Finkle, *supra* note 717; see also Danielle Douglas, *Attorney general says big banks' size inhibits prosecution*, WASH. POST, Mar. 7, 2013, at A12 (reporting that "Holder's admission bolsters criticisms that federal prosecutors are deeming some banks 'too big to jail'"); *supra* notes 436–37, 447–48 (discussing Breuer's explanations as to why DOJ chose not to indict HSBC or UBS).

719. Andrew Ross Sorkin, *Realities Behind Prosecuting Big Banks*, N.Y. TIMES, Mar. 12, 2013, at B1; see also Blackwell & Finkle, *supra* note 717 (reporting that Holder's statement appeared "to conflict with" the Obama Administration's repeated claim that Dodd–Frank "effectively ended too big to fail").

that were at the center of the financial crisis.<sup>720</sup> As Andrew Ross Sorkin observed, Holder's concern about the systemic impact of indictments against megabanks created a "powerful argument . . . that prosecutors should focus on the individuals responsible for the misconduct" at those banks.<sup>721</sup>

During a follow-up hearing before the Senate Banking Committee on March 7, 2013, Senator Elizabeth Warren (D-MA) pointed out that HSBC paid a fine, but none of HSBC's executives was criminally prosecuted or was banned from the banking industry and HSBC was allowed to continue operating in the U.S.<sup>722</sup> In response to a question from Senator Jeff Merkley (D-OR) on how regulators could "explain [the HSBC settlement] to your neighbor," FRB Governor Jerome Powell conceded that it was difficult to reconcile HSBC's treatment with the principle that "we're all equal under the law."<sup>723</sup> Powell also admitted that questions about "the fairness of the system" would not be resolved until the FRB and other federal regulators demonstrated their ability to end TBTF treatment for megabanks.<sup>724</sup>

## 2. The Senate Investigation of JPMorgan's "London Whale" Scandal Shows that Wall Street Banks Continue to Engage in Speculative Risk-Taking While Avoiding Regulatory Oversight

On March 14, 2013, the Senate's Permanent Subcommittee on Investigations (PSI) released its report on JPMorgan's "London Whale" trading debacle, which inflicted \$6.2 billion of losses on the bank.<sup>725</sup> The PSI's report presented a "devastating" and "scathing" portrayal of systemic failures of risk management and oversight by JPMorgan and by its primary regulator, the OCC.<sup>726</sup> As shown below, JPMorgan's executives (i) allowed the bank's traders to make enormous bets on synthetic credit derivatives that exceeded the bank's internal risk limits, (ii) sought to conceal the bank's rapidly growing trading losses from the

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720. Sorkin, *supra* note 719; *supra* notes 415-16, 426-30 and accompanying text (discussing the absence of criminal prosecutions against any senior executives of major financial institutions).

721. *Id.*

722. Victoria Finkle, *Six Takeaways from Senate Bruising of Regulators on 'Too Big to Jail'*, AM. BANKER, Mar. 8, 2013 (describing the Mar. 7 hearing before the Senate Banking Committee) (available on Lexis).

723. *Id.*

724. *Id.*

725. Mike Ferullo, *Bank Supervision: JP Morgan and OCC Officials Face Criticism For Failure to Stem Risky Derivatives Trades*, 100 BNA'S BANKING REP. 502 (Mar. 19, 2013).

726. Jessie Eisinger, *Lessons Learned After Financial Crisis: Nothing Much Has Changed*, N.Y. TIMES, Mar. 20, 2013, at B5 (describing the PSI report as "devastating"); Dan Fitzpatrick et al., *Senate Slams Bank on 'Whale'—Panel Says J.P. Morgan Misled Regulators and Investors, Ignored Risks in Big Trades*, WALL ST. J., Mar. 15, 2013, at A1 (describing the PSI report as "scathing").

OCC until several weeks after the “London Whale” problem was exposed by the press, and (iii) made statements to the press about the trading losses that were false or misleading. For its part, the OCC ignored numerous warning signs about JPMorgan’s high-risk trading activities and failed to take prompt and effective action after the agency saw press reports about the bank’s trading losses.

- In 2005, JPMorgan created the Chief Investment Office (CIO) to invest the bank’s “excess deposits,” and CIO began investing in synthetic credit derivatives in 2006.<sup>727</sup> CIO did not disclose the existence of its Synthetic Credit Portfolio (SCP) to the OCC until January 2012.<sup>728</sup> An internal bank audit in late 2007 stated that SCP was pursuing “proprietary position strategies,” and an OCC official later described SCP’s operations as “‘classic prop trading,’ a view buttressed by the fact that CIO had no client-facing customers or client-facing activity.”<sup>729</sup>
- Between 2007 and 2011, SCP produced about \$2.5 billion in revenues for JPMorgan, with peak revenues of \$1.05 billion in 2009.<sup>730</sup> CIO’s traders expanded the aggregate notional amount of SCP’s synthetic credit derivatives from \$4 billion to \$51 billion during 2011 and generated trading gains of more than \$450 million by the end of that year.<sup>731</sup> JPMorgan’s senior management was pleased with CIO’s performance, and CIO head Ina Drew encouraged CIO’s traders to try to “repeat their performance” in 2012.<sup>732</sup> During 2010 and 2011, Drew received total compensation of \$29 million, while CIO’s chief investment officer, Achilles Macris, received \$31.75 million and CIO’s key traders—Javier Martin-Artajo and Bruno Iksil—received \$22.73 million and \$14.08 million, respectively.<sup>733</sup> Those employees were “among the most highly-paid employees in [JPMorgan], and their compensation was reviewed by the bank’s Operating

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727. By 2012, CIO used JPMorgan’s “excess deposits” to create “a portfolio of approximately \$350 billion, a historic high.” U.S. Senate Permanent Subcommittee on Investigations, *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses: Majority and Minority Staff Report* 21-22, 35-37 (Mar. 15, 2013) [hereinafter *Senate London Whale Report*], available at <http://www.levin.senate.gov/newsroom/press/release/senate-investigations-subcommittee-holds-hearing-and-releases-report-on-jpmorgan-chase-whale-trades/?section=alltypes>.

728. *Id.* at 35, 38-39.

729. *Id.* at 38, 41-42 (quoting JPMorgan internal audit report dated Nov. 29, 2007, and PSI interview with Mike Sullivan, OCC, on Aug. 30, 2012).

730. *Id.* at 50, 56.

731. *Id.* at 50-54.

732. *Id.* at 54-56.

733. *Id.* at 57-58; see also *id.* at 21-25 (describing the roles of Ina Drew, Achilles Macris, Javier Martin-Artajo and Bruno Iksil within CIO).

Committee and approved by CEO Jamie Dimon.”<sup>734</sup>

- At the end of 2011, JPMorgan’s senior managers told CIO to reduce SCP’s risk-weighted assets (RWA) in order to decrease the amount of capital JPMorgan would be required to maintain under “upcoming Basel III standards.”<sup>735</sup> However, instead of reducing SCP’s portfolio (which would have involved trading losses), CIO’s traders greatly expanded SCP’s notional size from \$51 billion at the end of 2011 to \$157 billion at the end of March 2012.<sup>736</sup> CIO’s traders gambled that their purchases of massive volumes of synthetic long positions (which bought protection) on investment-grade debt would permit them to reduce JPMorgan’s RWA without having to sell SCP’s very large existing synthetic short positions (which sold protection) on high-yield debt.<sup>737</sup>
- CIO’s traders also gambled that they could generate gains from newly-purchased synthetic long positions on investment-grade debt that would offset large losses that were already embedded in SCP’s existing synthetic short positions on high-yield debt.<sup>738</sup> Unfortunately, “[n]ot only did the SCP’s short positions lose value as the economy improved [in early 2012], but the long credit protection the CIO purchased for investment grade companies did not increase in value as much as was needed to offset the losses.”<sup>739</sup> As a result, SCP’s losses rapidly escalated from early January to the end of March 2012.<sup>740</sup>
- When Ina Drew finally ordered CIO’s traders to stop SCP’s trading operations on March, 23, 2012, SCP’s portfolio was so large that its positions “became visible to the rest of the market.”<sup>741</sup> News reports about CIO’s “London Whale” trades began to appear in early April, and hedge funds and other

734. *Id.* at 59.

735. *Id.* at 60–61.

736. *Id.* at 62–85; *see also id.* at 93 (“At its height in March 2012, the [SCP] portfolio included holdings of more than 100 types of credit derivatives, almost all index or tranche holdings, most of which had lost value since their acquisition.”).

737. *Id.* at 65–73.

738. *Id.* at 68–85.

739. *Id.* at 75–90 (quote at 78). The PSI report and the OCC subsequently described the behavior of CIO’s traders in the first quarter of 2012 as “doubling down” on a “losing trading strategy.” *Id.* at 82 (quoting email from Elwyn Wong, OCC, to Scott Waterhouse and others, OCC, dated June 29, 2012).

740. *Id.* at 75–90.

741. *Id.* at 85–86, 90. On Mar. 23, when Drew told CIO’s traders to stop trading in SCP, Bruno Iksil told a CIO colleague that “[i]t is over/it is hopeless now . . . . I tell you, they are going to trash/destroy us . . . . I am going to be hauled over the coals . . . you don’t lose 500M without consequences.” *Id.* at 123, 124 (quoting Iksil’s instant messages to Julien Grout on Mar. 23, 2012). In a subsequent message on the same day to another colleague, Iksil admitted that “the guys” in the market “know my position because [I] am too big for the market . . . . [I] am too visible.” *Id.* at 124 (quoting instant message from Iksil to Ade Adetayo on Mar. 23, 2012).

investors placed large bets against SCP's positions.<sup>742</sup> Jamie Dimon ordered JPMorgan's derivatives team to "dismantle" SCP, and the team transferred most of SCP's positions to JPMorgan's investment bank for liquidation. JPMorgan's losses from SCP's trades exceeded \$6.2 billion by the end of 2012.<sup>743</sup>

- SCP breached CIO's trading risk limits on hundreds of occasions without any effective response from JPMorgan's risk managers. After SCP surpassed CIO's value-at-risk (VAR) limit in January 2012, CIO persuaded JPMorgan's risk managers to approve a new, unproven and flawed VAR model. The new model—which JPMorgan revoked in May 2012—reduced CIO's reported VAR by half and thereby doubled CIO's VAR risk limit.<sup>744</sup> CIO's traders used the new VAR model to justify large increases in SCP's notional size and risk.<sup>745</sup> Similarly, when SCP exceeded CIO's Comprehensive Risk Measure (CRM) in March 2012, CIO's chief market risk officer dismissed the CRM results as "garbage" and CIO failed to heed the CRM breach.<sup>746</sup> SCP also jumped over additional trading restrictions, including "credit spread risk metrics," "mark-to-market stress limits," "stop loss advisories" and "concentration limits," but JPMorgan's risk managers did not respond to any of those breaches.<sup>747</sup> The Senate PSI report concluded:

In contrast to JPMorgan Chase's reputation for best-in-class risk management, the [London] whale trades exposed a bank culture in which risk limit breaches were routinely disregarded, risk metrics were frequently criticized or downplayed, and risk evaluation models were targeted by bank personnel seeking to produce artificially lower capital requirements.

. . . In fact, from January 1 through April 30, 2012, CIO risk limits and advisories were breached more than 330 times.<sup>748</sup>

- When CIO finally disclosed SCP's existence to the OCC in January 2012, "the CIO downplayed the portfolio's importance by misinforming the OCC that it planned to reduce the SCP."<sup>749</sup>

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742. *Id.* at 90–93.

743. *Id.* at 92–93.

744. *Id.* at 160, 166–81, 185–87.

745. *Id.* at 182–25.

746. *Id.* at 187–92; *see also id.* at 190 (quoting email from Peter Weiland to Javier Martin-Artajo dated Mar. 2, 2012).

747. *Id.* at 198–213 (quotes at 198, 207, 208, 211).

748. *Id.* at 154.

749. *Id.* at 216 (quote), 227–29.



During February and March, as SCP's size and losses steadily mounted, JPMorgan "began to omit key CIO performance data from its standard reports to the OCC."<sup>750</sup> As a result, the OCC was "surprised" to learn about SCP's enormous size and extensive losses when "media reports unmasked the role of JPMorgan Chase in the whale trades" in April 2012.<sup>751</sup> After reading these press reports, the OCC asked for more information about SCP, but JPMorgan provided "inadequate information that delayed effective oversight."<sup>752</sup> Indeed, the OCC "received such limited data [from JPMorgan] about the trades and such blanket assurances from the bank about them that, by the end of April, the OCC considered the matter closed."<sup>753</sup> On May 4, 2012, shortly before JPMorgan filed its first-quarter financial results showing a large loss from SCP's trades, JPMorgan's chief financial officer, Douglas Braunstein, finally told Scott Waterhouse, the OCC's examiner-in-chief, about the magnitude of SCP's problems.<sup>754</sup>

- Despite having more than sixty resident examiners at JPMorgan,<sup>755</sup> the OCC failed (i) to inquire about CIO's extraordinary trading gain of \$400 million at the end of 2011, (ii) to identify SCP's rapidly growing size and losses until press reports about SCP appeared in April 2012, (iii) to inquire about CIO's adoption of a new VAR model that cut SCP's risk profile in half, (iv) to notice or respond to numerous reports from JPMorgan indicating that CIO was breaching multiple trading risk limits, and (v) to notice that JPMorgan omitted key CIO performance data from its reports to the OCC in February and March 2012.<sup>756</sup> The OCC understood CIO's operations so poorly that OCC examiners initially viewed SCP as "a low risk hedge-management activity, and thus not a high supervisory priority."<sup>757</sup>
- Even after JPMorgan publicly disclosed large losses from SCP's trading activities in May 2012, two senior OCC officials at first downplayed the seriousness of those losses until Thomas Curry,

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750. *Id.* at 216 (quote), 230–31.

751. *Id.* at 217 (quotes), 236.

752. *Id.* at 237.

753. *Id.* at 217 (quote), 237–41.

754. *Id.* at 242–43; *see also id.* at 243 (stating that Waterhouse was "taken aback" by Braunstein's call "since the bank should have updated him about the mounting losses prior to that telephone call").

755. *Id.* at 27 (stating that the OCC had "approximately 65 on-site examiners who are responsible for reviewing nearly every facet of JPMorgan Chase's activities and operations. Several OCC examiners were responsible for overseeing the CIO.>").

756. *Id.* at 9, 216–17, 226–34.

757. *Id.* at 234, 234 n.1322 (quoting memorandum from Sally Belshaw, OCC, to Mike Brosnan, OCC, dated Oct. 26, 2012, entitled "Surrounding Losses at CIO and Lessons Learned").

the recently-appointed Comptroller of the Currency, demanded a more thorough review.<sup>758</sup> The OCC subsequently issued a case-and-desist order against JPMorgan in January 2013, which required the bank “to undertake a number of actions to strengthen its risk management and derivatives trading practices.”<sup>759</sup> However, as of mid-2013, the OCC had not assessed any civil money penalties against JPMorgan despite finding that the bank committed “regulatory violations” and engaged in “unsafe and sound practices in its derivatives trading and valuation activities.”<sup>760</sup>

- JPMorgan’s evasion of OCC oversight of SCP was part of a larger pattern of resistance to OCC supervision. In December 2010, when the OCC requested better documentation of CIO’s investment policies and portfolio decisions, Ina Drew “sternly” declared that the OCC was trying to “destroy” JPMorgan’s business and remove “necessary flexibility from the CIO.”<sup>761</sup> The OCC’s examiner-in-charge for JPMorgan admitted that it was “very common” for the bank to “push back on examiner findings and recommendations,” and that senior bank executives “yelled at OCC examiners” and called them “stupid” during one meeting.<sup>762</sup> In early 2012, JPMorgan CEO Jamie Dimon instructed JPMorgan’s investment bank to stop providing daily profit and loss reports to the OCC for a week, claiming that the OCC did not need such reports.<sup>763</sup> When the OCC finally asked for daily profit and loss reports from CIO in May 2012, the head capital markets examiner told his colleagues, “Bank will likely object to this.”<sup>764</sup> The PSI’s report viewed the examiner’s comment as “disturbing evidence of not only the bank’s resistance to OCC oversight, but also the OCC’s failure to establish a regulatory relationship in which the bank accepted its

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758. *Id.* at 246–48 (explaining that Mike Brosnan, head of the OCC’s Large Bank Supervision division, and OCC Chief Counsel Julie Williams at first did not view JPMorgan’s disclosure of SCP’s trading losses as presenting a serious problem for JPMorgan or the OCC); *see also id.* at 234–36 (reporting that senior OCC officials, including Mr. Brosnan and Ms. Williams, “initially accepted the bank’s characterization of the SCP as a hedging mechanism intended to reduce bank risk”).

759. *Id.* at 250; *see also* Office of the Comptroller of the Currency, *In re JPMorgan Chase Bank, N.A.*, Enforcement Action #2013-001, Jan. 14, 2013 [hereinafter *OCC JPMorgan Order*], available at <http://www.occ.gov/static/enforcement-actions/ea2013-001.pdf>.

760. *Senate London Whale Report*, *supra* note 727, at 236, 249–50; *see also OCC JPMorgan Order*, *supra* note 759, at 1–4, 25–26 (stating that the OCC reserved the future right to assess civil money penalties “based on the findings set forth in this Order”).

761. *Senate London Whale Report*, *supra* note 727, at 222–23.

762. *Id.* at 224 (quoting PSI interview with Scott Waterhouse on Sept. 17, 2012).

763. *Id.* at 225 (noting that Dimon “raised his voice in anger” when he learned that JPMorgan’s chief investment officer ordered the investment bank to resume providing the daily profit and loss reports to the OCC).

764. *Id.* at 231 (quoting email from Fred Crumlish, OCC, to Scott Waterhouse and others, OCC, dated May 7, 2012).

obligation to readily provide data requested by its regulator.”<sup>765</sup>

- In an earnings call with investors, analysts and the media on April 13, 2012, Dimon called SCP’s trading problems “a complete tempest in a teapot” and indicated that it was “our job to invest that portfolio wisely and intelligently . . . over a long period of time to earn income and to offset other exposures we have.”<sup>766</sup> During the same call, Braunstein stated that SCP’s trading decisions “are made on a very long-term basis” and “effectively balanced from a risk standpoint” so that “[w]e are very comfortable with our positions as they are held today.”<sup>767</sup> He further maintained that “those positions are fully transparent to the regulators” because the regulators “get the information on those positions on a regular and recurring basis as part of our normalized reporting.”<sup>768</sup>
- The PSI’s report strongly criticized Dimon’s and Braunstein’s statements during the earnings call for being “incomplete, contain[ing] numerous inaccuracies, and misinform[ing] investors, regulators and the public.”<sup>769</sup> The PSI’s report concluded that the earnings call and other statements by JPMorgan misled investors, regulators and the public by “downplaying the portfolio’s size, risk profile, and losses; describing it as the product of long-term investment decisionmaking to reduce risk . . . and claiming it was vetted by the bank’s risk managers and transparent to regulators, none of which was true.”<sup>770</sup>

Gretchen Morgenson concluded that the Senate’s PSI’s report “disproves the premise” that the Dodd–Frank Act will “make our system safe from the kinds of reckless banking activities that brought the economy to its knees.”<sup>771</sup> Similarly, in Jesse Eisinger’s view, the PSI’s

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765. *Id.*

766. *Id.* at 259 (quoting Dimon’s comments during the earnings call on April 13, 2012).

767. *Id.* at 258 (quoting Braunstein’s comments during the same earnings call).

768. *Id.* at 258–59 (same). Dimon had previously approved a list of “talking points” about SCP’s trading problems prepared by JPMorgan’s chief spokesman, Joe Evangelisti, and many of those talking points were echoed by Dimon and Braunstein in the earnings call on April 13, 2012. *Id.* at 255–56, 258–59.

769. *Id.* at 252–54.

770. *Id.* at 16; *see also id.* at 10–13, 252–55, 265–300 (criticizing JPMorgan’s public disclosures related to its SCP trading problems in April and May 2012); Eisinger, *supra* note 726 (“The Senate report makes it clear that JPMorgan misled shareholders and the public, particularly on its April 13, 2012, conference call.”).

771. Gretchen Morgenson, *JPMorgan’s Follies, for All to See*, N.Y. TIMES, Mar. 17, 2013, § BU, at 1 (contending that the PSI’s report confirms that “JPMorgan is too big to regulate” as well as being “too big to be allowed to fail and too big to prosecute”); *see also* Eisinger, *supra* note 726 (concluding that, in view of the PSI’s report, the claim that bankers and regulators “have learned their lesson” from the financial crisis is only “a sham”).

report demonstrates that “[b]ankers aren’t acting cautious and chastened. Risk managers aren’t in the ascendance on Wall Street. Regulators remain their duped and docile selves.”<sup>772</sup> Simon Johnson agreed that the “London Whale” scandal “reinforce[s] the view” that the “largest banks have become too complex to manage,” while Attorney General Holder’s testimony confirms that “too-big-to-fail exists and Dodd–Frank did not end it.”<sup>773</sup>

#### V. CONCLUSION: WALL STREET’S “VICTORY” OVER DODD–FRANK, THE BROWN–VITTER BILL AND THE FUTURE DIRECTION OF THE TBTF DEBATE

Based on the analysis set forth above, one might conclude that the battle for financial reform has been irretrievably lost. Wall Street’s leaders are largely unrepentant for the immense harm their institutions inflicted on the U.S. economy during the financial crisis, and their outlook and behavior have not changed in any significant way since the crisis. Congress and federal regulators continue to knuckle under to the enormous political influence wielded by megabanks. Wall Street has blocked any meaningful implementation of Dodd–Frank’s reforms that might have forced large financial conglomerates to change their business model or to reduce their appetite for risk-taking. Financial giants continue to make speculative bets and to disregard regulatory restrictions, believing that federal agencies will not interfere with their gambling *ex ante* and will not hold their managers personally accountable for reckless behavior or legal violations *ex post*. Megabanks and their creditors remain confident that federal agencies will arrange bailouts when the next systemic financial crisis occurs. “And so, despite Dodd–Frank, we are still threatened by the same dangers” from Wall Street.<sup>774</sup>

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772. Eisinger, *supra* note 726. In a similar vein, Jonathan Weil alleged that the OCC was “complicit” in “keep[ing] quiet while JPMorgan spread falsehoods,” because the OCC failed to correct JPMorgan’s assertion on April 13, 2012, that SCP’s positions were “fully transparent to the regulators . . . on a regular and recurring basis.” Jonathan Weil, *JPMorgan Silent Partner Revealed in Whale Fiasco*, BLOOMBERG, Mar. 21, 2013 (also reporting that (i) during the PSI’s hearing on Mar. 15, 2013, Scott Waterhouse, the OCC’s examiner-in-chief, acknowledged that the statement on April 13, 2012, by JPMorgan’s chief financial officer, Douglas Braunstein, was “not true,” and (ii) “[t]his was the first time anyone from the OCC had said publicly that Braunstein’s statement was false”).

773. Simon Johnson, *Big Banks Have a Big Problem*, NY TIMES BLOGS (ECONOMIX), Mar. 14, 2013 (available on Lexis).

774. Rivlin, *supra* note 7. In a speech to a Philadelphia conference in April 2013, Columbia University economist Jeffrey Sachs voiced similar but even stronger conclusions in much starker language. He declared, “I regard the moral environment [on Wall Street] as pathological . . . [Wall Street bankers believe they] have no responsibility to their clients, they have no responsibility to people, to counterparties in transactions, . . . they have gamed the system to a remarkable extent.” Sachs also alleged that “financial fraud” was endemic on Wall Street due to “a docile president, a docile White House and a docile regulatory system that absolutely can’t find its voice . . . . We have a corrupt politics

While it is increasingly clear that Dodd–Frank’s key reforms have failed to accomplish their goals, that lamentable fact may contain a silver lining. The financial industry may come to regret its remarkable achievement in “delaying and undermining the Dodd–Frank financial overhaul law and staving off criminal investigations into wrongdoing.”<sup>775</sup> Wall Street’s apparent victory over Dodd–Frank may ultimately prove to be a “catastrophic success.”<sup>776</sup>

Attorney General Holder’s “too-big-to-jail” admission and the Senate PSI’s “damning report” on JPMorgan could prove to be a “crucial turning point,” because they could trigger a new wave of public outrage that would force Congress and federal regulators to adopt “more radical solutions” to the TBTF problem.<sup>777</sup> In late March 2013, a national survey found that half of American adults supported a mandatory breakup of the twelve largest banks.<sup>778</sup> A few days later, Senators voted 99–0 in favor of a non-binding resolution calling for an end to implicit government subsidies for banks larger than \$500 billion.<sup>779</sup>

Also in March, Federal Reserve Bank of Dallas President Richard Fisher and FDIC Vice Chairman Thomas Hoenig repeated their previous calls for far-reaching reforms to address the TBTF problem. Fisher and Hoenig argued that Dodd–Frank’s complex and highly discretionary reforms would not eliminate large explicit and implicit TBTF subsidies

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to the core, I am afraid to say, and . . . both parties are up to their neck in this.” John Aidan Byrne, *Wall St.’s Criminal Behavior: Sachs rips into bankers*, N.Y. POST, April 28, 2013, at 35 (quoting speech by Sachs), 2013 WLNR 10678310.

775. Jesse Eisinger, *In Brown–Vitter Bill, a Bank Overhaul with Possible Teeth*, N.Y. TIMES, May 2, 2013, at B4.

776. Ezra Klein, *Big Banks’ Success Could Spell Their Doom*, BLOOMBERG, April 3, 2013.

777. Victoria Finkle, *Seven Reasons the Debate Over ‘Too Big To Fail’ Is Here to Stay*, AM. BANKER, April 2, 2013, 2013 WLNR 7937747; see also CBS News, “Banks too big to jail, fail or nail face new scrutiny,” Mar. 15, 2013 (available on Lexis) (detecting “a new spirit . . . among [Washington] policy makers, amplified by a growing chorus of media voices, that is willing to challenge Wall Street and push for additional reform”); Finkle, *supra* note 707 (reporting that Attorney General Holder’s testimony triggered a petition drive by Moveon.org calling on the Obama Administration “to break up the big banks and prosecute the criminals who used them to destroy our economy”); Ben Weyl, *Banks on the Block in GOP Rebranding*, CQ WEEKLY, Mar. 23, 2013, 2013 WLNR 7833025 (reporting that Sen. Elizabeth Warren’s “outspoken” attacks on TBTF banks have “drawn popular support”; for example, a video clip of a Senate committee hearing in which she “lectured regulators for not prosecuting wrongdoing by large institutions . . . has been viewed on YouTube more than 900,000 times”).

778. Jeff Bater, *‘Systemic Risk’ Survey Finds Half of Americans Would Favor Plan to Break Up Banks*, 100 BNA’S BANKING REP. 551 (Mar. 26, 2013) (reporting on a nationwide survey released by Rasumussen Reports on Mar. 21, 2013, which found that 50% of American adults supported a mandatory breakup of the twelve largest U.S. banks, while 23% were opposed and 27% were undecided).

779. The unanimous Senate vote occurred on a “non-binding” amendment to a Senate budget resolution. Cheyenne Hopkins, *Senators Give Unanimous Support to Ending Too-Big-to-Fail Banks*, BLOOMBERG, Mar. 25, 2013; Simon Johnson, *The Debate on Bank Size Is Over*, NY TIMES BLOGS (ECONOMIX), Mar. 28, 2013 (available on Lexis).

for megabanks.<sup>780</sup> Accordingly, they maintained that (i) the federal safety net—including federal deposit insurance and the Fed’s emergency credit facilities—must be restricted to the traditional deposit-taking, payment services and lending activities of commercial banks, and (ii) nontraditional activities (including derivatives and other capital markets operations) must be conducted in separate nonbank entities that would *not* be protected against failure by the federal government.<sup>781</sup> Fisher’s and Hoenig’s proposals to deny federal safety net subsidies to nonbank affiliates of financial conglomerates are conceptually similar to the “narrow banking” proposal I have previously advocated as well as the “ring-fencing” reforms that are currently being considered by the U.K. and EU governments.<sup>782</sup>

Hoenig also maintained—like Andrew Haldane of the Bank of England—that global bank regulators should abandon Basel III’s risk-weighted capital rules. In place of Basel III, Hoenig would establish much higher leverage capital requirements for megabanks, to be determined by dividing each bank’s tangible equity by its unweighted assets (including off-balance-sheet risk exposures).<sup>783</sup> Many analysts

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780. Richard Fisher, “Ending ‘Too Big to Fail,’” Remarks before the Conservative Political Action Conference, National Harbor, MD, Mar. 16, 2013 (arguing that Dodd–Frank’s “promise” to end TBTF “rings hollow . . . . Dodd–Frank is long on process and complexity but short on results” and “market discipline is still lacking” for the largest banks) [hereinafter Fisher Mar. 16, 2013 Speech], available at <http://www.dallasfed.org/news/speeches/fisher/2013/fs130316.cfm>; Thomas M. Hoenig, *Stop the subsidies for big banks*, WASH. POST, Mar. 29, 2013, at A13 (“While some suggest that the 2010 Dodd–Frank Act removed all protections and subsidies for these largest firms, there is no evidence to support that assertion.”). For additional evidence that Dodd–Frank has not ended TBTF subsidies for megabanks, see Wilmarth, *supra* note 109 (Part I), at 1–18; *supra* notes 113–15 and accompanying text.

781. Fisher Mar. 16, 2013 Speech, *supra* note 780; Richard Fisher & Harvey Rosenblum, “Vanquishing Too Big to Fail,” Fed. Res. Bank of Dallas, *2012 Annual Report* (2013), available at <http://www.dallasfed.org/microsites/fed/annual/2012/ar12b/index.cfm>; Hoenig, *supra* note 780; Hoenig April 17, 2013 Speech, *supra* note 714; Thomas M. Hoenig, *Banking Safety Net Makes Wall Street Dangerous*, AM. BANKER (online ed.), Jan. 17, 2013, available at <http://www.americanbanker.com/bankthink/banking-safety-net-makes-wall-street-dangerous-1055949-1.html>.

782. For my “narrow banking” proposal, see Wilmarth, *supra* note 109 (Part II), at 1–7; Wilmarth, *supra* note 12, at 1034–52. For the “ring-fencing” reforms currently under consideration by the U.K. and EU governments, see Michael Beaton, *Bank Ring-Fencing in the UK: The Financial Services (Banking Reform) Bill 2013*, Feb. 15, 2013, available at <http://www.economonitor.com/blog/201302/bank-ring-fencing-in-the-uk-the-financial-services-banking-reform-bill/#idc-container>; Julie Patient, *International Banking: Next Stage of the UK’s Banking Reform Bill: Putting Up the Fencing*, 100 BNA’S BANKING REP. 403 (Feb. 26, 2013); Martin Wolf, *Liikanen is at least a step forward for EU banks*, FT.COM, Oct. 4, 2012; Alex Barker, *EU review wants bank trading ringfenced*, FT.COM, Oct. 2, 2012.

783. Thomas M. Hoenig, “Basel III Capital” A Well-Intended Illusion,” Remarks before the 2013 Research Conference of the Int’l Ass’n of Deposit Insurers, April 9, 2013 [hereinafter Hoenig April 9, 2013 Speech], available at <http://www.fdic.gov/news/news/speeches/spapr0913.html>; Andrew G. Haldane, “The Dog and the Frisbee,” Speech at the Federal Reserve Bank of Kansas City’s 36th economic policy symposium, Aug. 31, 2012, at 6–14, 18–20, available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf>.

agree that Basel's regime of complex risk-weighting formulas has long been subject to gaming and arbitrage by the largest banks, and that much stronger leverage requirements are needed to discourage excessive risk-taking and reduce the likelihood of a future financial crisis.<sup>784</sup>

In April 2013, Senators Sherrod Brown (D-OH) and David Vitter (R-LA) introduced a bill (Brown–Vitter) that incorporated key aspects of Fisher's and Hoenig's reform proposals. Brown–Vitter would (i) direct federal banking agencies to abandon the Basel III risk-based capital regime and instead impose minimum leverage capital requirements (to be phased in over five years) of 8 percent for banks with assets between \$50 billion and \$500 billion and 15 percent for banks larger than \$500 billion, (ii) require large banking organizations to satisfy separate capitalization requirements for their nonbank subsidiaries, (iii) prohibit FDIC-insured banks from transferring their safety net subsidies to nonbank affiliates, and (iv) prohibit regulators from using the federal safety net to protect nonbank affiliates.<sup>785</sup> Brown–Vitter's mandate for a 15 percent leverage capital ratio for banks larger than \$500 billion would be similar to the capital ratios that large banks maintained between the creation of the Fed in 1913 and the establishment of federal deposit insurance in 1933.<sup>786</sup> Senator Brown declared that the bill would impose “more market discipline on the financial services industry” and present megabanks with a clear choice: “they can increase their capital or bring down their size.”<sup>787</sup> Senator Vitter explained that it was time to “level the playing field” between big and small banks and remove the government “subsidy” favoring megabanks.<sup>788</sup>

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784. E.g., ADMATI & HELLWIG, *supra* note 523, at 94–191, 217–24; Brendan Geeley, *Ditch Basel Rules, Just Raise Capital, Vitter Says*, BUSINESSWEEK (May 1, 2013), <http://www.businessweek.com/articles/2013-05-01/ditch-basel-bank-rules-just-raise-capital-vitter-says>; Simon Johnson, *The Case for Megabanks Fails*, NY TIMES BLOGS (ECONOMIX), May 2, 2013 (available on Lexis); Gretchen Morgenson, *Trying to Slam the Bailout Door*, N.Y. TIMES, April 28, 2013, § BU, at 1; John Plender, *Make simplicity a priority in banking*, FT.COM, Dec. 6, 2012; *Big Banks Still Aren't Safe Enough*, BLOOMBERG, April 30, 2013 (editorial); *What's So Radical About a Safer Financial System?*, BLOOMBERG, April 9, 2013 (editorial).

785. Sherrod Brown & David Vitter, *Make Wall Street Choose: Go Small or Go Home*, N.Y. TIMES, April 24, 2013, 2013 WLNR 9991786; Cjors Bruce, *Capital: Senate Bill Would Hike Capital Requirements for Large Banks*, 100 BNA'S BANKING REP. 784 (April 30, 2013); Cheyenne Hopkins, *Too-Big-to-Fail Bill Pitched as Fix for Dodd–Frank Act's Flaws*, BLOOMBERG, April 24, 2013.

786. ADMATI & HELLWIG, *supra* note 523, at 243 n.26 (quoting May 16, 2012 op-ed by Alan Meltzer, which stated, “In the 1920s, capital ratios for large New York banks ranged from 15% to 20% of assets.”); Hoenig April 9, 2013 Speech, *supra* note 783 (stating that “the equity capital to assets ratio for the [banking] industry [from 1913 to 1933] ranged between 13 and 16 percent, regardless of bank size”).

787. Morgenson, *supra* note 784 (quoting interview with Sen. Brown).

788. David Dayen, *Banking Regulation: Closed for Business*, AMERICAN PROSPECT BLOGS, April 24, 2013, 2013 WLNR 10013210 (quoting Sen. Vitter); see also Jack Torry, *Brown bill puts onus for failure on banks*, COLUMBUS DISPATCH (OH), April 25, 2013, at 4A, 2013 WLNR 10171762 (quoting Sen. Brown's statement that “taxpayers shouldn't have to subsidize . . . risk-taking” by megabanks).

Supporters praised Brown–Vitter as a direct challenge to the TBTF subsidies enjoyed by megabanks.<sup>789</sup> In contrast, Wall Street institutions and their lobbyists vehemently attacked the bill for mandating “[e]xcessively high capital [that] will restrict banks’ ability to lend to business . . . and hurt economic growth.”<sup>790</sup> Critics also argued that Brown–Vitter would force the largest banks to break up because they could not raise the estimated \$1 trillion or more in new capital that Brown–Vitter would mandate.<sup>791</sup>

Wall Street’s assertion that Brown–Vitter’s higher leverage capital requirements would significantly reduce business lending is unpersuasive. Additional equity capital would be advantageous as a funding source for bank loans (especially if TBTF subsidies are removed) because equity investors—unlike depositors and other short-term creditors—cannot “run” on banks by suddenly withdrawing their investments during a crisis.<sup>792</sup> In fact, S&P’s report on Brown–Vitter concluded that it would be “manageable” for banks with assets between \$50 billion and \$500 billion to satisfy Brown–Vitter’s 8 percent leverage capital requirement.<sup>793</sup> Most small banks (with assets under \$10 billion)

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789. E.g., Matt Taibbi, *Too-Big-To-Fail Takes Another Body Blow*, May 1, 2013 (describing Brown–Vitter as “a gun aimed directly at the head of the Too-Big-To-Fail Beast”), available at <http://www.rollingstone.com/politics/blogs/taibblog/too-big-to-fail-takes-another-body-blow-20130501>; see also Morgenson, *supra* note 784 (“[I]f you’re a large and powerful financial institutions that’s too big to fail, you won’t like this bill one bit.”); Simon Johnson, *Brown–Vitter Rearranges Financial-Reform Battlefield*, BLOOMBERG, April 28, 2013 (“Intellectually, the tide has turned . . . Brown–Vitter provides an appropriate roadmap for addressing some of the core problems [of TBTF megabanks] and making the financial system significantly safer.”).

790. Mark DeCambre, *A bank-buster bill; Critics: Regs would cripple big lenders*, N.Y. POST, April 9, 2013, at 28, 2013 WLNR 8632050 (quoting Rob Nichols, CEO of the Financial Services Forum); see also Torry, *supra* note 788 (quoting Jeff Sigmund of the American Bankers Ass’n, who asserted that Brown–Vitter “would harm banks and their customers, local communities and the broader economy”); *SIFMA Statement on Brown–Vitter Legislation*, TARGETED NEWS SERVICE, April 24, 2012 (available on Lexis) (quoting SIFMA news release alleging that Brown–Vitter “would force financial institutions to raise capital excessively higher than current levels, which would limit an institution’s ability to lend to businesses, hampering economic growth and job creation”).

791. Eisinger, *supra* note 775 (summarizing arguments made by critics of Brown–Vitter); Taibbi, *supra* note 789 (same); see also Standard & Poor’s, “Brown–Vitter Bill: Game-Changing Regulation For U.S. Banks,” April 25, 2013 (“We do not see equity markets being able to meet the massive level of common equity the bill requires of the largest banks . . . . Instead, the largest banks would need to break up or deleverage.”) [hereinafter S&P Brown–Vitter Report], available at <http://www.standardandpoors.com/prot/ratings/articles/en/us/?articleType=HTML&assetID=1245350762438#ID273>.

792. ADMATI & HELLWIG, *supra* note 523, at 49–51, 97–100, 107–47; see also Barbara A. Rehm, *Why We Don’t Need Brown–Vitter, At Least Not Yet*, AM. BANKER, May 2, 2013 (summarizing the view of Fred Cannon, director of U.S. research for Keefe, Bruyette & Woods, that “higher capital can lead to less lending, but it doesn’t have to . . . . Some banks may choose to shrink assets, including loans, to reach the stricter capital ratios, but others won’t.”) (available on Lexis).

793. S&P Brown–Vitter Report, *supra* note 791 (determining that banks with assets of \$50 to \$500 billion already have an average leverage capital ratio of 6.6% and “should be able to meet the proposed minimum requirement [of 8%] in five years,” as required by Brown–Vitter).



already have tangible equity ratios that exceed 8 percent.<sup>794</sup>

The largest banks (with assets over \$500 billion), which would need to satisfy Brown–Vitter’s 15 percent leverage requirement, devote a relatively small share of their assets to business lending. A recent Fed staff study found that big banks (with assets over \$250 billion) allocated only 14 percent of their assets to business lending in 2007, and that share declined to 12 percent in 2012. In contrast, smaller banks (with assets under \$10 billion) devoted 30 percent of their assets to business lending in both 2007 and 2012.<sup>795</sup> In 2012, smaller banks also provided more than half of all loans to small businesses—the most bank-dependent class of business borrowers—while big banks furnished only a quarter of such loans.<sup>796</sup> Thus, requiring big banks to maintain higher levels of equity capital would be unlikely to reduce lending dramatically to bank-dependent business firms.

Wall Street’s second argument—that it would be impossible for megabanks to raise the additional capital required by Brown–Vitter—actually proves the need for the bill. If it is true, as claimed in S&P’s report, that megabanks would be “[f]aced with little to no access to equity markets,” then we *should* want megabanks to “be forced into asset sales, divestitures, or . . . to break up.”<sup>797</sup> Moreover, contrary to Wall Street’s claim that Dodd–Frank has eliminated TBTF subsidies, S&P’s report essentially admitted that an implicit TBTF subsidy still exists for megabanks. In that regard, S&P’s report warned that enactment of Brown–Vitter might force the credit agency to *remove* its current ratings *upgrade* for the largest U.S. banks because that upgrade is dependent on the presumed access of those banks to “government support” during a crisis: “Under our methodology, we would potentially *no longer factor in government support* if we believed that once large banks are broken up [due to Brown–Vitter], we would not classify those banks as having high systemic importance.”<sup>798</sup>

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794. *Id.* (chart 3) (showing that all size groups of banks smaller than \$10 billion had average tangible equity ratios higher than 8 percent in 2012, except for banks smaller than \$500 million, which had an average tangible equity ratio of 5.99%).

795. Jeffrey W. Gunther & Kelly Klemme, “A Lender for Tough Times,” in Fed. Res. Bank of Dallas, *2012 Annual Report* (text and Chart 2), available at <http://www.dallasfed.org/microsites/fed/annual/2012/e2/1201e2.cfm>.

796. *Id.*

797. Taibbi, *supra* note 789 (quoting S&P Brown–Vitter Report, *supra* note 791); see also Eisinger, *supra* note 775 (observing that the claim by megabanks that “they couldn’t sell that much stock” actually “make[s] Senator Brown’s and Senator’s Vitter’s case for them. If investors are so terrified of the big banks that they won’t buy their stock, that’s a terrific problem”).

798. S&P Brown–Vitter Report, *supra* note 791; see also Taibbi, *supra* note 789 (observing that the quoted passage represents “an explicit admission that Dodd–Frank didn’t fix the Too-Big-To-Fail issue,” despite Wall Street’s assertions to the contrary). In a previous research report, issued in July 2011, S&P similarly acknowledged that an implicit TBTF subsidy remained for megabanks,

In view of Wall Street's vehement attacks on Brown-Vitter and likely opposition to the bill from the Obama Administration and key congressional leaders, the bill's chances of passage seemed very doubtful in mid-2013, as this article went to press.<sup>799</sup> However, some analysts suggested that Brown-Vitter had produced three significant changes in the political and regulatory landscape surrounding the TBTF debate. First, Brown-Vitter highlighted the inadequacy of Dodd-Frank's reforms as well as the very poor implementation of those reforms.<sup>800</sup> Second, Brown-Vitter focused the TBTF debate on issues where Wall Street was highly vulnerable, including (i) the dangerously low levels of tangible equity capital held by the largest banks, (ii) the unfairness of their safety net subsidies, and (iii) the risks to the FDIC and taxpayers posed by the ability of megabanks to transfer their subsidies to their nonbank affiliates engaged in derivatives and other speculative capital markets activities.<sup>801</sup> Third, Brown-Vitter could

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notwithstanding Dodd-Frank's reforms. The 2011 report concluded: "We believe that under certain circumstances and with selected systemically important financial institutions, future extraordinary government support is still possible." Standard & Poor's, *Global Credit Portal: RatingsDirect: The U.S. Government Says Support For Banks Will Be Different 'Next Time'—But Will It?*, July 12, 2011, at 2; see also *id.* at 8, 9–10 (classifying the U.S. as "supportive" of major banks because "[t]he U.S. government indeed has a long track record of supporting its large and systemically important financial institutions despite its stated preference for not doing so. [Dodd-Frank] may limit this activity, but we believe the government may try to avoid contagion and a domino effect if a SIFI finds itself in a financially weakened position in a future crisis."), available at [http://www.politico.com/pdf/PPM223\\_7-12-11\\_-\\_the\\_us\\_government\\_says\\_support\\_for\\_banks\\_will\\_be\\_different\\_nexttime\\_but\\_will\\_it\\_071211.pdf](http://www.politico.com/pdf/PPM223_7-12-11_-_the_us_government_says_support_for_banks_will_be_different_nexttime_but_will_it_071211.pdf).

799. Donna Borak, *Treasury's Lew Aligns with Fed, Big Banks in TBTF Debate*, AM. BANKER, May 22, 2013, 2013 WLNR 12477817 (reporting that Treasury Secretary Jacob Lew testified during a Senate Banking Committee hearing that "lawmakers should hold off on further legislative reforms to the financial system until Dodd-Frank is fully implemented," and he "also expressed worry about [the Brown-Vitter] bill"); Dayen, *supra* note 788 (reporting that Treasury Undersecretary Mary Miller "poured a giant bucket of cold water" on Brown-Vitter in her speech claiming that Dodd-Frank had "already solved" the TBTF problem and that megabanks did not have an "unfair advantage" over smaller banks in the form of TBTF subsidies, and noting that "[w]hat's striking about Miller's speech is how closely it mirrors the arguments set forth in several recent papers put out by the big banks, their lobbyists, and their allies"); Victoria Finkle, *'Too Big To Fail' Bill Puts Banking Chairmen in Tight Spot*, AM. BANKER, May 1, 2013 (reporting that (i) Senator Tim Johnson (D-SD), chairman of the Senate Banking Committee, probably would not support Brown-Vitter because he was "a staunch defender of Dodd-Frank" and also maintained "ties with Citigroup," whose "employees and political action committee were Johnson's top contributors during the 2012 election cycle," and (ii) Rep. Jeb Hensarling (R-TX), chairman of the House Financial Services Committee, also seemed unlikely to support Brown-Vitter) (available on Lexis); Shahien Nasiripour & Tom Braithwaite, *Finance: Out to break the banks*, FT.COM, April 30, 2013 (stating that many members of Congress "like the donations of the biggest [banking] groups and are susceptible to the argument that breaking up banks such as JPMorgan would push their business to foreign groups, such as Deutsche Bank or Barclays, that can offer a full suite of products").

800. Finkle, *supra* note 777; Hopkins, *supra* note 785; Nasiripour & Braithwaite, *supra* note 799.

801. Rob Blackwell, *Why the Brown-Vitter Bill Matters—Even If It Doesn't Pass*, AM. BANKER, April 29, 2013 (available on Lexis); Finkle, *supra* note 777; Johnson, *supra* note 789; Nasiripour & Braithwaite, *supra* note 799.

provide political cover for federal regulators to wield their (as yet unexercised) powers under Dodd–Frank to impose significantly higher capital requirements on megabanks and to require divestitures of assets by large banks that fail to submit satisfactory orderly resolution plans (living wills).<sup>802</sup>

As Senators Brown and Vitter explained in floor statements, the TBTF issue raises profound questions about the concentrated economic and political power wielded by a small group of megabanks.<sup>803</sup> In 1990—before the advent of nationwide and conglomerate banking—the four largest U.S. banks held \$519 billion of assets, equal to just 9 percent of domestic GDP.<sup>804</sup> By 2011, the four largest U.S. banks—JPMorgan, BofA, Citigroup and Wells Fargo—held \$7.5 trillion of assets, equal to 50 percent of GDP.<sup>805</sup> Similarly, the total assets of the six largest U.S. banks (including Goldman Sachs and Morgan Stanley) grew from 18 percent of GDP in 1995 to 63 percent of GDP in 2012.<sup>806</sup>

The foregoing figures include only the on-balance-sheet assets of the largest banks and considerably understate their actual risk exposures and economic significance.<sup>807</sup> Under international accounting standards—which would require on-balance-sheet recognition of much larger amounts of their derivatives exposures and mortgage securitizations—the four largest U.S. banks would have held 93 percent of domestic GDP in 2012, while the six largest banks would have held 102 percent of GDP.<sup>808</sup>

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802. Blackwell, *supra* note 801; Michael R. Crittenden, *Banks Feel Heat on Capital—Long-Term Debt Proposal Aims to Ensure Creditors Share in Cost of Failure*, WALL ST. J., May 2, 2013, at C1; Peter Eavis, *A New Fed Thought for ‘Too Big to Fail’ Banks: Shrink Them*, NY TIMES BLOGS (DEALBOOK), May 3, 2013, 2013 WLNR 10900409; Nasiripour & Braithwaite, *supra* note 799.

803. 159 Cong. Rec. S994 (daily ed. Feb. 28, 2013) (remarks of Sen. Brown) [hereinafter Brown Floor Statement]; *id.* S995 (remarks of Sen. Vitter) [hereinafter Vitter Floor Statement].

804. Fisher & Rosenblum, *supra* note 781 (text and Chart 1); *see also supra* notes 354–56 and accompanying text (describing 1994 and 1999 federal laws that authorized the creation of nationwide banks and financial conglomerates (universal banks)).

805. Fisher & Rosenblum, *supra* note 781 (text and Chart 2) (showing that the four largest U.S. banks in 1990 were Citicorp, BofA, Chase Manhattan and JPMorgan).

806. Brown Floor Statement, *supra* note 803, at S994.

807. Fisher & Rosenblum, *supra* note 781.

808. Yalman Onaran, *U.S. Banks Bigger Than GDP as Accounting Rift Masks Risk*, BLOOMBERG, Feb. 19, 2013 (providing figure for the four largest banks); Brown Floor Statement, *supra* note 803, at S994 (providing figure for the six largest banks). Unlike international accounting standards, U.S. accounting principles allow U.S. banks to exclude from their balance sheets (i) derivatives positions that are subject to netting agreements with counterparties and (ii) mortgage securitizations that are guaranteed by Fannie Mae and Freddie Mac. The on-balance-sheet assets of major U.S. banks, as shown under U.S. accounting principles, understate their true risks because (i) derivatives netting agreements frequently fail during financial crises due to defaults by counterparties, and (ii) since 2008 the four largest U.S. banks “have faced demands to take back \$67 billion of mortgages sold to securitizations backed by Fannie Mae and Freddie Mac . . . because the loans hadn’t met underwriting standards”). Onaran, *supra*.

As shown above, the explosive growth and consolidation of megabanks during the past two decades have produced a comparable expansion of their political clout.<sup>809</sup> In criticizing the “intense concentration of power” held by the largest banks, Senators Vitter and Brown pointed to the examples of Senator John Sherman and President Theodore Roosevelt, who opposed “unfettered growth and power” among the industrial trusts of the late 19th century.<sup>810</sup> Similarly, Louis Brandeis and Franklin Roosevelt fought against the concentrated economic and political power of the largest banks during the first four decades of the 20th century.<sup>811</sup> Brandeis denounced the leading New York investment banks of the early 1900s as a “financial oligarchy,”<sup>812</sup> a term also used by Simon Johnson and James Kwak to describe today’s megabanks.<sup>813</sup> Similarly, Richard Fisher has attacked megabanks as beneficiaries of “crony capitalism” that enjoy “an unlevel playing field, tilted to the advantage of Wall Street against Main Street, placing the financial system and the economy in constant jeopardy.”<sup>814</sup>

Writing at the end of 2009, Johnson and Kwak expressed serious doubts about the Obama Administration’s financial reform plan that led to the Dodd–Frank Act. As they explained, the Obama reform plan presented a series of “technical solutions” based on the assumption that, given additional tools, financial regulators could “regulate large banks more effectively.”<sup>815</sup> Unfortunately, as they also pointed out, “solutions that depend on smarter, better regulatory supervision and corrective action ignore the political constraints on regulation and the political power of the large banks” and also avoid “tackling the underlying problem: the existence of TBTF institutions.”<sup>816</sup> Accordingly, they

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809. Brown Floor Statement, *supra* note 803, at S994 (noting that the four largest U.S. banks are the product of 33 mergers involving 37 banks since 1995, and describing the largest banks as “so often having their way in this city and with regulators all over the country”); JOHNSON & KWAK, *supra* note 15, at 84–152 (discussing the rapid growth of major banks and the political influence they wielded during the 1990s and 2000s); *supra* Parts III and IV(A)(1) (describing the financial industry’s political clout and its many legislative and regulatory victories over the past two decades).

810. Vitter Floor Statement, *supra* note 803, at S995; *see also* Brown Floor Statement, *supra* note 803, at S994 (describing Senator Sherman’s opposition to the “outsized economic and political power” of the trusts).

811. JOHNSON & KWAK, *supra* note 15, at 22–37, 121; *see also id.* at 14–22, 33–34 (pointing out that Thomas Jefferson and Andrew Jackson provided earlier examples of successful opposition to entrenched financial and political power).

812. LOUIS D. BRANDEIS, OTHER PEOPLE’S MONEY: AND HOW THE BANKERS USE IT 3–4 (1914, Norman Hapgood reprint ed. 1933).

813. JOHNSON & KWAK, *supra* note 15, at 6, 10, 89–90, 120–21.

814. Fisher Mar. 16, 2013 Speech, *supra* note 780; *see also id.* (criticizing the “privileged status” of TBTF megabanks that “places them above the rule of law” and “undermines citizens’ faith in the rule of law and representative democracy”).

815. JOHNSON & KWAK, *supra* note 15, at 191–92, 205–08 (quotes at 191, 207).

816. *Id.* at 207, 213.

called for explicit restrictions on the maximum size of banks, based on “a popular consensus that too big to fail is too big to exist.”<sup>817</sup> As noted above, an attempt by Senators Brown and Kauffman to impose maximum size limits on banks was opposed by the Obama Administration and defeated in the Senate.<sup>818</sup> Instead, Congress passed Dodd–Frank, which—as partially implemented to date—has left the TBTF status of megabanks largely intact.

Johnson and Kwak warned that anyone “tak[ing] a stand against concentrated financial power” today would face daunting political obstacles, just as Theodore Roosevelt faced long odds when “he took a stand against concentrated industrial power” in the early 1900s:<sup>819</sup>

The challenge we face today is similar to the one faced by President Roosevelt a century ago . . . . The conventional wisdom, shaped through three decades of deregulation, innovation, and risk-taking that brought us the financial crisis, is that large, sophisticated banks are a critical pillar of economic prosperity. The conventional wisdom has entrenched itself in Washington, where administration officials, regulators, and legislators agree with the Wall Street line on intellectual grounds, or see their personal interests (financial or political) aligned with Wall Street . . . . The megabanks used political power to obtain their license to gamble with other people’s money; taking that license away requires confronting that power head-on.<sup>820</sup>

Wall Street’s political machine has thus far succeeded in watering down Dodd–Frank’s statutory language and in undermining the implementation of those provisions that survived the legislative gauntlet. Nevertheless, as Johnson & Kwak observed, “the most effective constraint on the financial sector is public opinion.”<sup>821</sup> It remains possible that continued revelations of excessive risk-taking and other abuses on Wall Street could finally “shift the weight of public opinion against our new financial oligarchy.”<sup>822</sup> Critics of Wall Street must persevere in their efforts to persuade the American people to demand fundamental reforms, like Brown Vitter, that could finally end TBTF subsidies for megabanks and thereby break Wall Street’s seemingly invincible power.

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817. *Id.* at 221 (quote). Johnson & Kwak proposed “a hard cap on size” of 4 percent of domestic GDP (about \$600 billion in 2009) for commercial banks and a similar cap of 2 percent of GDP for investment banks. *Id.* at 214–17.

818. *See supra* note 700 and accompanying text (discussing the defeat of the Brown–Kauffman Amendment).

819. JOHNSON & KWAK, *supra* note 15, at 222.

820. *Id.* at 221.

821. *Id.*

822. *Id.* at 221–22.