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The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated

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Abstract

Several commentators have argued that financial "reform" legislation enacted after a market crash is invariably flawed, results in "quack corporate governance" and "bubble laws," and should be discouraged. This criticism has been specifically directed at both the Sarbanes-Oxley Act and the Dodd-Frank Act. This article presents a rival perspective. Investors, it argues, are naturally dispersed and poorly organized and so constitute a classic "latent group" (in Mancur Olson's terminology). Such latent groups tend to be dominated by smaller, but more cohesive and better funded special interest groups in the competition to shape legislation and influence regulatory policy. This domination is interrupted, however, by major crises, which encourage "political entrepreneurs" to bear the transaction costs of organizing latent interest groups to take effective action. But such republican triumphs prove temporary, because, after the crisis subsides, the hegemony of the better organized interest groups is restored.

As a result, a persistent cycle that this article calls the "Regulatory Sine Curve" can be observed: the legislative success of the latent investor group is followed by increasingly equivocal implementation of the new legislation, tepid enforcement, and eventual legislative erosion. This article traces that pattern with respect to both the Sarbanes-Oxley Act and the ongoing implementation of the Dodd-Frank Act.

This article does not deny that "reform" legislation often contains flaws (as does much deregulatory legislation). But these are usually quickly eliminated in the latter half of the cycle. The greater dilemma is instead whether the problem of systemic risk can be satisfactorily addressed in the presence of the Regulatory Sine Curve.

Keywords: Dodd-Frank Act, Sarbanes-Oxley Act, financial regulation, latent group, securities regulation, regulatory sine curve, Basel III

JEL Classifications: E58, G18, G28, G30, G32, G38, K20, K22, K23

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Introduction

A good crisis should never go to waste. In the world of financial regulation, experience has shown – since at least the time of the South Seas Bubble three hundred years ago – that only after a catastrophic market collapse, can legislators and regulators overcome the resistance of the financial community and adopt comprehensive "reform" legislation.[1] U.S. financial history both confirms and conforms to this broader generalization. The Securities Act of 1933 and the Securities Exchange Act of 1934 were the product of the 1929 stock market crash and the Great Depression, and their enactment had to await the inauguration of President Franklin Roosevelt in 1933. The decisive event fueling public indignation and shaping these statutes was the Pecora Hearings before the Senate Banking and Currency Committee, which continued from 1932 to 1934.[2] The Sarbanes-Oxley Act ("SOX") was enacted, possibly in some haste, in 2002, following the collapse of Enron in late 2001 and WorldCom in 2002 and an accelerating crescendo of financial statement restatements by other public corporations.[3] Finally, the Dodd-Frank

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[1] For the view that securities regulation, over the last 300 years, has depended on market crashes to fuel it, see Stuart Banner, What Causes New Securities Regulation?: 300 Years of Evidence, 75 Wash. U. L. Q. 849 (1997).

[2] See Joel Seligman, THE TRANSFORMATION OF WALL STREET: A History of the Securities and Exchange Commission and Modern Corporate Finance (1982) at 1-2, and 39-40.

[3] For a description of the increasing rate of financial irregularity and accounting restatements in this era leading up to the enactment of SOX, see John C. Coffee, Jr., What Caused Enron?: A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269 (2004).

Act, enacted in 2010,[4] followed an even greater financial collapse, one 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) being bailed out at taxpayer expense. In each of these episodes, abundant evidence of financial chicanery and fraud was uncovered, and the public was outraged and revulsed. Not surprisingly, in each of these cases, the comprehensive reform legislation that followed in the wake of the market collapse showed hints of the public's desire for retribution.[5] All that is different this time is that the crisis may be wasted – as hereinafter explained.

Why is it that securities and financial reform legislation seems only to be passed after a crash or similar crisis? The most plausible answer involves a basic and foundational theory of political science. Numerous as investors and shareholders are in the United States, they are dispersed, disorganized, and their potential political power is diffused. Easily distracted by other important issues, their attention span is also short. In contrast, the financial services industry is well organized, can keep its focus on the issues that most affect it, and has an obvious incentive to maintain a powerful lobbying presence that will give them disproportionate influence. Hence, as any reader of Mancur Olson's classic book, THE LOGIC OF COLLECTIVE ACTION,[6] will recognize, smaller, better-organized groups are likely to dominate larger, but more diffuse, groups with much

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[4] The full title of this statute is the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). It will be called the Dodd-Frank Act herein.

[5] In the case of SOX, this is clearest in the new criminal penalties and enhanced penalties in Section 902 to 906 of SOX. In the case of Dodd-Frank, Section 748 sets forth elaborate provisions to protect and subsidize "whistle-blowers" who report misconduct to the SEC. Both provisions seek to detect and punish miscreants.

[6] Mancur Olson, Jr., THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2d ed. 1965).

greater memberships, in seeking to influence either legislation or regulatory policy.[7] Olson's prediction that smaller, but more cohesive, interest groups would predictably outperform larger citizen-based "latent" groups now seems obvious, but it implies that groups representing investors or shareholders are likely to be at a severe disadvantage in competing with well-funded business lobbies.

If so, how is it then that reform legislation ever passes? Later theorists, building on Olson's model, have focused on the role of "political entrepreneurs."[8] In crises, including market crashes, political entrepreneurs gain attention and electoral success, they argue, by exploiting the popular discontent. Essentially, these entrepreneurs assume the transaction costs of organizing otherwise latent interest groups in order to secure

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[7] For later and fuller statements of Olson's seminal "public choice" perspective, see Russell Hardin, COLLECTIVE ACTION (1982) and Todd Sandler, COLLECTIVE ACTION: Theory and Applications (1992). For a specific application of Olson's ideas to the world of corporate governance, see Robert A Prentice and David B. Spence, Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom, 95 Geo. L. J. 1843, 1847-49 (2007).

[8] The "political entrepreneur" or "public entrepreneur" is a creative actor, modeled after Joseph Schumpeter's economic entrepreneur, who solves the essential dilemma in Mancur Olson's theory of collective action: namely, that individuals would rationally prefer to free ride on the efforts of others. Olson was extremely pessimistic about the ability of large groups to take meaningful action. Later theorists explain reform legislation as the product of "public entrepreneurs" seeking "political profit" in the form of votes or election to office. By manipulating incentives and rewarding their coalition partners, these actors motivate otherwise passive "latent groups." See, e.g., Elinor Ostrom, GOVERNING THE COMMONS (1990); Richard B. Wagner, "Pressure Groups and Political Entrepreneurs: A Review Article," PUBLIC CHOICE (1966); Stephen Kuhnert, An Evolutionary Theory of Collective Action: Schumpetarian Entrepreneurship for the Common Good, 12 Constitutional Political Economy 13-29 (2001). To summarize, from the perspective of political science, the "public entrepreneur" is the dynamic actor who makes possible collective action in the common interest by bearing the transaction costs that group members will not bear. Some political figures do appear to have played such an entrepreneurial role after both the Enron/WorldCom scandals of 2001-2002 and the 2008 financial crisis. The most obvious nominees for such a role in this author's judgment would be Eliot Spitzer and Andrew Cuomo, who each moved from New York Attorney General to New York Governor after achieving broad recognition for actively challenging misconduct and conflicts of interest on Wall Street. It is unclear whether any figure, since SEC Chairman Arthur Levitt, has played a corresponding role in the national government.

election (or re-election) by assisting the public to overcome entrenched business interests.[9]

For many, this is precisely how republican government ought to function: leaders arise to aggregate the discontent and frustrations of citizens. But to a vocal school of conservative critics of securities regulation, such democratic eruptions are dismaying, dangerous, and need to be discouraged. The most outspoken and doctrinaire of these critics is undoubtedly Yale Law School Professor Roberta Romano. In a well-known article, she condemned SOX for imposing "quack corporate governance" on the United States.[10] Her thesis is, narrowly, that SOX's key provisions on corporate governance were not supported by the then available empirical academic literature and, more generally, that when Congress acts in the wake of a financial crisis, it will predictably adopt hasty, ill-conceived legislation. Thus, she proposes, among other restrictions, that all Congressional legislation regulating the securities markets or corporate governance come with a mandatory sunset provision under which the legislation would expire within a relative brief period thereafter, unless it was re-adopted by a subsequent Congress.[11]

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[9] See Hardin, supra n. 7, at 35-37 (explaining role of political entrepreneurs who market ideas and aggregate support from latent groups). Anthony Downs argues persuasively that only during periods of intense public pressure for change, can legislative inertia and interest group veto power be overcome and reform legislation passed. See Anthony Downs, Up and Down with Ecology – "The Issue-Attention Cycle", 28 Pub. Int. 38 (1972). The passage of environmental laws has followed this same cycle in the view of several commentators. See Christopher H. Schroeder, Rational Choice Versus Republican Moment – Explanations for Environmental Laws, 1969-1973, 9 Duke Envtl. L & Pol'y F. 29, 33-56 (1998).

[10] Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L. J. 1521 (2005).

[11] Id. at 1600 to 1602. Professor Romano is also highly critical of the role of "policy entrepreneurs" in the passage of SOX. Id. at 1568 to 1569. However, she does not use this term in any defined or theoretical sense, but simply levies ad hoc criticisms at a variety of officials (some elected and some administrative officials), most notably Senator Sarbanes. Id. at 1584. Indeed, the "policy entrepreneurs" she most frequently criticizes are SEC Chairman Arthur Levitt and

Any such reform, of course, would ignore Mancur Olson's critical insight: the majority will likely be dominated over the longer term by smaller, but better-motivated, interest groups. Thus, crisis breeds an opportunity to overcome legislative inertia. From this starting point, it follows that the consequence of a mandatory sunset rule is to protect the hegemony of well-financed and better-organized interest groups from majoritarian attack. After the financial crisis passes and some semblance of "normalcy" returns, potential political entrepreneurs will be less willing to take on a coalition of well-financed, tightly organized business interest groups, because they would know that the dispersed investor community could not maintain its zeal for long. Financial industry lobbyists could then easily organize to prevent the re-enactment of the original legislation, once it reached its moment of sunset. As a result, passage of significant legislation would mark only the midpoint of the political battle, which would become more protracted and costly, extending to the end of the sunset period and potentially chilling aggressive administrative implementation during the interim.

Under the original Romano proposal, reform legislation would automatically lapse unless (1) the impact of these provisions were first studied and approved by the SEC, and (2) Congress then re-enacted these provisions, based on the SEC's

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SEC Chief Accountant Lynn Turner. Id. at 1549 to 1550. Neither were politicians who held (or had sought) elective office, and hence they did not stand to gain from political activism. Thus, they would not satisfy the definition of public entrepreneurs used in much of the political science literature as one seeking political profit. See supra note 8. Rather, these persons come closer to being technocrats (although on the highest level). Thus, Professor Romano's critique of the individuals most involved in the enactment of SOX never integrates with any broader theory, and she never discusses Mancur Olson or other political science theorists. Her article seems generally unaware of the political science literature and focuses exclusively on empirical economics.

endorsement, within a few years thereafter.[12] More recently, she has refined her procedures, but still insisted on a mandatory sunset after five to six years, not just for securities laws, but for all "foundational financial legislation."[13] Thus, under her approach, not only the Securities Act of 1933 and the Securities Exchange Act of 1934 would have expired by the end of the 1930s, but similarly the Glass-Steagall Act or legislation regulating the capital adequacy and risk management polices of banks and other financial institutions would also self-destruct, unless spared by Congress. Such an outcome seems sensible only if one believes (as she may) that markets need little regulation (and thus that regulatory interventions should be short-lived, disappearing like snowflakes in the sun).

Nonetheless, Professor Romano has her loyal allies.[14] Together, they comprise what might be called the "Tea Party Caucus" of corporate and securities law professors,[15]

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[12] Id. at 1601. Even with SEC endorsement, she contemplates that Congress would still have to re-enact the statute.

[13] See Roberta Romano, Regulating in the Dark, Yale Law School Working Paper (available at http://ssrn.com/abstract=1974148) (December 18, 2011). Under her revised proposal, the sunset would take effect in five to six years. Id. at 15.

[14] See Stephen M. Bainbridge, THE COMPLETE GUIDE TO SARBANES-OXLEY: UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS (2006); Henry N. Butler & Larry E. Ribstein, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT (2006); Stephen N. Bainbridge, Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure, 2 Corp. Governance L. Rev. 69 (2006); Larry E. Ribstein, Sarbox: The Road to Nirvana, 2004 Mich. St. L. Rev. 279 (2004); Larry E. Ribstein, Bubble Laws, 40 Hous. L. Rev. 77 (2003-2004); Larry E. Ribstein, International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law, 3 J. Corp. L. Stud. 299 (2003); Larry E. Ribstein, Markets v. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. Corp. L. (2002-2003); Larry E. Ribstein, Sarbanes-Oxley After Three Years, 2005 N.Z.L. Rev. 365 (2005).

Although these authors do not tire of criticizing SOX, they have not convinced others. Reviewing the same economic evidence, Professor John C. Coates finds it harder to balance the costs and benefits of SOX and generally takes a more balanced position. John C. Coates, The Goals and Promises of the Sarbanes-Oxley Act, 21 J. Econ. Perspectives 91 (2007). Viewing and their key themes are: (1) Congress should not legislate after a market crash, because the result will be a "Bubble Law" that crudely overregulates,[16] (2) state laws are superior to federal law in regulating corporate governance, because the states are restrained by the competitive pressure of the market for corporate charters; and (3) federal securities law should limit itself to disclosure (at most) and not attempt substantive regulation of corporate governance.[17] The underlying theory here comes very close to asserting that

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SOX in a less economic light, Professor Donald Langevoort sees SOX as reflecting a shift by Congress from an exclusively contractarian perspective to a more trust-based conception of the corporation. See Donald Langevoort, The Social Construction of Sarbanes-Oxley, 105 Mich. L. Rev. 1817, 1828-1833 (2007).

[15] While there is irony in this term, it is also intended to be accurate; the three occupy a polar position at one end of the continuum in terms of their unbroken skepticism and rejection of governmental regulation. At the same time, as I am happy to recognize, all three are original and creative legal scholars.

[16] Both Professors Bainbridge and Ribstein regularly use the term "Bubble Law" to refer to federal legislation adopted in the wake of a crash that tends to displace state corporate law. See Ribstein, Bubble Laws, supra note 14, and Bainbridge, Dodd-Frank: Quack Corporate Governance Round II, 95 Minn. L. Rev. 1779 (2011).

[17] Professor Romano has argued that the federal securities laws had historically avoided substantive regulation of corporate behavior, staying safely "within a disclosure regime." See Roberta Romano, Does the Sarbanes-Oxley Act Have a Future?, 26 Yale J. on Reg. 229, 231 (2009). The distinctive failure of SOX in her view "is its break with the historic federal regulatory approach of requiring disclosure and leaving substantive governance rules to the states' corporation codes." Id. at 232. This is a dubious historical generalization. Although the Securities Act of 1933 and the Securities Exchange Act of 1934 do utilize disclosure as their preferred tool, the federal securities laws have frequently regulated substantive corporate conduct and governance. The most controversial federal securities statute of the 1930s was the Public Utility Holding Company Act of 1935, which imposed a "death sentence" on public utility pyramids and holding company structures – clearly an example of aggressive substantive regulation. See J. Seligman, supra note 2, at 122-23 (describing the Public Utility Holding Company Act as "the most radical reform measure of the Roosevelt Administration"). Similarly, the Investment Company Act of 1940 regulates the board structure of investment companies; initially, it required a minimum 40% of each investment company's board be composed of disinterested directors (Id. at 228-229), and it also compels them to hold a diversified portfolio and not sell securities "short" – again substantive regulation. More recently, the Foreign Corrupt Practices Act required stronger internal controls over financial reporting (as Professor Romano acknowledges). See Romano, supra, at 231. Thus, SOX was only a break with an imagined past in which the federal securities laws exclusively required disclosure.

democracy is bad for corporate efficiency, and thus legislative inertia should be encouraged.

This article is not a response to Professor Romano's sunset proposal. That idea is unlikely to gain any serious traction outside of the small community of free market and libertarian theorists who believe financial markets are naturally self-regulating. But this article is a response to the world view favored by these scholars and an attempt to focus attention on the critical implementation stage at which reform legislation is regularly frustrated. Here, it must be acknowledged that the Tea Party Caucus is having an impact, particularly as they shift their focus from SOX to the Dodd-Frank Act where the stakes are higher. With the same fervor that they once attacked SOX, they are now seeking the dismantling of the Dodd-Frank Act, which they also view as having imposed "quack corporate governance" on the financial markets.[18]

In response, this article will argue that their shared thesis is unsound for at least three reasons: (1) unhappy as they may be with democratic majorities, they have no coherent theory that explains why democratic majorities should be constrained in their

[18] See Stephen Bainbridge, Dodd-Frank: Quack Corporate Governance Round II, 95 Minn. L. Rev. 1779 (2011). Like Professor Romano, Professor Bainbridge is also suspicious of "suspect policy entrepreneurs" who were in his view seeking "to advance a long-standing political agenda." Id. at 1816. For him, the "suspects" are activists within the "institutional community, especially union and state and local pension funds." Id. Citing Professor Romano, he speculates that these activists are seeking to "reap private benefits not shared with other investors." Id. Although this could conceivably be true in some instances, he provides little, if any, evidence and wholly ignores the even greater possibility that the business interests resisting "reform" are also seeking to gain (or protect) private benefits of their own. For example, corporate executives opposed to "say on pay" or other compensation reforms have a clearer self-interest and more evident desire for private benefits than do the public pension funds who favor "say on pay."

Professor Romano has also made clear that she views the Dodd-Frank Act as being as defective as SOX. See Romano, supra note 13, at 9-11.

ability to act after a crisis;[19] (2) they fail to understand the ease with which legislative mistakes or misjudgments can be corrected in the process of administrative implementation;[20] and (3) even if it is conceded that legislative misjudgments are often made, their proposed reforms (most notably the mandatory sunset provision) are an unnecessary "fifth wheel," given the ease with which business interest groups can push back, repealing or downsizing legislation whenever they can make a colorable case that the legislation's costs exceed its benefits. Although Professor Romano argues that it would "take a Herculean effort to repeal [SOX's reforms] given the organization of government,"[21] one has to wear blinders to make this statement. The downsizing of SOX, as later detailed, began quickly after its passage in 2002 and continues to date. Legislative efforts to repeal or downsize much of the Dodd-Frank Act are already well-advanced.[22] Professor Romano and her allies thus miss exactly what a Mancur Olson would have predicted: once the crisis subsides, more organized interests groups regain the upper hand and begin to extract concessions, exemptions or outright repeal.

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[19] Reasonable people can, of course, disagree about the costs and benefits of most statutes. But the claim made by Professor Romano and her allies is that post-crash legislation almost invariably fails. This is a heroic claim that must also factor into its calculus the costs of crashes in under-regulated markets. Professor Romano's distinctive claim is that "policy entrepreneurs" incorporate their pre-conceived policy agendas into hasty legislation. Ultimately, everyone has pre-conceived ideas to which they turn in a crisis, and, as later discussed, the core ideas underlying SOX came from the administrative agency with the most information and experience in the field (i.e., the SEC), not from some idiosyncratic lone Congressman.

[20] See text and notes infra at notes 47 to 48 (discussing exemptive authority possessed by Securities and Exchange Commission under the federal securities laws). Professor Romano at no point discusses this authority, which permits the SEC to escape overly burdensome regulation without the need for legislative action. Perhaps, she believes the SEC is "captured" by liberal "policy entrepreneurs," but her silence on this point is revealing.

[21] See Romano, supra note 13, at 6-7.

[22] See text and notes infra at notes 174 to 180.

Interestingly, the erosion of SOX has had almost nothing to do with the weaknesses diagnosed by Professor Romano – i.e., the haste surrounding its passage or the asserted lack of empirical evidence supporting its reforms. Rather, what has most motivated the opposition to SOX was the high costs of the requirement in SOX Section 404 for tighter internal controls on financial reporting.[23] Yet, these costs resulted not from the legislation, itself, but from unanticipated, post-enactment administrative action.[24] Those costs have already been reduced by administrative and legislative action, but the business community remains unsatisfied and senses that complete victory is obtainable (and without any mandatory sunset legislation).[25] Given their relative success, this episode hardly evidences the need for sunset provisions, as the business community seems more than capable of protecting its own interests.

Similarly, as the opposition to the Dodd-Frank Act mounts, this counterreaction is being driven by attempts to protect executive compensation, high leverage, bank profitability, and managerial discretion – each of which has powerful champions. In contrast, the goal of curbing systemic risk has no obvious political champion among the usual participants in the political process of financial regulation.[26] Given the resulting

[23] See 15 U.S.C. § 7262. For a more detailed discussion of this provision, see text and notes infra at notes 59 to 67.

[24] As later discussed, the high costs of Section 404 came not from any provision of the statute, but from action taken by a self-regulatory body (the Public Company Accounting Oversight Board ("PCAOB")), which required that the auditors conduct a full-scale audit before attesting under Section 404(b) to management's evaluation of its internal controls. See text and notes infra at 59 to 66. SOX's Section 404 imposed only the requirement that the auditor "attest to management evaluation." This is hardly evidence of legislative haste or of a populist eruption. A cynic might well attribute the high costs of a Section 404 audit to either a desire on the part of the accountants' self-regulator to benefit accountants with high fees or to the limited competition within the highly concentrated accounting industry.

[25] See text and notes infra at notes 69 to 71 and notes 174 to 180.

[26] See text and notes infra at notes 37 to 38.

imbalance, Mancur Olson's model predicts the likely outcome: interest group politics will produce major revisions to the Dodd-Frank Act, both in the administrative and legislative processes.

Although SOX and the Dodd-Frank Act share many similarities, two major differences between them stand out and suggest that the Dodd-Frank Act is even more vulnerable: First, the Dodd-Frank Act has a much narrower focus than SOX and intends reforms that could prove much more costly to financial institutions than anything in SOX. Although the Dodd-Frank Act also makes some attempts to regulate corporate governance at public corporations, it concentrates to a much greater extent on the problem of systemic risk at large ("too big to fail") financial institutions. Unfortunately, systemic risk is a complex and relatively opaque concept which the average citizen does not understand or easily identify with. Second, the Dodd-Frank Act depends upon administrative implementation to a far greater degree than did SOX because Congress simply could not specify in detail all the proper steps that needed to be taken with respect to capital adequacy, liquidity ratios, OTC derivatives, and similar complex financial issues applicable mainly to large financial institutions. For both reasons, the Dodd-Frank Act is particularly exposed to what may happen in the post-euphoric period after the legislation passes when public's attention turns elsewhere and business interest groups reestablish their usual dominance over the technical process of policy implementation.

If one believes that systemic risk is a serious problem that needs to be addressed rigorously, this vulnerability is disquieting because, as later described, SOX was effectively downsized in the period after its passage – by subsequent legislation, equivocal agency rule-making, judicial hostility, and timid underenforcement by regulators. That pattern may well repeat – with the result that adequate protections against systemic risk will not be implemented. This claim does not rest on any premise that regulatory agencies have actually been "captured" by the financial industry,[27] but that industry may gain influence at the administrative implementation stage and may force regulators to trim their sails. Not only does the administrative stage inherently have lower visibility and is at least as susceptible to lobbying pressure (because of the influence of the "revolving door" on bureaucratic staffers who expect eventually to return to the financial industry[28]), but industry efforts at this later, more pedestrian stage are less likely to attract challenges from political entrepreneurs who appear in crises to champion the cause of investors.

A roadmap of this article is now in order. Part I of this article present a model of how financial reform legislation is frustrated and downsized. This model does not depend on "industry capture,"[29] but rather applies the insights of Mancur Olson (and others) to the real world of lobbying and administrative implementation. Part I will also contrast this model with that offered by Professor Romano and her allies. Next, on the premise that what is past is prologue, Part II of this article will examine how SOX's provisions were weakened, abandoned, or downsized at the implementation stage. Such administrative softening (or even abandonment) of legislative enactments may be even

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[27] The term "capture" is inherently elusive and suggests that a permanent victory is won by the industry. In contrast, this article suggests that the opposing sides can each dominate at various points, but the forces championing public-regarding legislation are only advantaged after a major crisis.

[28] This topic is being increasingly debated in the press. See Andrew Ross Sorkin's, "The SEC's Revolving Door," New York Times, August 2, 2011 at Dealbook, p. 1.

[29] Professor Romano asserts that this author assumes that administrative agencies have been captured. See Romano, supra note 13, at 18 to 19. No such assumption is made, but some agencies are very resource constrained and may also be intimidated by a hostile Congress with control over their budget.

more likely in the case of the Dodd-Frank Act, because (1) the prospective costs to the financial industry are higher, (2) the Dodd-Frank Act has no natural allies among the major political players who usually support "reform" legislation applicable to the financial markets;[30] and (3) the Dodd-Frank Act is even more dependent on administrative implementation and rule-making. Part III will examine the policy premises underlying the Dodd-Frank Act. Rather than idealize this legislation, it will acknowledge that some of its reforms were flawed or even inconsistent. But legislation in the real world will always be imperfect; this is the necessary consequence of the logrolling and compromise needed to assemble a majority in a divided political environment. Part IV will then turn to the implementation of Dodd-Frank and the associated attempts – legislative and judicial – to downsize it. The evidence to date suggests that a crisis is being wasted, and thus the danger of future systemic risk catastrophes remains clear and present. All this will set the stage for a concluding section that will ask (and only partially answer) the ultimate question: what reforms could work?

Part I. <u>The Regulatory Sine Curve and Statutory Correction</u>

This article's fundamental premise is that a "Regulatory Sine Curve" governs the intensity of the oversight exercised by financial regulators. By this phrase, it is meant both that (1) regulatory intensity is never constant, but rather increases after a market crash, and then wanes as (and to the extent that) society and the market return to normalcy, and (2) the public's passion for reform is short-lived and the support it gives to political entrepreneurs who seek to oppose powerful interest groups on behalf of the public also wanes after a brief window of opportunity. This same pattern may

[30] See text and notes infra at notes 36 to 38.

characterize other forms of regulation (for example, environmental regulation may wax and wane also with highly publicized, vivid environmental disasters), but important differences exist. Financial regulation is inherently opaque, and the public lacks the same visceral identification with the key values in play. Few in the public care as passionately about systemic risk as they may care about the environment or civil rights. Thus, the public's attention span may be shorter, and the window of opportunity briefer within which reform legislation can be passed.

The key implication of the Regulatory Sine Curve is not that legislation is futile, but that erosion of the statute's commands will predictably begin shortly after its passage. Core provisions of the legislation will likely remain (just as the core provisions of the federal securities laws, including those of SOX, remain in place), and sometimes courts will fill in the gaps in legislation expansively.[31] Nonetheless, the greater the legislation's reliance on administrative implementation, the greater the erosion that becomes likely, at least if the legislation conflicts with the industry's preferences. This perspective posits both that downsizing and correction is inevitable and that, to a degree, it may often even be desirable. But the likelihood of such erosion also justifies strong legislative action in the first instance (and possibly the framing of some key policies in prophylactic terms that prevent or at least retard their erosion). This perspective fundamentally conflicts with that of Professor Romano and the Tea Party Caucus, who believe that reform legislation passed after a crash will always enact foolish "quack cures" and thus should be

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[31] Certainly, the federal courts aggressively filled in the gaps in the federal securities laws in the 1960s by, among other things, implying private causes of action. See J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (implying a private cause of action to enforce federal securities laws). That period of liberal construction of the federal securities laws has now ended, but courts may uphold or invalidate administrative rules implementing the Dodd-Frank Act to the extent they understand and accept the purpose of the legislation.

discouraged. For both sides, a common starting point is the recognition that (i) legislation is often flawed and unrationalized and (ii) SOX and the Dodd-Frank Act have their own curious, overbroad and inconsistent elements. But this article responds that the likelihood of legislative errors and misjudgments hardly merits Draconian measures (such as a sunset provision) because "correction" is both possible through a variety of less drastic and more feasible means and probably inevitable in light of the Regulatory Sine Curve.

The standard cyclical progression along the Regulatory Sine Curve (from intense to lax enforcement) is driven by a basic asymmetry between the power, resources and organization of the latent group (i.e., investors) and the interest groups affected by the specific legislation. Cohesion among investors begins to break down once "normalcy" returns. Professor Romano has disputed this view of investors as a dispersed latent group,[32] chiefly for two reasons: (1) investors, she argues, are effectively represented in the typical legislative battles over financial regulation by powerful champions, most notably, in her view, "well-funded and politically influential labor unions, public pension funds, and the plaintiff's bar"[33]; and (2) business is not "monolithic" but has often conflicting interests.[34]

Both claims are easily refuted. Most recent studies have found that business groups dominate the lobbying process.[35] Thus, to consider public pension funds a

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[32] She acknowledges that her work never discusses Mancur Olson and related theorists but asserts that "it would be a mistake to do so." See Romano, supra note 13, at 20 n. 11.

[33] Id. at 21.

[34] Id. at 21.

[35] Political scientists have assembled a great deal of evidence on this score. As one survey by them summarizes:

> "Whether we measure it by organizations represented, by money spent, by issues acted on, or participation in rule-making, we see that businesses and trade

counterweight to major financial institutions is to mistake an ox for a bull. Pension funds, as fiduciaries for their beneficiaries, do not make political contributions and are thus relatively impotent as political actors. Labor unions can, of course, lobby and make political contributions, but their political power has steadily subsided for decades as the percentage of the U.S. work force that is unionized has declined.[36] The plaintiff's bar may be active in politics, but its financial resources are also dwarfed by those of the major financial institutions, and, as a practical matter, both unions and the plaintiff's bar largely limit their efforts to the Democratic side of the political aisle (while business groups contribute heavily to both sides).[37]

Equally important, these three alleged champions of investors in the political process often have interests that diverge from those of investors. To the extent that closer regulation of banks and financial institutions would restrict their ability to increase

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> associations consistently mobilize at roughly ten times the rate that those forces that might countervail them do."

See Dorie Appollonio, Bruce Cain, and Lee Drutman, Access and Lobbying: Looking Beyond the Corruption Paradigm, 36 Hastings Const. L. Q. 13, 47 (2008). This study further reports data on lobbying expenditures and finds that 71.7% of such expenditures are made by "business," while only 4.2% are made by "labor." Id. at 50 (Table 2). Examining spending on federal lobbying, they also find that the "Finance/Insur/RealEst" sector is the single largest spender, while labor ranks only eighth. Id. at Table 3. Finally, whatever the data shows with regard to the past, there is new evidence that corporate political and lobbying expenditures have significantly increased in response to a recent Supreme Court decision holding that the First Amendment protects certain corporate political contributions. See John C. Coates, IV, Corporate Politics, Governance and Value Before and After Citizens United, (available at http://ssrn.com/abstract=1975421) (December 22, 2011).

[36] Appollonio, Cain and Drutman report that in 2006 the "Finance/Insur/RealEst" lobby expended $258.9 million, while "labor" expended $66.6 million – a roughly four to one ratio. Id. at 50 (Table 3). Of course, this understates the real disparity because political contributions and lobbying by labor almost certainly does not concentrate on financial sector issues, but on traditional labor issues.

[37] Apollonio, Cain, and Drutman report data showing that the "Finance/Insur/RealEst" lobby allocates its expenditures 54% to Republicans and 44% to Democrats, while labor allocates 12% to Republicans and 87% to Democrats. Id. at Table 3.

lending or to underwrite subprime mortgages, this is contrary to the natural interests of unions, who tend to favor easy credit and increased lending. Increased lending, after all, creates jobs, and job creation is a principal goal of both labor and some civil rights groups. In short, those seeking to reduce systemic risk have few natural political allies; it is a cause that unites largely the technocrats.

Professor Romano's claim that business is not "monolithic" is, of course, correct to a degree. Often, business interest groups do battle each other. But the interests of the financial services industry are remarkably well aligned in opposing increased regulation of their capital structure, leverage, executive compensation and risk management policies, and they have been vocal in claiming that the Dodd-Frank Act places them at a competitive disadvantage in an increasingly global marketplace.[38] At a minimum, the business community shares a common desire to resist the encroachment of regulatory power over their capital, leverage, and compensation decision-making. It is entirely understandable that they resist, but such regulatory oversight is exactly what the goal of limiting systemic risk requires.

Professor Romano proceeds directly from her premise that reform legislation is always flawed to her conclusion that mandatory sunset legislation is necessary. Others

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[38] Indeed, Professor Romano herself argues that much of the business community is united in opposition to the Dodd-Frank Act, believing it has "exacerbated the severe economic downturn that has followed the global financial crisis." Romano, supra note 13, at 9. For a representative and revealing statement by the financial services industry that it considers both Dodd-Frank Act and Basel III a threat to the U.S. economy and international competitiveness, see "Rules Present a Grave Threat to the Economy," Targeted News Service, October 3, 2011 (summarizing press release issued by Financial Services Roundtable, a major trade association for the financial services industry).

have pointed out that the mandatory sunset remedy lacks any serious empirical support.[39] This seems a curious omission for someone whose primary objection to reform legislation is that Congress did not wait for empirical research to discover the optimal remedy.[40] Still, in the absence of such research, it is useful to ask two questions: (1) What would be the likely consequences of a sunset requirement?, and (2) What are the less drastic alternatives to her proposed sunset rule?

With regard to the first question, the existing imbalance between the resources of the contending sides in legislative battles over financial regulation would be greatly compounded by any mandatory sunset remedy. The "reform" side would have to win twice, including after the crisis subsides. The necessary second legislative affirmation of the original victory might be denied because of a minority veto (for example, because of a blocking position on a key committee or a filibuster). It was exactly for this reason that Justice (then Professor) Breyer in a well-known book on reforming the administrative process decided that a mandatory sunset law was too Draconian a remedy.[41] Further, to the extent that the recurring battle over financial regulation is between those who want more regulation and those who want less, a sunset remedy is inherently one-sided

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[39] See Prentice and Spence, supra note 7, at1855 (noting that Professor Romano "offers no evidence that laws enacted in a short time frame tend to have more problems than laws enacted over a longer period" and "no empirical evidence that sunshine laws provide any benefits on balance"). It seems ironically inconsistent for Professor Romano to criticize Congress for enacting many of SOX's provisions without (in her view) adequate empirical support and then for her to propose a legislative remedy of her own (a mandatory sunset rule) that also has no empirical support.

[40] Although Professor Romano believes there is "long and well established U.S. experience with sunset legislation," she concedes that "[t]here is a dearth of research empirically analyzing sunset reviews," and the research that does exist is "mostly qualitative." Romano, supra note 13, at 17 n. 9. In short, her own proposal does not have the empirical foundation that she insisted SOX and the Dodd-Frank Act should have.

[41] See Stephen Breyer, REGULATION AND ITS REFORM (1982) at 366-367.

because it applies only to legislation that imposes new regulation and not to legislation that repeals existing regulation. In truth, deregulation can equally be achieved in haste, with the consequence being ill-considered "reforms" that expose financial markets to catastrophe.[42] If her remedy were truly even-handed, it would apply to deregulatory provisions as well. Either way, the cost of such a remedy is continuing uncertainty and potential paralysis, as nothing could be assumed to be permanent.[43]

To disagree with Professor Romano's reforms, it is not necessary to take the opposite position to her on all issues. One need not claim that reform legislation is typically carefully written or well-planned. Rather, this article starts from the view stated by Bismarck over a century ago, when he compared the framing of legislation to the making of sausage.[44] Political compromises are often unprincipled, odd, and place together strange bedfellows. Haste (Professor Romano's obsession) contributes to this

[42] A good example of hasty deregulatory legislation would be the Commodity Futures Modernization Act of 2000 ("CFMA"), Pub. L. No. 106-554, 114 Stat. 2763, 2763A-365, which exempted over-the-counter derivatives, including swaps, from the jurisdiction of both the Commodities Future Trading Commission and the Securities and Exchange Commission. The Act's wholesale deregulation of swaps in 2000 set the stage for AIG's collapse in 2008 when it could not honor the enormous commitments that it had made by means of unregulated credit default swaps.

[43] For example, if, pursuant to such an even-handed sunset, the CFMA had been subjected to an automatic termination if Congress did not reaffirm it within five years, the institutions writing credit defaults swaps over this interim might have faced considerable uncertainty that could have chilled their willingness to enter this field. Even more frightening (to all except the extreme right) is the idea that the Federal Reserve Board could similarly vanish, if a polarized Congress could not act within Professor Romano's proposed deadline.

[44] Otto von Bismark (1815-1898), the Chancellor of Imperial Germany, is reputed to have said: "Laws are like sausages, it is better not to see them being made." See www.brainyquote.com/quotes/o/ottovonbis161318.html.

state of affairs,[45] but it is only one of many factors. Indeed, it is not clear that slow and piecemeal legislative reform is any less flawed.[46]

Even if haste does produce error (as seems logical), this risk does not imply that reformers should remain passive after a financial crisis. At worst, they will face an imperfect choice: act quickly and imperfectly, within a brief window of opportunity, or face the likelihood that the forces of legislative inertia will regain the upper hand and prevent any reform. In fact, however, the choice is usually less stark than this. The key lesson to be learned from reviewing the response to SOX is that the "correction" of reform legislation is virtually inevitable. In turn, this undercuts the case for legislative passivity or mandatory sunsets. Those whose oxen are gored will predictably organize to secure relief. As later described, SOX exemplifies this pattern.

Accordingly, what is the best, most feasible remedy for legislative error and misjudgment? In this article's view, it is the remedy that already exists under the federal securities laws and that Professor Romano never discusses. Under Section 36 of the

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[45] In fact, courts have noted that SOX was "hastily passed and poorly drafted." See <u>In re Enron Corp. Sec. Litig.</u>, 2004 U.S. Dist. LEXIS 8158 at *11 (S.D. Tex. Feb. 25, 2004); <u>In re Adelphia Communications Corp.</u>, 2005 U.S. Dist. LEXIS 10349 at *5 n.8 (S.D.N.Y. May 31, 2005). On the other hand, other courts have observed that drafting ambiguities arise in all major legislation and are eventually corrected or clarified. Thus, in <u>SEC v. WorldCom, Inc.</u>, 2003 WL 22004827 (S.D.N.Y. Aug. 26, 2003), United States District Judge Jed Rakoff wrote:

> "While Sarbanes-Oxley has been criticized in some quarters, there can be no doubt that it addresses some of the very problems presented by this Company's history. . . . As with other major legislation covering significant new territory, there are provisions of Sarbanes-Oxley that will benefit from either clarifying regulations or from exemptive actions." <u>Id</u>. at *17 and n. 43.

This article agrees with Judge Rakoff: a corrective process naturally follows comprehensive legislation (whether it is adopted in haste or more deliberately).

[46] Congress passed the Glass-Steagall Act, separating investment banking from commercial banking in haste in 1932, then repealed it slowly over several decades, culminating with the Graham-Leach-Bliley Act of 1999. Reasonable persons can disagree over which statute was more flawed.

Securities Exchange Act of 1934 (and similar sections in other federal securities laws), the SEC possesses "general exemptive authority" and can "conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this title, or any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[47] This is fairly sweeping language that gives broad authority to the administrative agency, which will have the benefit of greater information and post-enactment experience, to override Congress.

The advantages of such an administrative exemptive approach begin with the fact that, under it, delay, stalling tactics, or a minority veto could not overturn a prior Congressional enactment. Uncertainty is also reduced, as an administrative agency, with greater experience and objectivity, must be persuaded to act. The agency's actions are likely to be both more predictable and more incremental, thus avoiding the uncertain all-or-nothing choice inherent in sunset provisions. Only if one believes that the SEC has been "captured" by some interest group does this more tailored and precise remedy seem inferior to a gamble on a sunset provision.[48]

To sum up, the contrast between the Tea Party Caucus's perspective and that taken here is basic, but both share some common elements. Under the world as viewed by Professor Romano and her allies, reform legislation follows "a media clamor for

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[47] See 15 U.S.C. § 78mm. This provision was added in 1996 by Pub. L. 104-290. Similar exemptive provisions are set forth in Section 28 ("General Exemptive Authority") of the Securities Act of 1933, 15 U.S.C. § 77z-3, and Section 206A ("Exemptions") of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6a.

[48] Because Professor Romano never discusses the option of agency exemptive authority, one cannot know her criticisms of it (or even if she was aware of these provisions).

action,"[49] and this "media frenzy . . . compels legislators not only to respond, but to respond quickly, even though they . . . cannot possibly determine what would be the best policy to adopt in the circumstances."[50] Typically, she argues, they adopt "recycled proposals fashioned to resolve quite unrelated problems, imagined or real, which policy entrepreneurs advance as ready-made solutions to immediate concerns, to a Congress in need of off-the-shelf proposals that can be enacted quickly."[51] Further, because Congress is risk averse and self-interested, Congress delegates great discretion to administrative agencies as "a means by which legislators can avoid responsibility for adverse policy consequences."[52]

The alternative view, here presented, agrees that crisis is a precipitant, allowing legislative inertia to be overcome. After a crisis, Congress tends to adopt proposals that the relevant administrative agency has long favored, but that were frustrated by powerful lobbies. Only with a crisis can reformers (or "political entrepreneurs" in the political science vernacular) aggregate sufficient support to pass reform legislation. For example, in the years prior to the Enron and WorldCom crisis in 2001-2002, SEC Chairman Arthur Levitt had sought to respond to a soaring number of financial statement restatements and had campaigned to restrict auditor conflicts of interest.[53] But he was rebuffed by the

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[49] See Romano, supra note 13, at 4.
[50] Id. at 5-6.
[51] Id. at 6.
[52] Id. at 8.
[53] Financial statement restatements at publicly traded companies appear to have risen from 49 in 1996 to an estimated 250 in 2002, or an increase of approximately 270 percent over the five years ending in 2002. See, John C. Coffee, Jr., What Caused Enron?: A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269, 283 (2004).

industry.[54] With the Enron and WorldCom's insolvencies and the evidence of financial impropriety manifest to all, Levitt and others (most notably, Senator Paul Sarbanes) were able to convince Congress to replace auditor self-regulation with a new body: the Public Company Accounting Oversight Board ("PCAOB").[55] The PCAOB was the centerpiece of SOX, but it was hardly an "off-the-shelf" proposal. But for the crisis, auditor self-regulation would have persisted. Depending on which perspective is preferred, Arthur Levitt and Paul Sarbanes are either the heroes or villains of this story.[56]

But the story does not end there. "Correction" does follow, both in the form of administrative rules that soften some legislative commands and in the form of legislation curbing the prior statute. The next section will describe this process in more detail, as it applied to SOX, and a later section will turn to the Dodd-Frank Act. Reasonable persons can disagree about whether this corrective process went too far (as this author tends to believe) or not far enough. But it is an inevitable part of the Regulatory Sine Curve, which is next examined in operation.

Part II: <u>SOX Revisited: The Downsizing of Reform</u>

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[54] Even Professor Romano has recognized that "the provision of nonaudit services by auditors had been subject to persistent efforts at elimination by the SEC prior to SOX's prohibition." See Romano, supra note 10, at 1534. Thus, the legislative provisions that she most objects to in SOX did not come from the liberal constituencies of which she is suspicious (unions, public pension funds, and the plaintiff's bar), but from the administrative agency with the most experience in the field. This does not fit her diagnosis that Congress turns in a crisis to the pet ideas of special interest groups or individual Congressmen, and adopts them without careful evaluation. Similarly, Professor Bainbridge claims that "suspect policy entrepreneurs" conspire to "hijack the legislative process to advance a long-standing political agenda." See Bainbridge, supra note 16, at 1816. This simply did not happen in the case of SOX, where the principal administrative agency in the field had clearly detected a decline in the performance of a critical gatekeeper.

[55] The PCAOB is established, and its powers specified, in Title I of the Sarbanes-Oxley Act of 2002. See Sections 101 to 110, 15 U.S.C. §§ 7211 to 7220.

[56] Professor Romano has made it very clear that she considers both to have been "policy entrepreneurs" who foisted flawed legislation on the country. See Romano, supra note 10, at 1549-50 and 1584.

Professor Romano's article on "Quack Corporate Governance" principally focused on four areas where, in her view, SOX's reforms were unsupported by the empirical academic literature: (1) independent audit committees; (2) the restrictions on auditors providing nonaudit services to audit clients; (3) executive loans, and (4) executive certification of financial statements.[57] Interestingly, the efforts to revise or downsize SOX have largely ignored the first three of these areas. In contrast, the fourth area (the prohibition on executive loans) has been quickly and quietly curtailed as a result of collective action taken by the private bar (and acquiesced in by the SEC).[58] The weight of academic empirical research appears not to have had much impact either on SOX's proponents or its critics. Instead, the business community focused primarily on softening the requirements imposed by SOX's Section 404, which required an annual independent review of a public company's internal controls that became more costly than most had anticipated.

This section will focus on those areas where SOX encountered the greatest resistance or has been the most abandoned: (1) Section 404; (2) executive loans; and (3), Section 307, which required lawyers representing the corporation to report securities (and similar) violations up the corporate ladder.

A. <u>Section 404 and Internal Control Reports</u>. Although Section 404 of SOX became highly controversial in time, it was a "sleeper" provision that attracted comparatively little attention initially. As passed, it mandated only that the SEC adopt a new "internal control report" that had to be included in the issuers' annual report on Form

[57] See Romano, supra note 10, at 1529 to 1542.
[58] See text and notes infra at notes 73 to 82.

10-K.[59] In this report, management had to assess the effectiveness of management's internal controls over financial reporting. Then, Section 404(b) required the company's outside auditor to "attest to and report on" management's assessment.[60] Such an attestation requirement was not inherently costly. What made this provision become costly and controversial was the subsequent decision of the Public Company Accounting Oversight Board ("PCAOB"), made two years after SOX's passage, to require a full scale audit of the issuer's internal controls before the auditor might so attest. Under its Auditing Standard No. 2, adopted in 2004,[61] the PCAOB required the auditor to test and evaluate both the design and operating effectiveness of the issuer's internal controls before it could deem itself satisfied with management's own assessment requirement. Effectively, this implied that the auditor must conduct two full audits: the first being the traditional audit of the issuer's financial statements, and the second being the audit of the issuer's internal controls.

This proved expensive and provoked a political reaction. But the decision to require a full audit was not the product of SOX, itself. The accounting profession largely welcomed this dual audit requirement, which proved very lucrative for them. Nonetheless, if auditors were happy with this rule, issuers were not. Almost immediately

[59] Section 404(a) of Sarbanes-Oxley Act ("Management Assessment of Internal Controls") required an "annual internal control report" that contained "an assessment , as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." See 15 U.S.C. § 7262. As the caption to the section states, this Section 404(a) report was to be prepared by the issuer's management.

[60] See 15 U.S.C. § 7262. The last sentence of this Section 404(b) then added that this attestation "shall be made in accordance with standards for attestation engagements issued or adopted by the [Public Company Accounting Oversight Board.]"

[61] The PCAOB's authority to adopt this rule came from Section 404(b). See supra note 60. See Securities Exchange Act Release No. 49884 (June 23, 2004) ("Order Approving Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements").

following the adoption of Auditing Standard No. 2 in 2004, issuers and others began to call for it to be downsized. In 2006, an SEC Advisory Committee recommended that this internal controls audit be waived in the case of smaller companies, which it defined as those with a market capitalization under $125 million.[62] Foreign issuers, who began to delist from U.S. exchanges in significant numbers in the period after 2000, often pointed to Section 404 as a leading cause of their decision to flee the U.S. markets. Both successfully delayed the application of Section 404 to them.

Finally, in 2007, the PCAOB relaxed Auditing Standard No. 2 by replacing it with Auditing Standard No. 5, which softened a number of its requirements.[63] An announced intention of this revision was to reduce audit costs, particularly for smaller companies.[64] A follow up SEC study of Section 404 found a significant decrease in audit costs as a result of the 2007 changes.[65]

Still, this marginal improvement did not satisfy Congress. The Dodd-Frank Act continued the downsizing of the internal controls audit by exempting from Section 404(b) issuers that were neither "accelerated filers" nor "large accelerated filers."[66] Effectively, this meant that non-accelerated filers (i.e., filers with a market capitalization of $75 million or less) were still required to include management's evaluation of its internal

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[62] See Securities Act Release No. 8666 (March 3, 2006) ("Exposure Draft of the Advisory Committee on Smaller Public Companies").

[63] See Securities Exchange Act Release No. 34-56152 (July 27, 2007) ("Order Approving Proposed Auditing Standard No. 5: An Audit of Internal Controls Over Financial Reporting That Is Integrated With An Audit of Financial Statement").

[64] The SEC emphasized this likely cost reduction in approving Auditing Standard No. 5. Id. at 18 (noting that most commentators on proposed Auditing Standard No. 5 believed it would reduce the costs of compliance with Section 404).

[65] See Securities and Exchange Commission, Study on Section 404 (April 2011), available at http://www.sec.gov/news/studies/2011/404float-study.pdf.

[66] See Section 989G of the Dodd-Frank Act (adding new Section 404(c) to the Sarbanes-Oxley Act of 2002).

controls in their Annual Report on Form 10-K, but they no longer had to include their auditor's attestation to that report (which would have required an audit under the PCAOB's rules).[67] The SEC further accommodated newer issuers by delaying Section 404's internal control attestations until a public company was required to file its second Form 10-K, thereby effectively giving a company two years after its IPO before such a report was due.[68]

Even the Dodd-Frank Act's partial repeal of Section 404 has not ended the push for still greater downsizing. In late 2011, the Council on Jobs and Competitiveness, a White House-created advisory body, issued a report calling for the massive downsizing of SOX's requirements with respect to public companies having a market capitalization below $1 billion.[69] Section 404 seems to be the primary target (but hardly the exclusive one). The proposed $1 billion market capitalization cutoff would exempt roughly two-thirds of the roughly 5,700 public companies listed on major U.S. stock exchanges.[70] This proposal has already elicited a sharp editorial rebuke from the New York Times,[71] but the proposal does appear to have bipartisan support.

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[67] See Securities Act Release No. 33-9142 (Sept. 15, 2010) (adopting new rules in response to Section 989G of Dodd-Frank Act).

[68] See Item 308 and Item 308T of Regulation S-K, 17 C.F.R. § 229.308 and 308T. These provisions permit newly public companies to delay until their second annual report on Form 10-K the filing of management's assessment (and the accompanying auditor's attestation) of internal controls over financial reporting.

[69] David Milstead, "A Desperate Obama Kicks Investor Protection to the Curb; in a bid to create jobs the U.S. President appears willing to gut measures that defend shareholders," The Globe and Mail, October 18, 2011 at p. B19.

[70] Id.

[71] See "Not Their Job," New York Times, October 20, 2011 at p. 28. Pending legislation would exempt "emerging growth companies," which are defined as companies with less than $1 billion in gross revenues and $700 million in public float, from Section 404(b). See text and notes infra at notes 174 to 180.

Reasonable persons can debate the wisdom of the PCAOB's various actions (both in requiring an audit of internal controls and then in sparing from that audit smaller issuers, who are actually more likely to experience internal control problems).[72] But three conclusions seem justified: (1) "Hasty" Congressional action did not cause the Section 404 crisis (rather more deliberate action by a politically neutral, self-regulatory organization did); (2) A corrective process curbed much of the perceived problem within a few years of SOX's passage (and may yet sweep away still more of SOX's provisions); and (3) Even Section 404 will not be nullified, as the maximum proposed retrenchment would still leave the internal controls audit in place for larger companies with a market capitalization over $1 billion. Again, whether this corrective process went too far or not far enough can be debated, but it exemplifies the Regulatory Sine Curve in operation. Dodd-Frank is likely to receive similar treatment.

B. Executive Loans and Section 402. Section 402 of SOX is distinctive. Unlike other provisions of SOX (or the Dodd-Frank Act) that authorize agency rule-making, Section 402 baldly prohibited public companies from arranging or extending credit to their executive officers or directors.[73] Adopted with little discussion and late in the process of drafting SOX,[74] it did not address such obvious issues as travel advances,

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[72] For evidence in support of a strong internal controls audit requirement, see Robert Prentice, Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404, 29 Cardozo L. Rev. 703 (2007). This issue is not, however, the focus of this article.

[73] Section 402 has been codified as Section 13(k) of the Securities Exchange Act of 1934 ("Prohibition on Personal Loans to Executives"). See 15 U.S.C. § 78m(k). The language of Section 13(k) is broad, because it precludes the issuer not only "to extend or maintain credit," but also "to arrange for the extension of credit, or to renew any extension of credit." See Section 13(k)(1).

[74] As Professor Romano notes, Section 402 "was introduced at the end of the legislative process in the Senate as a floor amendment substitute for a provision" that was initially drafted "as a disclosure measure." Romano, supra note 10, at 1538.

relocation and retention loans, and broker-assisted cashless stock option exercises. Thus, Section 402 provides some support for the Romano critique that post-crash reform legislation can be overbroad and can disrupt legitimate business practices and objectives. What she ignores, however, is that it did not last long.

Despite Professor Romano's views that executive loans were a matter of "settled state law" and had not generated "scholarly controversy,"[75] the empirical evidence actually seems to indicate that such loans resulted in stealth compensation and were associated with both higher rates of financial misstatement and lower industry-adjusted returns.[76] Further, although Professor Romano defends executive loans as leading to greater stock ownership and thus a better alignment of interests between corporate management and shareholders, several studies question this linkage (partly because the stock so acquired could be immediately sold) and in any event find that such loans may have induced managers to pursue high-risk corporate investment policies.[77]

Of course, what moved Congress in adopting SOX was not the empirical studies or the economic arguments, but the anecdotal evidence of extreme abuse: Bernie Ebbers, CEO of WorldCom, borrowed $408 million from his company (and could ultimately repay none of it); Ken Lay, CEO of Enron, received $70 million in loans from Enron (as

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[75] Id. at 1538.

[76] This evidence is concisely summarized by Professors Prentice and Spence. See Prentice and Spense, supra note 7, 1894 to 1895. See also, Kathleen M. Kahle & Kuldeep Shastri, Executive Loans, 39 J. Fin. & Quantitative Analysis 791, 794-95 (2004); Charles Cullinan et al., A Test of the Loan Prohibition of the Sarbanes-Oxley Act: Are Firms that Grant Loans to Executives More Likely to Misstate Their Financial Results?, 25 J. Acct. & Pub. Policy 485 (2006) (finding "significant association between executive loans and financial misstatements"); Elizabeth A. Gordon et al., Related Party Transactions: Associations with Corporate Governance and Firm Value at 6 (EFA 2004 Maastricht Meeting, Paper No. 4377) (2004) (available at http://ssrn.com/abstract=55893) (finding "strong negative relationship between industry-adjusted returns and . . . loans" to executives).

[77] See Prentice and Spence, supra note 7, at 1893 to 1894.

opposed to only $67 million in compensation); and Dennis Kozlowski, CEO of Tyco, borrowed approximately $270 million (which he largely used to purchase personal assets and real estate, rather than stock).[78] As of the time that Congress enacted SOX in 2002, the average cash loan disclosed by those public companies that disclosed loans to executives was $11 million, and the total insider indebtedness for such companies was $4.5 billion.[79] Worse yet, many of these executive loans were secured by only the stock itself; thus, if the stock price dropped, the board faced the choice of lending additional amounts to the executives or watching them sell their stock and drive down the company's stock price.[80]

The bottom line then is that Congress had legitimate justifications for seeking to curb executive loans, but arguably did so clumsily and in an overbroad fashion. What happened next? The real surprise in the aftermath to Section 402 is that the SEC did virtually nothing. Instead, a coalition of some 25 major law firms drafted and publicly released a memorandum explaining how they would interpret Section 402,[81] and the SEC quietly acquiesced. Many of the positions taken in this memorandum were quite reasonable, while others were more questionable (and almost certainly would not have been proposed in an SEC release). More important than the particular positions taken is

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[78] Id. at 1893-1894.
[79] See Lucian Bebchuk and Jesse Fried, PAY WITHOUT PERFORMANCE: The Unfulfilled Promise of Executive Compensation at 114 (2004).
[80] See Prentice and Spence, supra note 7, at 1894.
[81] The memorandum was released by the 25 law firms jointly on October 15, 2002. Other firms joined in later. The memorandum is available on several websites, and the author is relying on the version posted by Sullivan & Cromwell. See Sullivan & Cromwell, "Memorandum Re Sarbanes-Oxley § 402 – Interpretations Issued by 25 Law Firms" (October 15, 2002) (available at http://www.adrbnymellon.com/files/climail4.pdf).

the fact that the bar simply replaced the SEC as the authoritative interpreter of the statute's meaning. This example shows the Regulatory Sine Curve on steroids.

Why did the SEC behave so passively? One reason may have been that the corporate power to make loans to executives is usually governed by state law, and the SEC may not have felt comfortable invading Delaware's territory. More likely, however, is a second explanation: the SEC is a lawyer-dominated agency that does not want to become involved in a confrontation with the elite law firms of the private bar. Once those firms had taken a collective position, the confrontation would have been personal and even bruising if the SEC had rejected their interpretation (on which advice their clients were presumably relying). Here, we need to take into account the much discussed "revolving door" phenomenon under which SEC staffers join the Commission for a brief tour of duty before returning to positions on Wall Street or in the private bar. Given such career expectations, SEC staffers may be far more anxious about confronting the bar than any other interest group.

Still, the result was that the SEC allowed the bar to dictate the interpretation of a statutory provision in a manner that closely circumscribed what Congress had broadly, if clumsily, forbidden. The result was that a legislative "Thou Shall Not" was converted into a much weaker administrative "Thou generally should not . . ." Interestingly, in the time since the 25 law firm memorandum was adopted, the SEC has – with one exception – never brought an enforcement proceeding to contest an executive loan.[82] One suspects

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[82] The lone exception to this generalization appears to be In the Matter of Peter Goodfellow and Stamatis Molaris. (Securities Exchange Act Release No. 34-52865 (Dec. 1, 2005)). In this case, the CFO of a public corporation authorized an interest-free loan to the CEO, and two weeks later the CEO approved a similar interest-free loan to the CFO. The approval of the board of directors was never sought; nor was disclosure made to the board. This last fact (the absence of board

that the opportunities were there for enforcement actions if the SEC had been willing to pursue them.

C. Attorneys As Whistle Blowers and Section 307. Section 307 of SOX instructed the SEC to adopt minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of public companies. This provision was adopted with considerable fanfare by Senators who noted that lawyers were always "present at the scene of the crime" when securities frauds occurred.[83] The Commission responded by adopting its "Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer" with even greater fanfare in 2003.[84] Under it, attorneys have an obligation to report material violations of federal or state securities laws, or breaches of fiduciary duty, to the issuer's chief legal officer or to its chief executive officer.[85] If the

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approval) plus the fact that the officers acknowledged their awareness of SOX's prohibition on executive loans (but did not consult counsel) may explain why the SEC made an exception and sued in this case and not in others (at least to date).

[83] The co-sponsors of Section 307 ("Rules of Professional Responsibility for Attorneys") were Senator Michael Enzi (R-Wyo.), the Senate's lone accountant, and Senator John Corzine. Reviewing Enron, WorldCom and other recent scandals, Senator Enzi told the Senate:

> "One of the thoughts that occurred to me was that probably in almost every transaction there was a lawyer who drew up the documents involved in that procedure."

148 Cong. Rec. S6554 (daily ed., July 10, 2002) (Statement of Senator Enzi). For a fuller discussion of Section 307 and the debate over it, see John Coffee, The Attorney As Gatekeeper: An Agenda for the SEC, 103 Colum. L. Rev. 1253 (2003).

[84] See 17 C.F.R. § 205.1 to 205.7. See also Sec. Act Rel. No. 33-8185 (January 29, 2003). Although the Commission adopted its "up the ladder" reporting requirement of evidence of material violations of law, it abandoned, under pressure from the American Bar Association, its original proposal that the attorney resign and report to the SEC when the corporate client refuses to correct or rectify a material violation of law. See Sec. Act Release No. 33-8186 (January 29, 2003).

[85] Rule 3 ("Issuer as Client") requires an attorney appearing and practicing before the Commission in the representation of an issuer (which terms are very broadly defined) who

issuer still fails to take action, the lawyer may be required to report further to the company's audit committee.[86] Under some limited circumstances, the lawyer is even permitted (but not required) to disclose a material violation of law directly to the SEC.[87]

Aspirational as SEC Standards of Professional Conduct are, they have been followed by total silence on the enforcement front. Despite numerous instances in which lawyers were clearly aware of executive misconduct – and both the stock option backdating scandal and the mutual fund market timing scandal followed the adoption of these standards and presented instances in which attorneys were deeply implicated in misconduct involving violations of the federal securities laws – the SEC appears never to have charged an attorney representing a public corporation with violating this rule. To be sure, lawyers have been indicted for securities fraud and insider trading and civilly sued by the SEC, but these cases usually involve egregious self-dealing. The lesser remedy of asserting a professional conduct violation has simply not been used by the SEC.

Why not? Sanctioning attorneys for failure to report violations up the ladder within the corporate structure would again place the SEC in a position of high conflict with the bar. In contrast to prosecutions of attorneys for insider trading or other scienter-based offenses, the SEC's enforcement of reporting rules would reach attorneys who acted only negligently and or who declined to act (without in either case any clear element of self-dealing).

"becomes aware of evidence of a material violation by the issuer or by any officer, director, employee or agent of the issuer" to "report such evidence to the issuer's chief legal officer . . . forthwith." 17 C.F.R. § 205.3(b).

[86] See 17 C.F.R. § 205.3(b)(3).

[87] See 17 C.F.R. § 205.3(d)(2).

The SEC has long (and perhaps unwisely) resisted entering this zone, based on the overbroad rationale that to discipline attorneys for negligence or inaction would chill the attorney/client relationship and might dissuade clients from seeking legal advice.[88] A recent case exemplifies the SEC's continuing reluctance to engage in non-scienter based enforcement actions against attorneys. In In the Matter of Scott G. Monson,[89] the SEC's staff brought a cease and desist proceeding against a general counsel of a publicly held broker-dealer, who had allegedly facilitated late trading by that broker-dealer on behalf of its clients in over 600 mutual funds in violation of a very explicit and well-known Investment Company Act rule.[90] The attorney had drafted an agreement pursuant to which the broker-dealer's clients were authorized to engage in "late trading," but the SEC's staff did not allege that the attorney either knew that late trading violated the securities laws or that late trading was occurring. Noting that it had long avoided bringing cases against an attorney on the theory that the attorney "departed from professional standards of competence in rendering private legal advice to their clients,"[91] the Commission explained that such restraint was necessary to avoid "encroachment by the

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[88] For a brief period, the SEC had ruled that a securities attorney was obligated (under some circumstances) to advise the board if the attorney became aware that the corporation was acting in violation of the federal securities laws. This position still fell far short of a "whistle blowing" obligation and only recognized that the issuer was the client. See In the Matter of William R. Carter and Charles J. Johnson, Jr., 47 SEC 471 (1981). Still, it did recognize a professional obligation for the attorney sometimes to go to the board. Later, however, the Commission retreated from even this position. See Securities Act Release No. 6783 (July 13, 1988) ("Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission") (noting that "[S]ince Carter and Johnson, the Commission has not attempted to set professional standards of conduct in Rule 2(e) proceedings, but has relied on a showing of the violation of the securities laws"). Id. at n. 31. Section 307 of the Dodd-Frank Act essentially imposed a Carter and Johnson-like standard on the SEC, which it has so far failed to enforce.
[89] Admin. Proc. File No. 3-12429, 2008 SEC LEXIS 1503 (June 30, 2008).
[90] See Rule 22c-1 of the Investment Company Act of 1940.
[91] In the Matter of Scott G. Monson, supra note 89, at *17 to *18.

Commission on regulation of private attorney conduct historically performed by the states; interference with lawyers' ability to provide unbiased, independent legal advice regarding the securities laws, and chilled advocacy on behalf of clients in proceedings before the Commission."[92] On this basis, the Commission therefore affirmed dismissal of the Enforcement Division's complaint.

Arguably, these concerns are overblown when applied to an attorney who drafts an agreement expressly authorizing clearly unlawful conduct. Late trading is not a gray offense. More importantly, such an explanation – that the Commission will not normally proceed against professionals absent evidence of scienter – virtually implies that the Commission will not seriously enforce Section 307. Thus, it should not be surprising that Section 307 seems to have been abandoned by the Commission. As with its refusal to enforce the executive loan prohibition, the Commission seems unwilling to enter areas where it might either infringe on state regulation or encounter resistance from the bar. The consequence is that clear Congressional pronouncements are watered down or abandoned, and the rationale is basically the same rationale advocated by critics such as Professors Romano and Bainbridge: namely, that federal agencies should not "encroach" upon areas traditionally relegated to state regulation.

Possibly, this explanation for equivocal SEC enforcement in the case of the financial industry is too narrow. Some federal courts have expressed concern that the SEC is too easily satisfied with symbolic, but hollow, victories and too apprehensive about the prospect of a litigation defeat in truly contested litigation to take on a major

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[92] Id.

opponent. That was the thrust of Judge Rakoff's recent Bank of America decision.[93] For present purposes, it is not necessary to select the best explanation to reach the conclusion that equivocal enforcement by the SEC in cases involving major players in the financial industry has long been the pattern, and that pattern does not seem likely to change markedly in the near future.

D. An Evaluation. The Tea Party critics of both SOX and the Dodd-Frank Act argue that, because "reform" legislation is rushed and hastily framed, the policy formulation is distorted by "suspect policy entrepreneurs" who "hijack the legislative process to advance a long-standing political agenda."[94] Brief as this review of SOX has been, it should make clear that "suspect policy entrepreneurs" did not play a major role in adopting or expanding SOX's most controversial provision, Section 404. Nor is the meaning of "suspect policy entrepreneur" analytically clear or helpful. Many interest groups attempt to influence legislation and regulation (and business interest groups are particularly active). Why investor-oriented groups (such as public pension funds) are "suspect," while groups favoring the status quo (such as business interest groups) are not considered equally "suspect" has not been adequately explained by these critics.

As next explained, the same critique has been directed at the Dodd-Frank Act.[95] Once again, it has only limited explanatory power. Even if it were the case that investor-

[93] See S.E.C. v. Bank of America Corp., 653 F. Supp. 2d 507 (S.D.N.Y. 2009). The court did ultimately approve a revised settlement. More recently, Judge Rakoff has questioned the SEC's long-standing policy of allowing defendants to neither admit nor deny its allegations and settle the case without their resolution. See S.E.C. v. Citigroup Global Markets Inc., 2011 U.S. Dist. LEXIS 135914 (S.D.N.Y. November 28, 2011) (court declines to approve proposed settlement). This decision is on appeal and the issues in the case are beyond the scope of this article.

[94] These are Professor Stephen Bainbridge's words describing the drafting of the Dodd-Frank Act. See Bainbridge, supra note 16, at 1816.

[95] See in particular, Bainbridge, supra note 16.

oriented groups (such as pension funds and unions) are more active politically in the period following a crash, it remains unclear why their activity is "suspect," while the far better funded political activity of business interest groups in seeking to repeal or curtail such legislation after normalcy returns is not.

Part III. The Dodd-Frank Act: Premises and Policy Options

In 2008, Congress saw the nation's largest financial institutions race like lemmings over the cliff and into insolvency. Why did they all become insolvent at once? Three credible scenarios have been offered by a variety of commentators. Each seems correct in part, and each motivated the legislative effort that produced the Dodd-Frank Act:

A. Moral Hazard: "Executive Compensation Caused the Crash." Because a rapid shift towards incentive-based compensation at financial institutions focused senior management on short-term results, longer-term risks were ignored or underweighed.[96] For example, if the executives in charge of asset-backed securitizations at a financial institution could make $100 million in bonuses in a single year if sufficient deals closed that year, such expected compensation could easily produce a "damn-the-torpedoes,-full-speed-ahead" approach to risk taking. Indeed, why should such executives worry at all about the longer-term risks to their bank? Excessive compensation thus led to moral hazard. Inevitably, such a diagnosis leads to proposals to restrict executive compensation. But how and by whom? Here, the devil is in the details. Once we descend into the details

[96] For the fullest statement that executive compensation (and in particular incentive compensation) gave rise to a moral hazard problem, see Lucian A. Bebchuk and Holger Spamann, Regulating Bankers Pay, 98 Geo. L. J. 247 (2010); Lucian Bebchuk et. al., The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, 27 Yale J. on Reg. 257 (2010).

in the implementation process, the special interests and their lobbyists hold all the advantages.

2. Because Creditors Believed That "Too Big to Fail" ("TBTF") Banks Would Always Be Bailed Out, They Advanced Funds Too Cheaply and Allowed Banks to Become Overleveraged. Economists generally agree that an implicit Governmental subsidy for TBTF banks arose because the market assumed that such institutions would be bailed out. Such an implicit guarantee of their solvency leads investors to lend more cheaply to TBTF banks in comparison to smaller banks.[97] The larger the bank, the cheaper it could borrow, in part because all assumed that the government would not allow the bank to fail. Seeing this subsidy, the shareholders and managers of such financial institutions rationally exploited it by taking on excessive debt and leverage. In effect, the banking system was encouraged to risk a solvency crisis because all market participants believed that the Government would have to bail it out. From this perspective, the core evil is the implicit subsidy for TBTF banks through cheaper borrowing costs, and the obvious economic answer is to tax this externality and cancel this subsidy. But eliminating subsidies and taxing externalities means making banks less profitable, and any such program will be predictably fought by the industry at every possible level – usually with the counterargument that imposing higher costs on TBTF banks will mean reduced employment and lending.

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[97] For an aggressive statement of this view, see Anat R. Admati, et al., Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive, (Rock Center for Corporate Governance at Stanford Univ. Working Paper No. 86, 2010) (available at http://ssrn.com/abstract=1699704 (2010)); see also John Coffee, Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight, 111 Colum. L. Rev. 795, 800-801 (2011).

3. Bounded Rationality: Cognitive Limitations, Conflicts of Interest, and a Lack of Transparency Induced Market Participants to Repress Recognition of the Problems Overtaking The Market. AIG provides the paradigm of this problem.[98] By 2008, most major financial institutions had come to rely, directly or indirectly, on credit default swaps issued (or backstopped) by AIG to hedge these institutions' exposure to financial risks.[99] Had AIG's aggregate contingent liability on credit default swaps been publicly recognized, many would have recognized that AIG alone could not insure them against an exposure of this magnitude. Instead, even if the market's extraordinary dependence on AIG was dimly perceived, market participants were not forced to admit that the Emperor had no clothes. Instead, the problem was collectively repressed, which occurred to a considerable degree because the credit default swap market was itself opaque. Often for self-interested reasons (again involving executive compensation), financial managers persisted in maintaining highly vulnerable portfolios and remaining exposed to enormous risk, relying on an illusory form of insurance.

So what is the appropriate answer to this recurring tendency? If a stubborn refusal to recognize inconvenient truths is the problem, the obvious policy reform is greater transparency: require OTC derivatives to be traded over exchanges and through clearinghouses, and it will be less possible for one actor to assume AIG's position as the

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[98] For representative critiques from this perspective of bounded rationality, see Carmen Reinhart & Kenneth S. Rogoff, THIS TIME IS DIFFERENT: Eight Centuries of Financial Folly (2008); Donald Langevoort, Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk-Taking, 96 Cornell L. Rev. 1209, 1242 (2011); Gary Gorton, The Subprime Panic, 15 Eur. Fin. Mgmt 10 (2009).

[99] By the end of 2007, AIG had sold credit default swaps with a notional amount of roughly $527 billion, of which $61.5 billion referenced CDOs holding mortgage-backed securities as collateral. See Michael Lewis, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE, at 197 (2009).

counterparty for the entire market. As will be seen, the Dodd-Frank Act moves in this direction – equivocally and in a manner dependent on still pending implementation.

In response to all these perceived causes of the 2008 crisis, the Dodd-Frank Act pursued several strategies, broadly delegating authority to administrative agencies to fill in the details. First, in response to the initial hypothesis that excessive compensation induced excessive risk-taking, the Dodd-Frank Act adopted two somewhat inconsistent strategies. On one hand, it sided with traditional corporate governance reformers, enacting much of their standard agenda: access to the proxy statement, "say on pay" advisory shareholder votes, and the elimination of broker votes. On the other hand, the Dodd-Frank Act gave financial regulators a broad paternalistic power to restrict executive compensation. As will be seen, with the return of "normalcy," courts have struck down some of the corporate governance reforms (and others are in jeopardy).[100] Meanwhile, regulators are quietly downsizing the restrictions authorized by the Dodd-Frank Act on executive compensation.[101]

With respect to the second diagnosis that the "too big to fail" subsidy for banks induced the excessive leverage that underlay the 2008 crisis, the Dodd-Frank Act took elaborate steps to restrict federal lending to large financial institutions, except when they are being liquidated. The Dodd-Frank Act's goal was to signal that there would be no more bailouts, and hence creditors should not lend to TBTF banks on the same discounted terms. Yet, liquidity crises are endemic to banking, and whether the Dodd-Frank Act resolves or aggravates the "TBTF problem" is debatable. All that is clear is

[100] See Business Roundtable v. S.E.C., 647 F.3d 110 (D.C. Cir. 2011) (invalidating SEC's proxy access rule, which was adopted pursuant to Section 971 of the Dodd-Frank Act). This case is further discussed infra in the text and notes at notes 148 to 153.
[101] See text and notes infra at notes 154 to 164.

that, post-2008, the U.S. banking industry has become even more consolidated (as the survivors acquired those institutions that failed), and the failure of a TBTF bank would be even more catastrophic. Perhaps, as many suspect, financial regulators can still outflank the Dodd-Frank Act's restrictions and find ways to bail out a failing bank. But, if so, the implicit subsidy has not been ended and the potential for another systemic risk crisis remains latent beneath the surface of reform.

Finally, looking at the AIG paradigm, Congress decided to shift the trading of over-the-counter derivatives to exchanges and require the use of clearinghouses. But Congress stopped short of deciding how far to push this reform and instead delegated the issue (subject to some substantial exemptions to financial regulators).

This article does not portray the Dodd-Frank Act as "perfect" legislation. Like much "reform" legislation, it is a potpourri of different provisions, some of which may be inconsistent or poorly conceived. That is inevitable in the real world when Congress must act under time pressure and faces the need to satisfy many constituencies. Thus, this article focuses more on the incompleteness of the Dodd-Frank Act, the continuing need for detailed implementation, and the erosive impact of the Regulatory Sine Curve on that process. It will focus primarily on three areas: (1) executive compensation; (2) the "too big to fail" problem and proposed reforms to restrain risk-taking by TBTF banks, and (3) the over-the-counter derivatives area (where the AIG bailout provided the motivating force for Congress). Although it will agree that the Dodd-Frank Act was in some respects imperfectly designed, the greater problem is that it relies on administrative implementation that can be too easily frustrated.

A. <u>Executive Compensation and Shareholder Pressure</u>

The conventional story of the 2008 crisis—as best told by Professor Lucian Bebchuk and his coauthors[102]—focuses on the perverse influences created by executive compensation formulas. They argue not only that executive pay packages were excessively focused on short-term results, but that because senior executives' compensation packages were closely tied to highly levered bets on the value of the banks' assets, such executives shared in any shareholder gains but were insulated from shareholder losses.[103] Hence, they could focus on the upside and ignore the downside of any risky strategy. The result, they argue, is a classic moral hazard problem.

To corroborate their claim, Bebchuk and his coauthors have collected data showing that senior managers appeared to have profited handsomely even when shareholders lost virtually everything. Examining the failures of Bear Stearns and Lehman, they find that the top five executives at each firm cashed out extraordinary amounts of performance-based compensation during the 2000–2008 period. Specifically, they estimate that these top five management teams derived $1.4 billion and $1 billion, respectively, from cash bonuses and equity sales during this period.[104] These amounts substantially exceeded the same executives' stock holdings at the beginning of the period. If managers win when shareholders lose, this finding would seem to confirm Bebchuk's moral hazard diagnosis.

Their research has not, however, gone unchallenged. In particular, Rene Stulz has coauthored several papers that dispute this thesis that the executive compensation

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[102] See generally Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 Geo. L. J. 247 (2010); Lucian A. Bebchuk et al., The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2006, 27 Yale J. On Reg. 237 (2010).
[103] Bebchuk & Spamann, supra note 102, at 249–50.
[104] Bebchuk et al., supra note 102, at 261.

formulas for senior executives at financial institutions drove the 2008 crisis by creating an incentive to accept excessive risk.[105] In one paper, he and a coauthor find evidence that those banks with chief executive officers (CEOs) whose incentives were better aligned with their shareholders actually performed worse during the crisis.[106] They suggest that "CEOs with better incentives to maximize shareholder wealth took risks that other CEOs did not."[107] Nor do they find that bank CEOs reduced their stock holdings prior to 2008; hence, they suffered large wealth losses along with the shareholders.[108] In short, little evidence supports the claim that shareholders were being overreached by their CEOs.

In another study, Stulz and a coauthor find that banks with "shareholder-friendly" corporate governance performed worse during the 2008 crisis.[109] Indeed, banks that the market had favored in 2006 had especially poor returns during the crisis.[110] In other words, financial institutions that led the market in 2006 encountered disaster in 2008. In contrast, financial institutions that had seemed stodgy and unresponsive to shareholder

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[105] Andrea Beltratti & Rene M. Stulz, Why Did Some Banks Perform Better During the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation (European Corporate Governance Inst., Fischer College of Business Working Paper No. 2009-03-12, (2009)), available at http://www.ssrn.com/abstract=1433502; Rüdiger Fahlenbrach & Rene M. Stulz, Bank CEO Incentives and the Credit Crisis (The Ohio State Univ. Fisher College of Business, Working Paper No. 2009-03-13, 2009), available at http://www.ssrn.com/abstract=1439859.
[106] See Fahlenbrach & Stulz, supra note 105, at 1–2 (arguing that most plausible explanation for these findings is that CEOs "took actions that they believed the market would welcome," but "[e]x post, these actions were costly to their banks").
[107] Id. at 26.
[108] Id. at 2, 4.
[109] Beltratti & Stulz, supra note 102, at 3.
[110] Id. at 2. Banks that performed in the worst quartile of performance during the 2008 crisis had average returns of -87.44% during the crisis, but an average return of +33.07% in 2006. The best performing banks during the crisis had average returns of -16.58% during the crisis, but only average returns of +7.80% in 2006. Id. at 14.

desires in 2006 experienced the least losses in 2008. Such findings are at least consistent with the view that shareholder pressure led managers to take on higher leverage and accept greater risk in the boom years—with catastrophic consequences later in 2008. Shareholders in effect opted for a financial roller coaster, and the firms they controlled soared to record peaks and plunged to deep valleys in rapid succession.

Other studies by different teams of researchers have reached similar conclusions. Gropp and Köhler find that "owner controlled" banks had higher profits in the years before the 2008 crisis in comparison to "manager controlled" banks, but experienced larger losses and were more likely to require governmental assistance during the 2008 crisis.[111] Using a sample of 296 firms from thirty countries, Erkens, Hung, and Matos show that firms with more independent boards and higher institutional ownership experienced worse stock returns during the 2007–2008 crisis.[112] Specifically, they found that firms with higher institutional ownership took "greater risk in their investment policies before the onset of the crisis."[113] Such evidence suggests that even if managers would prefer to avoid high risk and leverage, their preferences can be overridden by shareholders, and that institutional investors in particular can compel firms to accept greater risk and thus cause them to suffer worse losses in a crisis.

The point here is not that Professor Bebchuk and his coauthors are wrong. They argue that the pay formulas used to compensate senior management at banks gave them

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[111] Reint Gropp and Matthias Köhler, Bank Owners or Bank Managers: Who is Keen on Risk? Evidence from the Financial Crisis 21 (European Bus. Sch., Research Paper No. 10-02, 2010), available at http://ssrn.com/abstract=1555663.

[112] David Erkens, Mingyi H. Hung, and Pedro P. Matos, Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide 2 (European Corporate Governance Inst., Finance Working Paper No. 249/2009, 2010), available at http://ssrn.com/abstract=1397685.

[113] Id. at 2.

an excessive incentive to accept risk. But such an increased incentive could be exactly what shareholders wanted. Shareholders have long used executive compensation to align managerial preferences with their own, and institutional investors certainly understand that managers are undiversified and thus risk averse about corporate insolvency. Being diversified and having limited liability, shareholders do not suffer as much as managers from a bankruptcy. To "correct" the managerial tendency toward risk aversion, shareholders might have been willing to accept even imperfect compensation formulas to seduce managers into accepting increased risk. Thus, both sides in this debate could have valid points. Bebchuk and company appear correct in arguing that compensation formulas create excessive incentives for bank managers to engage in risky activities, and Stulz and others can legitimately interpret their own data to mean that shareholder-controlled firms accept higher risk and hence are more prone to failure in a crisis than firms in which managers are free to enjoy the quiet life (and so avoid risk). Rather than managers overreaching shareholders, it looks instead as if these compensation formulas crudely aligned managerial and shareholder interests, but created a socially excessive incentive for risk-taking. Under this synthesis, shareholders, as principals, simply found ways to contract with managers, as their agents, to accept greater risk through lucrative compensation formulas.

But that only brings us back to the centrality of shareholder pressure and the gap in bank governance between what is privately optimal and what is socially optimal. Arguably, shareholders of financial institutions were willing to accept high leverage and risk, not simply because they were diversified, but because they believed that (1) major banks were "too big to fail," and (2) the implicit reduction in interest expense charged to "too big to fail" banks created an opportunity for "cheap" capital that could not be spurned. Based on these expectations, shareholders of major financial institutions could rationally pressure management to accept more risk than shareholders might consider advisable at industrial corporations.

At this point, it is necessary to disaggregate shareholders. Individual shareholders may sometimes also be risk averse and disinclined to pressure management toward greater risk and leverage, but they are a decreasing minority of all shareholders.[114] Yet, not only do institutional investors own a majority of the equity in U.S. public corporations, but their level of ownership rises to 73% when we focus on the top 1,000 U.S. corporations (among which large financial institutions easily rank).[115] Mutual funds now represent the largest category of institutional owner (in terms of equity holdings).[116] Their rise is important because, in comparison to pension funds, mutual funds more actively compete for the investor's favor, and their recent investment returns are likely to heavily influence this competition. As a result, they tend to be more proactive investors.

Historically, pension funds were largely indexed investors, holding large portfolios that mimicked the broader market. Thus, they were disinclined to become involved in individual corporate governance disputes, because they could not profit

[114] Recent estimates find retail (or individual) shareholders own only roughly 25% of the stock in publicly traded firms, with the balance being owned by institutional investors and foreign investors (who are also largely institutions). Alan R. Palmiter, Staying Public: Institutional Investors in U.S. Capital Markets, 3 Brook. J. Corp. Fin. & Com. L. 245, 262 tbl.1 (2009). Since 2001, institutional investors have held over 50% of the total outstanding equity in U.S. public corporations. Matteo Tonello and Stephen Rabin Rabimov, The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition 22 (2010) (The Conference Board Research Report No. R-1468-10-RR (2010)), available at http://ssrn.com/abstract=1707512.
[115] See Tonello and Rabimov, supra note 114, at 27 chart 14 (showing this percentage to have been 76.4% in 2007 and 73% in 2009).
[116] Id. at 24–26 & tbl.12 (showing mutual funds held 20.9% of the total equity U.S. market in 2009, slightly more than pension funds in aggregate).

significantly from them.[117] But this is changing. Increasingly, pension funds are investing their stock portfolios in hedge funds to obtain returns superior to simple indexing.[118] In turn, these hedge funds pursue proactive strategies, and one of their favorite targets is the underleveraged firm.[119]

The shareholders' preference for leverage is complemented (and to a degree made possible) by the creditors' continuing expectation that they will be protected in a federally-assisted rescue of a failing financial institution. When faced with a failing bank, the federal government has traditionally arranged shotgun marriages through mergers (with federal assumption of at least some of the failing firm's liabilities).[120] This was the strategy followed to rescue Bear Stearns, Merrill Lynch, and Wachovia during the 2008 crisis. Under this standard pattern, even if the shareholders of the failed bank were not protected, its creditors were. Thus, the implicit subsidy in interest rates remains and should logically continue to motivate shareholders to seek to exploit "cheap"

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[117] For the standard observation that many institutional investors hold too large a portfolio to have much interest in firm-specific corporate governance, see, e.g., Robert Cyran, Beware: Activists Are on the Hunt, N.Y. Times, Mar. 4, 2010, at B2.

[118] For example, CalPERS began investing in hedge funds in 2002 and has "moved the majority of its portfolio into direct investments in single and multistrategy hedge funds." Christine Williamson, Big Public Funds Outperform Their Hedge Fund Yardsticks: Plans Studied by P&I Post Average Gain of 11% in the Portfolios, Pensions & Investments, Sept. 20, 2010, at 1, 42. A number of other state pension funds have followed CalPERS in this shift. Id.

[119] Typically, the target of such an activist shareholder is an underperforming firm "with a pristine balance sheet." Cyran, supra note 117, at B2. Often, the activist shareholder proposes the sale of assets and a special dividend of the proceeds, which also raises leverage.

[120] Confronted with an approaching bank failure, the FDIC's preferred strategy has long been to arrange a "purchase and assumption" transaction with another bank—in effect, a shotgun marriage aided by the FDIC assuming some of the failed bank's liabilities. Jonathan R. Macey & Geoffrey P. Miller, Bank Failures, Risk Monitoring, and The Market for Bank Control, 88 Colum. L. Rev. 1153, 1182 (1988). In the standard "purchase and assumption" transaction, "the deposits of the failed bank are assumed by another bank, which also purchases some of the failed bank's assets." Id.

financing at the cost of excessive leverage.

From this perspective, it seems ironically counter-productive that the Dodd-Frank Act actually sought to increase the ability of shareholders to pressure managers, because such shareholder pressure would predictably often seek to compel managers to increase leverage and accept greater risk. Yet, the Dodd-Frank Act authorized the SEC to adopt rules giving shareholders "access to the proxy statement,"[121] enabling dissidents to mount campaigns for minority seats on the board without having to undertake costly proxy fights. The SEC responded to this invitation by quickly adopting new Rule 14a-11, which authorizes dissident shareholders to place their nominees on the corporate board at low cost.[122] Rule 14a-11 could be a desirable counterweight to entrenched managerial power in much of Corporate America, but again financial institutions are a special case. Given the natural tension between the social interest in prudent bank regulation and the shareholder interest in profit maximization through higher leverage, corporate

[121] Section 971 ("Proxy Access") of the Dodd-Frank Act added a new § 14(a)(2) to the Securities Exchange Act of 1934 that authorizes the SEC to adopt rules under which dissident shareholders may nominate candidates for the board of directors of a public company and include their nominees in the issuer's own proxy statement (thereby permitting these insurgents to economize on the costs of conducting a proxy fight). Dodd-Frank Act, Pub. L. No. 111-203, § 971, 124 Stat. 1376, 1915 (2010) (to be codified at 15 U.S.C. § 78n).

[122] Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,668 (Sept. 16, 2010). Specifically, if certain conditions are satisfied, the new rule will permit shareholders holding 3% or more of the corporation's voting power for a three year holding period to nominate candidates to fill up to the greater of (1) 25% of the director positions to be elected, or (2) one director. Id. at 56,674–75. These alternative candidates would run against those nominated by the Board's nominating committee. Effectively, this procedure would have spared the insurgents much of the costs of a proxy contest.

The business community challenged the SEC's new "proxy access" rule and invalidated it in court. See Business Roundtable v. S.E.C., 647 F.3d 1144, 1148-49 (D.C. Cir. 2011) (invalidating Rule 14a-11 for failure to "adequately assess the economic effects" of the rule). The impact of this case and the weapon it gives business interests to challenge "reform" legislation is assessed infra in the text and notes at notes 148 to 153.

governance reforms that enhance shareholder power may at the same time weaken regulatory control over financial institutions.

Still, if the drafters of the Dodd-Frank Act made a misjudgment in seeking to use shareholders to restrain corporate risk-taking, it was probably a minor error. Close students of the proxy rules doubt that the "proxy access" rule would have significantly altered the corporate governance landscape or that the most powerful activists (i.e., hedge funds) would have used it.[123]

In fairness to Congress, the Dodd-Frank Act did not rely exclusively on corporate governance reforms to restrict executive compensation. Rather than depending exclusively on the fox to guard the executive compensation henhouse, Congress also enacted a very paternalistic Section 956 of the Dodd-Frank Act, which authorized regulators to prohibit excessive incentive-based compensation at "covered financial institutions" that "could lead to material financial loss to the covered financial institution."[124] This was a more direct route to reform, but, as will be seen, financial regulators appear to be backing away from implementing Section 956 effectively.

B. Systemic Risk and the "Too Big to Fail" Problem

The overriding goal of Dodd-Frank Act was to reduce systemic risk. But dealing with systemic risk requires that we first understand it. Although there is no universally

[123] See, e.g., Marcel Kahan and Edward Rock, The Insignificance of Proxy Access, 97 Va. L. Rev. 1347 (2011). Under Rule 14a-11, activists who wish to use the rule must disclaim any intent to seek control. Hedge funds may often be unwilling to do this, as they wish to create at least the appearance of an impending control battle to boost the target's stock price. Also, the cost savings offered by the rule to them are insignificant where they would need to invest billions to acquire a significant position in a large financial institution.

[124] Section 956 also requires disclosure by the covered financial institution of "the structure of all incentive-based compensation" in order to enable the regulator to preclude excessive compensation. See infra at notes 154 to 158.

accepted definition of the term,[125] most agree that it has three faces:

(1) A financial institution can simply be "too big to fail." A Citigroup probably is, but Lehman was perceived not to be.

(2) An institution can be "too connected to fail," largely as the result of the increased use of over-the-counter derivatives (including credit default swaps). As a result, the failure of one can imply the eventual failure of its counterparties in a cascade of falling financial dominoes. This scenario explains the Government's bailout of AIG, upon whom all other major financial institutions had relied for protection.

(3) Financial institutions can also be too risk correlated to fail, with the result that the failure of one implies intense stress for the others. Although uncorrelated risk can be managed through policies such as diversification, risks that are correlated cannot be similarly resolved or protected against.

This last face of systemic risk – risk correlation – is probably the least understood and most dangerous. Because of market pressures (fueled again in part by shareholders willing to accept risk), large financial institutions are inclined to adopt similar investment and strategic policies (or face a stock market penalty for their refusal). Thus, in the late 1990s, large financial institutions began aggressively to develop their asset-backed securitization business, because it appeared to offer the highest return on their capital. Assume next that one such institution encounters a liquidity crisis (as Bear Stearns did in early 2008) and must sell illiquid assets (such as interests in asset-backed securitizations)

[125] For a fuller definition of the term, see Steven Schwarcz, Systemic Risk, 97 Geo. L. J. 193, 204 (2008).

into a thin market. Prices fall quickly throughout this market, and other financial institutions are as a result forced to write down their investments in similar assets. Moreover, short sellers and others realize that trouble at one financial institution signals distress at other similar institutions and compound the market pressure. This crisis then feeds on itself, as all these banks begin to sell the same now disfavored investments into the same, even thinner market.

How can one design an intelligent policy that reduces systemic risk, given the likelihood that market and shareholder pressures will lead financial institutions to follow the herd and pursue similar investment policies? Among the obvious options are:

(a) Higher Equity Capital Requirements. Such a strategy makes sense, but precisely because it will reduce leverage and thus bank profitability, it will be quietly resisted by banks. A variant on this general technique is to employ "contingent capital" – namely, a debt security that automatically converts by its terms into an equity security when the institution encounters a defined level of economic stress.[126]

(b) A Private, Industry-Funded Insurance System. Such an insurance system is essentially what the Federal Deposit Insurance Corporation ("FDIC") manages, and it has long been the preferred policy of the International Monetary Fund ("IMF"). Essentially, it replaces a public bailout with a private industry bailout, and forces the banking industry to internalize the costs of higher leverage. Put differently, this approach taxes the

[126] This conversion could be piecemeal and progressive, as the stock price fell to various lower levels, or it could occur when certain accounting-based tests are triggered. The conversion could be to a common stock or to a preferred stock (possibly with special voting rights). Either way, the primary goal is to avert bankruptcy and financial contagion. For a fuller review of the potential designs for contingent capital, see John C. Coffee, Jr., Systemic Risk After Dodd-Frank: Contingent Capital And the Need for Regulatory Strategies Beyond Oversight, 111 Colum. L. Rev. 795 (2011).

externality by imposing a charge on the industry to prefund such an insurance fund; this offsets the externality that arises when TBTF banks are able to borrow funds too cheaply because of an expected governmental guarantee.[127]

(c) Reducing Risk Through Prophylactic Rules. A third approach is to reduce the risk level of TBTF banks by denying them authority to engage in certain higher risk activities. As discussed later, the "Volcker Rule," which Dodd-Frank partially adopted, intends such a result by prohibiting large banks from engaging in proprietary trading or running hedge funds. Similarly, the now repealed Glass-Steagall Act separated investment banking from commercial banking in order to protect the latter institutions.

Dodd-Frank mandates only the last of these steps, through a provision popularly known as "the Volcker Rule."[128] It will be discussed shortly, but it is the primary exception to the generally accurate generalization that the Dodd-Frank Act did not mandate stricter standards on TBTF banks (but only authorized regulators to do so). For example, although Dodd-Frank authorizes the Federal Reserve to impose higher and more restrictive standards with regard to bank capital and leverage, it did not direct any specific such action and instead leaves these issues to the discretion of the Federal Reserve Board ("FRB") and a new body called the Financial Stability Oversight Council ("FSOC").[129] At earlier stages in the Dodd-Frank legislation, both the House and Senate versions of the Act did contain important provisions mandating a private industry

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[127] For the case for such a private, pre-funded fund, see Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank's Dangers and the Case For a Systemic Emergency Insurance Fund, 28 Yale J. on Reg. 151 (2011).
[128] See Section 619 of the Dodd-Frank Act. For a fuller review of the rule, see David Carpenter & Maureen Murphy, The "Volcker Proposals to Limit Speculative Proprietary Trading by Banks, Congressional Research Service (2010).
[129] See Section 111 of the Dodd-Frank Act (establishing the Financial Stability Oversight Council).

insurance fund (modeled after the FDIC), but these provisions were ultimately deleted at the conference stage. Why? Populist anger at the costly bailout of the banks (compounded by resentment over continued high executive compensation in the financial industry) made any "bailout" proposal politically unacceptable. In addition, some feared that the existence of such a fund would perpetuate a moral hazard problem, as creditors would feel protected and continue to lend at a discount.

Instead, Congress's attention in Dodd-Frank was chiefly directed at prohibiting future public bailouts by the Federal Reserve or the FDIC. To this end, regulators were stripped of their former authority to advance funds to major financial institutions facing a liquidity crisis.[130] Yet, it is still not clear that the market really believes that any future administration could truly tolerate a major bank failure, and many suspect that some means would be found to evade statutory obstacles in a major crisis. A future

[130] Section 1101(a)(6) of the Dodd-Frank Act restricts the Federal Reserve Board's former authority under section 13(3) of the Federal Reserve Act to make emergency loans to a failing institution. Dodd-Frank Act, Pub. L. No. 111-203, § 1101(a)(6), 124 Stat. 1376, 2113–15 (2010) (to be codified at 12 U.S.C. § 343). Under section 1101(a)(6), the FRB can no longer lend to a single firm, but it can make emergency loans "for the purpose of providing liquidity to the financial system, and not to aid a failing financial company." Id. Such lending must be incident to a "program or facility with broad-based eligibility." Id. Further, section 1101(a)(6) provides that such loans must be fully and adequately collateralized in a manner that "is sufficient to protect taxpayers from losses." Id. Neither Lehman nor AIG could have satisfied this standard. Finally, section 1101(a)(6) specifically denies the FRB the power to make loans to a "single and specific company" under its emergency lending authority or to make loans "for the purpose of assisting a single and specific company to avoid bankruptcy, resolution under title II of the Dodd-Frank" Act. In substance, this language means that the Federal Reserve's emergency lending authority cannot extend to a targeted bailout loan to a future Lehman, AIG or Bear Stearns.

In the case of the FDIC, which is permitted to lend to a "covered financial company" in receivership under section 204(d) of the Dodd-Frank Act, section 212(a) ("No Other Funding") bars the provision of funds by the FDIC to such companies outside of a Title II receivership. Id. §§ 204(d), 212(a) (to be codified at 12 U.S.C. §§ 5384, 5392). Although the FDIC can guarantee the obligations of a firm that is being liquidated (and there is no ceiling on its authority in this regard), it can do nothing for an individual firm that remains solvent. Possibly, the FDIC will continue to arrange mergers or "purchases and assumptions."

Administration might also be unwilling to liquidate a failing financial institution if its liquidation would be read politically as a failure of oversight on its part. Even among experienced practitioners, uncertainty surrounds what will actually happen the next time a major liquidity crisis erupts and a significant financial institution nears insolvency.[131] Possibly, the FDIC could liquidate the bank, but still spare its creditors by forming a "bridge company" whose debts would be assumed or guaranteed by it.[132] As a result, the market may still consider the creditors of large banks to be protected from failure, and hence the "too big to fail" subsidy may continue, even if to a reduced degree.

Rightly or wrongly, the Dodd-Frank Act seeks to cut off the possibility of central bank emergency funding for a bank in distress in order (in part) to end the idea that a bank can be "too big to fail." This reverses a policy followed by most central banks since at least the late 18th Century, when Walter Bagehot defined the role of the central banker as that of serving as the "lender of last resort."[133] Although a policy of ending emergency funding is at least a relevant response to the problem of the TBTF subsidy, it is a Draconian policy that represents a huge gamble.

Put simply, the core problem is that banks are inherently fragile. They (and

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[131] This author has had this conversation with a number of banking and securities law practitioners, including at conferences and symposia similar to this one. Most believe the Federal Reserve both could and would find ways to skirt statutory obstacles in a major crisis. Some of them emphasize that few would have standing to challenge unauthorized lending by the Federal Reserve. On the other side of this debate, it can be argued that the Federal Reserve has received intense criticism and "second guessing" from Congress since 2008, and has to fear that any evasion by it of Congress's restrictions on its lending authority could lead to loss of its autonomy. Hence, it is highly speculative as to whether and how far the Federal Reserve would dare to bend the law.

[132] The FDIC has this authority once it chooses to liquidate the financial institution. See Section 204(d) of the Dodd-Frank Act (discussed supra at note 130).

[133] See Walter Bagehot, LOMBARD STREET: DESCRIPTION OF THE MONEY MARKETS (1873).

similar financial institutions) are subject to a fundamental mismatch between the short-term character of their liabilities and the longer-term character of their assets.[134] Depositors expect and receive high liquidity, while borrowers expect to repay their loans over a longer, multiyear period. In good times, banks profit from this "maturity transformation", realizing the spread between the lower rate paid depositors and the higher rate charged borrowers. But, in bad times, banks have been classically subject to "runs" when depositor confidence is shaken.[135]

This mismatch is compounded by the practical necessity for a financial institution of using leverage. Arguably, only banks that employ high leverage can realize the full economies of scale that are inherent to the banking business. The more that a bank borrows and lends, the more that it can profit on its fixed costs.

Although investment banks are different from commercial banks in that they do not have depositors, they are equally subject to the same mismatch of short-term liabilities and long-term assets, because typically they finance their operations with short-term, often overnight borrowings in the "repo" market.[136] Thus, when the market suspects that a financial institution is subject to a risk of insolvency, short-term creditors

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[134] For an overview, see Richard A. Posner, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 128–30 (2009).

[135] For standard accounts of this mismatch, see generally Charles W. Calomiris & Joseph R. Mason, Fundamentals, Panics, and Bank Distress During the Depression, 93 Am. Econ. Rev. 1615 (2003); Douglas W. Diamond & Philip H. Dybvig, Bank Runs, Deposit Insurance, and Liquidity, 91 J. Pol. Econ. 401 (1983). For a concise summary of this literature as it applies to the 2008 crisis, see Gordon & Muller, supra note 127, at 7–13.

[136] The term "repo" refers to "security repurchase agreements," which usually involve highly liquid, investment grade securities that the borrower sells to the creditor at a slight discount but agrees to repurchase at the higher market price on a very short-term basis. If the borrower fails to repurchase, it suffers the loss of this discount. For discussion of the repo market and its destabilizing impact on the contemporary banking system, see Gary Gorton & Andrew Metrick, Regulating the Shadow Banking System BROOKINGS PAPERS ON ECONOMIC ACTIVITY 261 (Fall 2010) (available at http://ssrn.com/abstract=1676947).

may stage their own bank "run" by refusing to renew short-term credit lines or vastly increasing the interest rate. This functional equivalent to a "run" by depositors appears to have happened not only at Bear Stearns and Lehman, but across the banking system in 2008.[137] Yale Economics Professor Gary Gorton has argued that the 2008 panic was different from most panics in the nineteenth and early twentieth centuries in that it was a "wholesale" panic, not a "retail" panic, because the market suddenly learned that the banking system as a whole had become insolvent.[138]

This point about the "wholesale" character of the crisis explains why reforms such as private, industry-funded bailout funds are unlikely to prove adequate by themselves. Insurance can work to avert a crisis when a small percentage of the industry may fail, but not when a plurality may all fail contemporaneously because of risk correlation. A private insurance fund might be sufficient to bail out a Lehman (at most), but not the aggregate of Lehman, Citigroup, and Goldman, Sachs. To the extent that a systemic risk crisis is provoked by risk correlation, multiple contemporaneous failures become more likely that could dwarf such a fund. In 2009, much of the financial industry was threatened and the banking system effectively froze.[139]

The Dodd-Frank Act's decision to withdraw traditional emergency lending authority from the FRB and the FDIC for solvent banks facing only liquidity crises and its failure to adopt any FDIC-like, prefunded private insurance bailout fund, may prove in

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[137] Gary Gorton, SLAPPED IN THE FACE BY THE INVISIBLE HAND: THE PANIC OF 2007, at 4–5 (May 9, 2009) [hereinafter Gorton, Invisible Hand] available at http://ssrn.com/abstract=1401882.
[138] Id. at 37–38.
[139] See Victoria Ivashina & David Scharfstein, Bank Lending During the Financial Crisis of 2008, 97 J. Fin. Econ. 319 (2010) (available at http://ssrn.com/abstract=1297337 (finding new loans to large borrowers fell by 47% in the fourth quarter of 2008 in comparison to prior quarter, as banks cut back lending).

time to have been right or wrong, but they were certainly not the product of the "policy entrepreneurs" and activist investors that Professors Romano and Bainbridge accuse of "highjacking" reform legislation. Moreover, because these decisions were essentially negative ones that took authority away from (or did not extend authority to) financial regulators, they underscore the importance of the two affirmative steps that the Dodd-Frank Act did take: (1) It sought to reduce systemic risk at large financial institutions by adopting the Volcker Rule; (2) It authorized the FRB to adopt higher capital, liquidity and related prudential standards.

Thus, at the end of the day, the Dodd-Frank Act largely left everything up to the financial regulators, delegating them discretion but mandating relatively little. Such a strategy depends on whether effective implementation is possible in the current political environment, and there are substantial reasons to doubt that it is.

C. The Over-the-Counter ("OTC") Derivatives Market

The 2008 financial crisis crested when in rapid succession Lehman failed and AIG was bailed out. Lehman is the paradigm of the bank that arguably was "too big to fail," but AIG's story is more complex. It poses the problem of an opaque technology whose full impact was not clear. Potentially, AIG's failure could have sunk far more counterparties than Lehman ever conceivably threatened.

In response to the AIG episode, the Dodd-Frank Act sought to bring transparency to the OTC market by mandating the use of clearinghouses, exchange trading of OTC derivatives, and trade reporting. This effort was entirely rational and may yet be successful, but it is very much in doubt. Title VII of the Dodd-Frank Act establishes for the first time an integrated legal regime for the regulation of the derivatives market, assigning security-based swaps to the SEC and other swaps to the Commodities Futures Trading Commission ("CFTC").[140] Although this division perpetuates the U.S. long-standing preference for a multi-peaked regulatory structure, the two agencies seem to be operating in unison – at least for the time being. Both agencies are seeking to increase the standardization of swap agreements in order to facilitate their trading through a central clearinghouse. The key goal is to eliminate counterparty risk for dealers and investors by replacing the bilateral trading of OTC derivatives with trading through a centralized clearinghouse.

Yet inevitably, such a restructuring does not eliminate risk, but only shifts it. The new central clearinghouses will bear the counterparty risk, and the failure of any major clearinghouse could be an event that would trigger a major systemic risk crisis. Once again, systemic risk is being concentrated with the creation of another "TBTF" institution.

Because private mechanisms for dealing with counterparty risk clearly failed in 2008 (and indeed many financial institutions did not require major dealers, including AIG, to post collateral to secure their trades until the advent of the crisis), the case for use of clearinghouses is strong, but not without problems. Critics of the idea believe that clearinghouses are inherently exposed to failure. They argue that clearinghouses will be bureaucratic institutions less able or willing to assess risk positions in credit default swaps because they will not be as motivated by profit opportunities as individual

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[140] For overviews, see Jeremy Kress, Credit Default Swap Clearinghouses and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity, 48 Harv. J. on Legis. 56 (2011); Jonathan Urban, Regulation of Over-the-Counter Derivatives: The Ultimate Lesson of Regulatory Reform, 29 Rev. Banking & Fin. L. 52 (2010). See also SEC Release No. 34-63452 (Dec. 7. 2010) (proposing rules to be codified at 17 C.F.R. pt. 240).

dealers.[141] Others make a related argument: a meaningful reduction of counterparty risk in swap trading through multilateral netting of investment positions in a clearinghouse requires that the vast majority of the volume in swaps traded must clear through that clearinghouse.[142] In effect, to work, the clearinghouse must gain a near monopoly.

But here politics intervened. The Dodd-Frank Act contains an important exemption – known as the "end user exemption" – which exempts from its mandatory clearing requirement for swaps any counterparty who (1) is not a "financial entity," (2) uses the swap to hedge or mitigate commercial risk, and (3) notifies the appropriate regulatory agency (SEC or CFTC) as to how it generally meets its financial obligations associated with entering into such non-cleared swaps.[143] Politically, this was necessary to exempt major swap users who might have otherwise been able to block the legislation: for example, major airlines seeking to hedge the future cost of aviation fuel. Such "end users" did not wish to be subjected to the minimum capital and margin requirements that the Dodd-Frank Act imposed on swap dealers.[144] The consequence is that much of the volume in swaps will not be cleared and will escape margin requirements.

The SEC and the CFTC have proposed a joint rule to distinguish the commercial "end user" from more speculative financial investors in swaps.[145] Under it, much of swap trading will escape the collateral and capital rules that are intended to mitigate systemic risk. The two agencies cannot be faulted for obeying Congress, but politics has produced

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[141] See Craig Pirrong, The Clearinghouse Cure, Regulation Magazine (Vol. 31, No. 4) (Winter 2008-2009) at 48.

[142] See Darrell Duffie & Haoxiang Zhu, Does A Central Clearing Counterparty Reduce Counterparty Risk?, (Rock Center for Corporate Governance at Stanford Univ. Working Paper No. 46 _ 2011) (available at SSRN: http://ssrn.com/abstract=1348343 (April 2011)).

[143] See 7 U.S.C. § 2 (2010).

[144] See 15 U.S.C. § 8323 (2010).

[145] See SEC Release No. 34-63451 (Dec. 7, 2010).

a strange hybrid that could either reduce or exacerbate systemic risk. This vulnerability is compounded by a second difficulty: non-standardized swap contracts cannot be easily cleared. Worse yet, forcing complex derivatives into clearinghouses increases the operational risk for the clearinghouse because it will be required to clear products that it cannot easily price (and thereby set appropriate margins).[146] To the extent that clearinghouse members have a better more accurate understanding of these risks, they will possess asymmetric information and may be able to trade to their advantage and the clearinghouse's disadvantage.[147] Although swap dealers would have to share the costs of a clearinghouse failure, each has an incentive to trade against the clearinghouse in a way that in the aggregate increases the risk of systemic failure.

Part IV: The Implementation of the Dodd-Frank Act

The foregoing section has argued that the Dodd-Frank Act is a skeletal structure that has few affirmative commands but rather is heavily dependent on administrative implementation. As noted earlier, the financial industry's best opportunity to nullify costly regulation is often at the level of administrative implementation. Because (1) the administrative process is less visible and politically accountable, (2) some agencies (most notably the FRB) may be too closely aligned with the financial entities they are to regulate, or (3) the financial industry can both win concessions through negotiations and then challenge in court those regulations not otherwise watered down, the industry may win much at the implementation level that it could not achieve at the legislative level. In addition, the Regulatory Sine Curve concept discussed earlier suggests that regulatory

[146] See International Monetary Fund, GLOBAL FINANCIAL STABILITY REPORT: MEETING NEW CHALLENGES TO STABILITY AND BUILDING A SAFER SYSTEM, (April 2010) at p. 6.
[147] See Pirrong, supra note 141, at 46.

ardor wanes once the sense of emergency is lost.

Against that backdrop, this article will next survey the progress of the Dodd-Frank Act's implementation in three critical areas: (1) the attempt to curb excessive executive compensation; (2) the effort to end the "TBTF problem" by restricting risky activities that may cause bank failure; and (3) the effort to move OTC trading out of the shadows and into the sunlight of greater transparency. It is still premature to evaluate implementation with respect to the last two objectives, but a fuller assessment is possible of the effort to curb executive compensation.

A. Curbing Executive Compensation: The Road Not Taken. A major goal of the Dodd-Frank Act was to reduce the danger of moral hazard by better relating executive compensation to long-term performance. The Dodd-Frank Act approached this goal by two distinct means, both of which have now been largely frustrated. Each will be examined separately.

1. Proxy Access and Corporate Governance. As already noted, the Dodd-Frank Act instructed the SEC to use the standard inventory of corporate governance reform – proxy access, "say on pay," and a restriction on broker voting – to make corporate managers more accountable to shareholders. As discussed above, this may have been an ill-advised tactic (at least in the context of large financial institutions where excessive leverage needs to be discouraged). But vastly overshadowing the significance of the SEC's proxy access rule are the implications of the D.C. Circuit's decision in the Business Roundtable suit to invalidate that rule. The decision in Business Roundtable v. SEC[148] casts a substantial cloud over the SEC's ability to adopt other rules, even if not

[148] 647 F.3d 1144 (D.C. Cir. 2011).

related to corporate governance, in implementing the Dodd-Frank Act.

In adopting Rule 14a-11 (the proxy access rule), the Commission relied on Section 971 of Dodd-Frank Act, which authorized, but did not mandate, the Commission to adopt such a rule giving shareholders an alternative means by which to nominate and elect directors.[149] Because the Commission had discretion, it was subject to Section 3(f) of the Securities Exchange Act of 1934, which requires the Commission, when it determines if a rule is in the public interest, to "also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[150] On its face, this language has a relatively "soft" sound, mandating only consideration of these impacts, not that the Commission must determine that the interests of investor protection outweigh those of efficiency, competition and capital formation. Nonetheless, the D.C. Circuit has now several times invalidated SEC rules under this provision, finding that the Commission has a "statutory obligation to determine as best as it can the economic implications of the rule."[151]

In fact, the SEC did consider several economic studies on the likely impact of encouraging the election of dissident candidates and expressly noted the limitations of these studies. In their lawsuit, the Business Roundtable and the Chamber of Commerce asserted both that (1) "the Commission failed to appreciate the intensity with which issuers would oppose nominees and arbitrarily dismissed the probability that directors

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[149] The Commission proposed the proxy access rule in December, 2009 (See Securities Act Rel. No. 33-9086 ("Facilitating Shareholder Director Nominations") and adopted it in September, 2010. See Securities Act Rel. No. 33-9259, 75 Fed. Reg. 56, 668 (2010).

[150] See Section 3(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(f). Similar language also appears in the Investment Company Act.

[151] See Chamber of Commerce v. SEC, 412 F.3d 133, 142 (D.C. Cir. 2005). See also, American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166, 167-168 (D.C. Cir. 2010).

would conclude their fiduciary duties required them to support their own nominees,"[152] and (2) the Commission arbitrarily failed "to estimate the costs of solicitation and campaigning that companies would incur to oppose candidates nominated by shareholders. . . ."[153] Thus, a rule basically intended to tilt the balance of advantage in corporate board elections in favor of dissident shareholders was invalidated because the Commission did not (or could not) estimate the costs of the hostile corporate reaction to such efforts. By analogy, this is equivalent to invalidating an Environmental Protection Agency ("EPA") rule mandating that toxic wastes not be dumped into rivers and waterways because the EPA had not adequately estimated the costs to companies of alternative means of disposal.

Still, the relevant issue for this article is the decision's impact on future SEC attempts to adopt rules under the Dodd-Frank Act. The critics of SEC attempts to "federalize" corporate law by mandating corporate governance practices will celebrate the Business Roundtable decision because it seems to require the Commission to consider the empirical studies that they feel were disregarded in the enactment of SOX. Presumably, the D.C. Circuit would not attempt to hold Congress to this same standard, but to the extent that Congress enacts legislation giving the SEC any discretion as to the means to be used, the SEC's exercise of that discretion could be closely reviewed by the D.C. Circuit under the Section 3(f) standard.

This problem is not limited to SEC rules addressing corporate governance. Eventually, when the SEC adopts rules implementing the "Volcker Rule" (Section 619 of the Dodd-Frank Act) or mandating the use of clearinghouses or exchanges for the trading

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[152] 647 F.3d at 1149.
[153] Id. at 1150.

of security-based swaps, some interest group or individual financial institutions will feel aggrieved and sue. The outcome of such litigation cannot be predicted today, but it is sufficiently threatening that an overworked and underfunded SEC may compromise its rules, watering them down, to avoid the risk of another humiliating decision from the D.C. Circuit. Although Congress could legislate its own standards without delegating the matter to administrative agencies, that would imply abandoning the contemporary administrative state and reliance on administrative expertise. Not since the New Deal has the prospect of judicial challenge to legislative supremacy loomed as large on the horizon. To be sure, Congress could curb the D.C. Circuit's activism, but in the current polarized political environment such an effort seems unlikely.

2. Section 956. Congress did not rely exclusively (or even primarily) on corporate governance reforms to curb excessive executive compensation. Section 956 of the Dodd-Frank Act broadly authorized financial regulators to limit excessive compensation, but financial regulators have been equivocal in using the powers it conferred on them. Somewhat vaguely, Section 956 instructed a "covered financial institution" to disclose to its respective regulator "the structure of all incentive-based compensation" paid to officers, directors and employees in order to enable the regulator to prohibit excessive incentive-based compensation "that could lead to material financial loss to the covered financial institution."[154]

The issue was how broadly to construe this disclosure obligation. Although

[154] Section 956 of the Dodd-Frank Act has been codified at 12 U.S.C. § 564. Dodd-Frank does not require the disclosure of the actual compensation of any particular individual, but only the "structure of incentive compensation. The term "covered financial institution" is broadly defined to include depositary institutions, broker-dealers, and other financial institutions having more than $1 billion in assets.

Section 956 made clear that it was not requiring the disclosure of the individual executive's compensation,[155] regulators could have insisted on quantitative data about the aggregate incentive compensation paid by the firm and its distribution among employees and executives. What could such disclosure reveal that might be of material interest to investors? The following chart, taken from a study conducted by then New York Attorney General Andrew Cuomo of the incentive compensation received in 2008 by employees of the original TARP recipient financial institutions, shows the disclosures that could have been mandated under Section 956 (but were not):[156]

Selected TARP Recipients 2008 Bonus Compensation

Institution	Earnings / (Losses)	Bonus Pool	No. of Employees Receiving Bonus ≥ $3 million	No. of Employees Receiving Bonus ≥ $1 million
Bank of America	$4 billion	$3.3 billion	28	172
Citigroup, Inc.	$(27.7 billion)	$5.33 billion	124	738
Goldman, Sachs Group	$2.322 billion	$4.823 billion	212	953
J.P. Morgan Chase & Co.	$5.6 billion	$8.693 billion	≥ 200	1,626
Merrill Lynch	$(27.6 billion)	$3.6 billion	149	696
Morgan Stanley	$1,707 billion	$4.475 billion	101	428

As this chart makes clear, even when financial institutions lost billions, they still paid out bonuses totaling in the billions to hundreds of employees (see Citigroup and Merrill

[155] See Section 956(a)(2) of the Dodd-Frank Act ("Nothing in this section shall be construed to require the reporting of the actual compensation of particular individuals.")
[156] See Andrew Cuomo, NO RHYME OR REASON: The 'Heads I Win, Tails You Lose' Bank Bonus Culture at Appendix A (Report issued by New York Attorney General) (2009) (copy on file with Cornell Law Review).

Lynch in the above chart). When the firm did profit, the bonus pool was often a multiple of earnings (see Goldman, J.P. Morgan, and Morgan Stanley's in the above chart). Moreover, practices varied, thus making firm-specific disclosure more important. Reading the Cuomo data more closely, one finds the following number of employees receiving over $10 million in bonus compensation in 2008 at these firms: Merrill Lynch (14); Morgan Stanley (10); J.P. Morgan Chase & Co. (10); Goldman Sachs (6); Bank of America (4); Citigroup (3).[157] In sum, the Cuomo data underscores three conclusions: (1) the bonus culture persisted even in bad times; (2) bonus payments to executives often exceeded distributions to shareholders; and (3) some individuals received extraordinary incentive compensation that logically could cause a moral hazard problem.

Revealing as this information may be, disclosure pursuant to Section 956 will not yield anything remotely equivalent. This is because the major financial regulators have read Section 956 narrowly. The first interpretive problem posed by Section 956's broad language involved identifying those persons whose behavior could inflict "material financial loss" on their institutions. Only incentive compensation to such persons was subject to regulation. Obviously, the bank's janitor cannot ordinarily inflict a "material financial loss," but the history of broker-dealer firms suggest that traders often can (as happened in recent memory at both Barings and Societe Generale).

The principal financial regulators responded in unison to this challenge in April, 2011 with a joint set of rules that each adopted.[158] In the case of "covered financial institutions" (meaning basically any financial institution with total consolidated assets of

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[157] Id. at pp. 6-11.

[158] See SEC Release No. 34-64140 (April 14, 2011) ("Incentive-Based Compensation Arrangements") (to be codified at 17 C.F.R. pt. 248). Similar releases were contemporaneously proposed by the Treasury, the FRB, the FDIC, and other agencies.

$1 billion or more), these rules require an annual report that "describes the structure of the covered financial institution's incentive based compensation arrangements . . . that is sufficient to allow an assessment of whether the structure or features of those arrangements provide or are likely to provide covered persons with excessive compensation, fees, or benefits to covered persons or could lead to material financial loss to the covered financial institution."[159] This is rather general and abstract language, and no specific data was required. For example, regulators might have followed Andrew Cuomo's lead and required disclosure of the number of employees at a firm who received bonuses of over $1 million in the prior year (even if none were identified by name). Instead, the new rules do not require disclosure of quantitative data, but only a generalized narrative description. This seems likely to produce long-winded boilerplate from securities lawyers adept at covering the waterfront in opaque prose.

In the case of financial institutions with over $50 billion in total consolidated assets (i.e., the TBTF category), more was required by these regulations. Such institutions must provide a description of "incentive-based compensation policies and procedures" for two categories of persons: (1) executive officers, and (2) such "other covered persons who the board of directors, or a committee thereof, of the covered financial institution has identified and determined . . . individually have the ability to expose the covered financial institution to possible losses that are substantial in relation to the covered institution's size, capital or overall risk tolerance."[160] Again, this stops well short of revealing the full depth of the bonus culture at a firm, because many (potentially hundreds of employees) could receive incentive compensation in the million dollar range and yet be exempted

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[159] See Proposed Section 248.204(a) of Regulation S-P (to be codified at 17 C.F.R. 248.204(a)).
[160] Id. at Section 248.204(c)(3).

from disclosure because the board did not believe they could cause a "substantial loss" to the firm.

In short, only in the case of TBTF institutions do the rules require any specific disclosure or serious assessment of who could actually cause a substantial loss to the financial institution, but, even in these cases, the regulations still delegate to each covered financial institution the determination of who (beyond its executive officers) could expose it to such a "substantial loss." This delegation is significant because only the covered persons so identified (and executive officers) become subject to additional substantive requirements. In the case of the executive officers of these TBTF institutions, the proposed rules require deferral of at least 50% of the annual incentive-based compensation awarded for a period of not less than three years.[161] That may or may not be adequate, but the real surprise in these regulations is that, in the case of those persons specifically identified by the TBTF institution's board as being capable of exposing the institution to "substantial loss," no deferral was required. Instead, all that was mandated was that the board or committee must approve the incentive-based compensation arrangements for such persons and further determine "that the arrangement . . . effectively balances the financial rewards to the covered person and the range and time horizon of risks associated with the covered persons activities, employing appropriate methods for ensuring risk sensitivity, such as deferral of payments . . ."[162] In short, the only requirement for even those persons identified by the firm as being capable of causing it "substantial losses" is that the board or committee think seriously about

[161] Section 248.205(b)(3) ("Prohibitions") requires such a 50% deferral for "executive officers" (as defined) of "covered financial institutions" with assets in excess of $50 billion, but does not apply to other persons.
[162] See proposed Section 248.205(b)(3)(ii)(c).

deferral or some other means of ensuring “risk sensitivity.”

The proposed rules thus fall breathtakingly short of adequacy on two major grounds: (1) they wholly delegate to the firm the decision of who could cause it “substantial loss,” and (2) even with respect to the persons so identified, the rules require only process and no minimum deferral.

Why have financial regulators, in common, pulled their punches by (1) requiring little specific data, (2) allowing the firms to alone decide who (besides executive officers) can cause them significant loss, and (3) not even requiring some deferral of bonuses by the persons so identified? The most plausible answer is that regulators knew that a more effective rule might provoke significant employee defections, as “star” traders (and others) moved from investment banks to less regulated trading firms. Realistically, the non-executive officer most likely to be able to cause a substantial loss to a “covered financial institution” is a trader who is authorized to trade on a large position basis. Such traders have in recent memory caused staggering losses to some financial institutions (remember Nicholas Leeson at Barings and Jerome Kervais at Societe Generale).[163]

Although it is likely that most covered firms will report some employees who can cause it substantial losses, the number so reported will be likely far below the number that would be disclosed if more objective criteria were used. Underreporting the number of such persons has several attractions: (1) it makes the firm appear safer in general; (2) it spares the board (or committee) the obligation to engage in additional specific assessments of whether adequate risk sensitivity has been structured into each such person’s incentive compensation; and (3) it ensures that the persons who otherwise would

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[163] Nicholas Leeson’s unauthorized trades caused the failure of Barings in 1995, and Jerome Kervais racked up losses in excess of 4.2 billion pounds at Societe Generale in 2008.

be identified as being capable of causing “substantial loss” to the firm will not be restricted in their compensation by the appropriate regulatory agency. That is, despite the board or committee’s findings, the relevant regulator might still determine that there was inadequate risk sensitivity and thus that the compensation was excessive. However, if the “star” personnel are never so identified, this problem simply does not arise.

To summarize, the problem for the TBTF financial institution was that if highly compensated “stars” were subjected to the same deferral of incentive compensation as are executive officers, they might flee “covered financial institutions” to relocate at hedge funds, smaller banks, or go abroad to escape such controls. Fearing such migration, financial institutions probably lobbied for a weaker rule (and appear to have succeeded). Still, the irony is that few vice presidents at a financial institution can cause the same injury to it as can a star trader (such as such celebrated rogue traders as Jerome Kervais or Nicholas Leeson).[164] The choice for financial regulators was between an effective rule and some competitive injury to the TBTF banks. The latter consideration appears to have dominated, and that pattern may recur regularly as the implementation of the Dodd-Frank Act continues.

Executive compensation was the leading topic on which Congress (pushed by taxpayers) showed real anger. Still, once the negotiations moved from Congress to the regulatory agencies, that anger dissipated or at least yielded to concerns about employee defections and competitive injury. That could happen even more easily in other areas where the public anger was less intense.

[164] To illustrate this irony, the general counsel of a TBTF institution is typically an executive officer and thus subject to a 50% deferral. But the star trader who weekly bets billions of dollars in volatile markets is not subject to any similar deferral. This disparity cannot be easily justified.

B. The TBTF Problem. In the Dodd-Frank Act, Congress sought to address the TBTF bank in several ways: (1) providing for "resolution authority" to quickly liquidate a failed bank without the interminable process of a bankruptcy proceeding;[165] (2) reducing the risk level of banks, including by means of the Volcker Rule;[166] and (3) authorizing stricter prudential standards, including the use of a contingent capital standard.[167] As we have earlier seen with respect to SOX's prohibition of executive loans and, most recently, the Dodd-Frank Act's equivocal executive compensation rules, even clear Congressional statements can be enervated through administrative interpretation and underenforcement. Yet, in the case of the Dodd-Frank Act's approach to TBTF institutions, the legislation never articulated clear standards to begin with, and equivocal implementation will likely weaken these standards further.

1. Resolution Authority. The fact that financial regulators, acting in virtual unison, can liquidate a TBTF institution before it becomes legally insolvent does not mean that they will actually do so. Such action would imply a black eye for almost any Administration, suggesting that it had been a poor financial watchdog. Regulators might also fear that such action would trigger a financial panic. The temptation for regulators is thus "to kick the can down the road," hoping for the best and seeing little advantage in early intervention. Moreover, as the financial industry has grown more concentrated in the wake of the 2008 failures and consequent mergers, the remaining TBTF banks are even larger. Thus, any failure of one of them would be more serious. For all these reasons, the TBTF banks have increased incentives to maintain large lobbying cadres in

[165] See Dodd-Frank Act, Title II, Section 201-217 (codified at 12 U.S.C. §§ 5381-5394).
[166] See Section 619 of the Dodd-Frank Act.
[167] See Sections 112(a)(2), 115(b), and 165(b) of the Dodd-Frank Act (to be codified at 12 U.S.C. §§ 5322, 5325, and 5365, respectively).

Washington to protect their interests from adverse actions (which could never occur quickly in any event, because it would require high coordination and unanimity among regulators).

Still, suppose a TBTF bank does fail? At this point, the FDIC may be able to provide financing to a bridge company that acquires most of its assets. It could either decide to bail out the bondholders or to let them share in the pain in order to end the TBTF subsidy. The highly discretionary character of this choice suggests it too will invite heavy lobbying. In turn, the more that bondholders are in fact paid off from an FDIC fund (and the FDIC can borrow from the FRB for this purpose), the more that the TBTF subsidy survives. Ultimately, one cannot predict what will happen in any specific case, but the greater the fear of a financial panic, the more financial regulators are likely to want to cause bondholders to be paid in full to avert panic. Little may change, and the TBTF subsidy may persist.

2. The Volcker Rule. The Volcker Rule is a coherent response to the TBTF problem: that is, if banks are too big to fail, they must be regulated so that their risk-taking is constrained in order that they do not fail. But the Volcker Rule faces political problems. First, there is almost no evidence that proprietary trading was responsible for the failure (or near failure) of any financial institution in the 2008 crisis. In contrast, firms like Lehman failed because of their principal investments: Lehman made disastrous acquisitions of major real estate lenders and developers (including SunCal and Archstone), but those acquisitions, which made it undiversified and overleveraged, fell well outside the definition of proprietary trading in the Dodd-Frank Act. In this respect, the Volcker Rule is seriously underinclusive because it exempts principal investments

from its ban, despite the Lehman experience.

Second, Section 619 of the Dodd-Frank Act, which expresses the Volcker Rule, contains numerous loopholes and exceptions.[168] Chief among these are exceptions for hedging and market making by the covered financial institution. The financial regulators have recently released their proposed draft of the Volcker Rule.[169] On a preliminary review, it seems potentially tougher and more restrictive than many had expected. Still, the start of the process is not the end of the process, and opposition to it is mounting.[170] Always opportunistic, the financial services industry has seized on the crisis in European sovereign debt to warn that the Volcker Rule's implementation will curtail the demand for European sovereign debt and aggravate that crisis.[171] Here again, the experience with SOX may be repeated, with the proposed rules on proprietary trading being watered down.

3. Contingent Capital. One of the most original ideas proposed to avert TBTF debacles is a requirement that some portion of the financial institution's debt securities be required, in the original bond contract, to convert into an equity security if the financial

[168] See Section 619(d)(1). These include: (1) underwriting and market-making related activities, (2) risk-mitigating hedging activities; (3) investments driven by customer demand; (4) proprietary trading done outside the United States, and (5) such other activities as regulators determine by rule would promote safety and soundness of the banking system.
[169] On October 12, 2011, the SEC voted to propose a version of the Volcker Rule that was drafted in common with other financial regulators. See http://www.sec.gov/news/press/2011/ 2011-204.htm. A proposed release has not yet been issued, but a final rule must be adopted in 2012.
[170] See James Stewart, "Volcker Rule: Once Simple, Now Boggles," the N.Y. Times, October 22, 2011 at B-1, see also Editorial, "So Much for the Volcker Rule," The Wall Street Journal, October 24, 2011 at A-13 (noting that the 298 page proposed rule contains some "1,347 queries" that must be considered before a final rule is adopted).
[171] See Brooke Masters and David Oakley, "Bankers in Eurozone Warning," The Financial Times, November 22, 2011 at p. 15. See also text and note infra at note 188 (two partners at Davis Polk predict that proposed regulation implementing Volcker Rule will be withdrawn).

institution begins to approach insolvency.[172] Although the original idea was to convert the debt to equity on the doorsteps of insolvency, much more can be done with this flexible idea. Uniquely, it provides an ex ante tool. As the stock price of the institution declines, debt could convert at several stages on an incremental basis into an equity security, thereby diluting the equity and punishing the stockholders for their pursuit of higher leverage and risk-taking. Used this way, the tool has a prospective deterrent power. This author has proposed conversion of the debt into a voting preferred stock, whose holders would have incentives naturally aligned with other debt holders and adverse to the common stockholders.[173] The goal is again to create a counterbalancing constituency that would resist shareholder pressure.

Other innovative designs are possible, but the likelihood is high that the Federal Reserve will ignore all these possibilities. Instead, it will likely propose that contingent capital be used only as a form of prepackaged bankruptcy. If insolvency has become inevitable, even the financial industry recognizes that it would be quicker and simpler to convert much of the debt into equity than utilize the cumbersome procedures of resolution authority. The banking community would probably also prefer such a modest use of contingent capital because it reduces the uncertainty incident to a liquidation and avoids the mandatory ouster of responsible management that is required under "resolution authority."

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[172] While this technique for averting bankruptcy can be traced back for a considerable period, the author most responsible for its consideration in the context of a TBTF institution is Professor Mark J. Flannery. See Mark J. Flannery, "No Pain, No Gain? Effecting Market Discipline Via Reverse Convertible Debentures" in CAPITAL ADEQUACY BEYOND BASEL: Banking, Securities and Insurance 171 (Hal Scott ed., 2005). See also Coffee, supra note 126, (reviewing possible designs for the use of contingent capital).

[173] See Coffee, supra note 126, at 805-807, 828-834.

Still, such a minimal use of contingent capital is myopic. It surrenders the possibility of ex ante measures that could precede and avert insolvency. But if anything can be safely predicted, it is that the Federal Reserve is too closely imbedded within the banking community to propose any intrusive remedy that would be invoked well before a banking crisis has begun.

C. The Legislative Counterattack. As of early 2012, legislation is pending that would severely curtail many of the corporate governance provisions of the Dodd-Frank Act.[174] Essentially, the legislation would create a new category of issuer called an "emerging growth company," which would be exempt from many of the provisions of the proxy rules, including the Dodd-Frank Act's provisions as "say on pay" and related compensation disclosures, as well as Section 404(b) of SOX.[175] The term "emerging growth company" is broadly defined to include any issuer that has annual gross revenues of less than $1 billion and that has a public float of less than $700 million.[176] The

[174] The most relevant bill (and there are several) is the "Reopening American Capital Markets to Emerging Growth Companies," which is H.R. 3606 in the House and S.1933 in the Senate. For a brief description of this legislation, see "IPO 'On-Ramp'; Initial Public Offerings," Mondaq Business Briefing, December 27, 2011.

[175] S.1933 and H.R. 3606 would each amend Section 2(a) of the Securities Act of 1933 and Section 3(a) of the Securities Exchange Act of 1934 to define the term "emerging growth company." So long as currently private companies remained "emerging growth companies," these issuers would be exempt from Section 14A ("Shareholder Approval of Executive Compensation"), which mandates a shareholder advisory vote on executive compensation not less frequently than once every three years. Disclosure of the median of the annual total compensation of all employees, which was mandated by Section 953(b)(1) of the Dodd-Frank Act, would also be waived for "emerging growth companies" (as would compliance with Section 404(b) of SOX).

[176] S.1933 and H.R.3606 require both that the issuer have less than $1 billion in gross revenues for its last fiscal year and that the issuer not have common stock held by non-affiliates with a market value of $700 million or more. This market value standard, known as the "public float," was adopted by the SEC to define a "Well-Known Seasoned Issuer," which is entitled to use automatic shelf registration. See Rule 405, 17 C.F.R. 230.405. Thus, companies with a relatively large public ownership would still qualify as "emerging growth companies" and escape the Dodd-Frank Act's corporate governance provisions.

rationale for this broad exemption is that it would spur job creation by encouraging smaller companies to conduct initial public offerings. This rationale is doubtful, because the decline in IPOs, while real, dates back at least to the burst of the Internet IPO bubble in 2001 and thus could hardly have been caused by either the Dodd-Frank Act or SOX's Section 404. Many other factors better explain the decline in IPOs than any increase in regulatory costs after 2001.[177]

Still, such proposals chiefly demonstrate the continuing impact of the Regulatory Sine Curve. In 2011, financial industry representatives formed an industry study group, which called itself the "IPO Task Force," and it quickly prepared a report attributing the decline in IPOs to regulatory and market structure changes.[178] Entirely ignored by this

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[177] No dispute exists that the number of IPOs declined significantly after 2000. This number appears to have peaked at 791 IPOs in 1996 and then fallen to an average of 157 IPOs from 2001 to 2008, with a low of 45 in the financial crisis year of 2008. See IPO Task Force, Rebuilding the IPO On-Ramp, Presented to the U.S. Treasury (Oct. 20, 2011) (hereinafter, "IPO Task Force Report"). But what caused this decline? Industry groups cite costly regulation, but the impact of SOX's Section 404(b) was not felt until 2004 when Accounting Standard No. 2 was adopted by the PCAOB (see text and note supra at note 61), and the Dodd-Frank Act's rules have still not become effective. Thus, the legal environment of the 1990s, when IPOs peaked, was similar to that in the post-2000 decade, when they declined. Better explanations involve: (1) the loss of investor confidence in IPOs after the Internet bubble burst in 2000 and severe conflicts of interest involving securities analysts were exposed by Eliot Spitzer and others; (2) the "de-retailization of the market," as individual investors have left the market and institutional investors are less dependent on sell-side analysts; (3) the loss of interest by institutional investors in smaller IPOs, which cannot provide them with sufficient market depth to assure liquidity; and (4) the high fixed costs of smaller IPOs, which make it more cost efficient for smaller companies to raise capital in the private placement market. For a discussion of some of these explanations, see Testimony of John Coates, Professor of Law and Economics, Harvard Law School, Senate Banking, Housing and Urban Affairs Subcommittee on Securities, Insurance, and Investment, Hearing on "Examining Investor Risks in Capital Raising," December 14, 2011 (available on LEXIS).

[178] See IPO Task Force Report. For a more affirmative discussion of this report by its chairman, see Testimony of Kate Mitchell before House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises Hearing on "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" on December 15, 2011 (available on LEXIS). Her testimony does not focus on any of the provisions in the Dodd-Frank Act as a

report was the likely loss in investor confidence following the burst of the Internet stock bubble. The IPO Task Force proposed to remedy the decline in IPOs by dismantling many of the regulatory changes that were adopted following the 2001 market crash.[179]

Time and again, this is the key move: to blame economic stagnation and job loss, not on a crash or a bubble, but on the regulation that follows it. The legislation proposed by the IPO Task Force has broad bipartisan support and is one of several deregulatory proposals that seem likely to pass Congress as part of a job creation program.[180] Although it will likely accomplish little in terms of reversing the decline in initial public offerings, this legislation will ease constraints imposed on the financial services industry. Above all, this episode shows again that, once a crisis has passed, Congress can easily be persuaded

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significant barrier to an IPO, but does identify SOX's Section 404(b) as the most costly barrier to becoming a public company. Still, if so, this diagnosis hardly leads to a prescription of rolling back the Dodd-Frank Act.

[179] In particular, the IPO Task Force Report would override the existing rules of FINRA and permit securities analysts associated with an underwriter who is participating in the offering to issue reports on the issuer at the time of the offering. Today, FINRA Rule 2711 precludes a managing underwriter from distributing a research report about an issuer client until 40 days after the registration statement becomes effective (and other underwriters in the offering are similarly precluded for 25 days). This was a rule adopted by an industry self-regulatory body, not Congress, and these rules were adopted in response to the 2000-2002 controversy involving Internet securities analysts, most notably Henry Blodgett and Jack Grubman, who became iconic examples of conflicted securities analysts as a result of enforcement actions undertaken by then New York Attorney General Eliot Spitzer. Nonetheless, the IPO Task Force displays a collective amnesia about these conflicts, and Congress appears unable to resist the seductive argument that deregulation means job creation.

[180] A number of bills are pending and seem likely to pass in 2012 that would enable smaller companies to avoid either or both of the registration requirements of the Securities Act of 1933 or the reporting requirements of the Securities Exchange Act of 1934. For detailed reviews of them, see Coates, supra note 177 and Testimony of John C. Coffee, Jr., Adolf A Berle Professor of Law, Columbia University Law School, Before the Senate Committee on Banking, Housing, and Urban Affairs, on "Spurring Job Growth Through Capital Formation While Protecting Investors," December, 2011. It is not the contention of this article that these bills undermine the federal securities laws, but only that they show a recurrent pattern of thinking that considers only the costs of regulation and not the cost of crashes and bubbles. Absent restored investor confidence or major technological breakthroughs, there is little prospect of an upsurge in the number of IPOs.

to repeal legislation that it passed in response to the crisis. This does not prove that the original legislation was flawed, but only that Congress can be manipulated and, absent some countervailing force, has a limited attention span and will sometimes accept makeweight arguments. To be sure, in a national crisis, countervailing forces sometimes arise, but they do not remain organized and vigilant indefinitely – hence, the regulatory sine curve persists.

CONCLUSION

The key and recurring debate over financial reform is between those who distrust both legislation and regulation (a position that the Tea Party Caucus exemplifies) and those who believe strong regulation is necessary to restrain systemic risk. In this debate, the standard move of those who distrust regulation is to attribute economic stagnation and job loss to costly regulation, ignoring that the costs of market bubbles and crashes dwarf those of regulation. Their ability to do this (and frankly with some success) is evidence of a collective social amnesia that appears to overtake Congress and others, as soon as the crisis fades from the headlines. This recurrent amnesia is in turn the product of what this article has termed the Regulatory Sine Curve – a cycle that is driven by the differential in resources, organization, and lobbying capacity that favors those interests determined to resist further regulation.[181]

Without doubt, some regulation is foolish and overbroad, but the point emphasized by this article is that such overbroad regulation is usually repealed or

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[181] This disparity will only grow in the wake of Citizens United v. FEC, 558 U.S. _, 130 S. Ct. 876 (2010) (First Amendment protects independent expenditures in support of a political candidate from governmental regulation limiting such contributions). For the finding that corporate political and lobbying expenditures are increasing in the wake of this decision, see John C. Coates IV, Corporate Politics, Governance and Value Before and After Citizens United, (http://ssrn.com/abstract=1975421) (December 22, 2011).

curtailed relatively quickly (and without the need for mandatory sunsets). The greater danger is that the forces of inertia will veto or block all change. The pervasive underregulation of "shadow banking," which has continued for decades, appears to have been a leading cause of the 2008 financial debacle and the current economic stagnation. Failing meaningful implementation of the Dodd-Frank Act, financial executives may once again race like lemmings over the financial cliffs by taking on leverage that they cannot sustain. One cannot pretend to predict when this will occur, but driving this process will be the same perverse incentives: basically, short-term executive compensation and market pressure for higher leverage and greater risk-taking. These root causes will again be aided and abetted by equivocal regulation and bounded rationality.

In short, history repeats itself, particularly when it is ignored. In truth, the Dodd-Frank Act potentially faces even greater downsizing than SOX has experienced. This is because its effective implementation requires greater regulatory encroachment into the core business decisions of financial institutions over their capital adequacy, leverage, and compensation. Thus, the Dodd-Frank Act seems destined to be resisted even more aggressively than SOX was. If, however, the Dodd-Frank Act is similarly neutralized by a combination of equivocal rule-making and legal challenges, the consequences may be far more ominous. Systemic risk poses a far greater threat to both the United States and the world's economy than did the corporate governance failures and accounting irregularities to which SOX responded.

It is not the contention of this article that sustained reform is impossible or that, in response to a crisis, regulatory agencies are only capable of "rearranging the deck chairs on the Titanic." That would overstate. Indeed, political entrepreneurs who unite and sustain a political coalition of investors and enable them to resist better-funded special interest groups would be the heroes of this story – if only such actors were more visible.[182] In the absence of such leaders, the first and reflexive response of many regulatory agencies after a crash is simply to move the deck chairs around in a sufficiently noisy fashion to show that they are on the job. Some evidence suggests that is again happening.[183] Beyond this lack of imagination and political nerve, the greater problem is that financial regulators are often so closely intertwined with those that they regulate that they respond in an equivocal and even timid fashion.[184] The recent and joint rules on executive compensation adopted by the principal federal financial regulators exemplify this problem because the limited reach of these rules seems motivated more by a desire to protect the industry from competition than to control moral hazard.

What could be done to compensate for the predictable tendency toward rapid erosion of reform legislation? Arguably, one could advocate the use of stronger prophylactic rules in the original reform legislation with less delegation to administrative

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[182] As earlier suggested (see supra at note 8), Eliot Spitzer and Andrew Cuomo have at times played the "public entrepreneur" role, but the SEC has been far more cautious and bureaucratic.

[183] An excellent example is the SEC's latest release containing proposed rules for credit rating agencies. See SEC Release No. 34-64514 ("Proposed Rules for Nationally Recognized Statistical Rating Organizations") (May 18, 2011). The release contains voluminous rules governing the training and supervision of credit rating agency employees, but never recognizes that the underlying problem was not their lack of competence, but conflicts of interest and the pressure on them. See Coffee, Ratings Reform: The Good, the Bad, and the Ugly, 1 Harv. Bus. L. Rev. 231 (2011).

[184] This may be because of the "revolving door" phenomenon, risk aversion about the political or reputational consequences of a litigation defeat, or budgetary constraints that limit the agency's ability to engage in aggressive enforcement. No attempt is here made to disentangle the various causes. Finally, fear of judicial reversal may also cause the regulator to trim its sails and propose only equivocal rules.

agencies.[185] Such a proposal would be the polar opposite of Professor Romano's mandatory sunset rule. Although such a shift would be logical, this article still stops short of making any across-the-board such recommendation because it would entail undesirable rigidity. A second best substitute may be to use market-based reforms that use objective market tests and thus depend less on administrative implementation.[186] While disclosure is always a useful remedy, it needs to be refocused. Hopefully, the financial press might be persuaded to focus more on weak or equivocal administrative implementation. Some courts may also embarrass the SEC into stronger enforcement action.[187] It is premature, however, to evaluate these options until the implementation of the Dodd-Frank Act is further along.

"Capture" is an overused and underdefined term. This article does not assert that financial regulators have been captured, but does conclude that they are far better at prosecuting outliers and crooks than in controlling reckless ambition by those at the top of the corporate hierarchy. To be sure, some desirable reforms will emerge from the Dodd-Frank Act that will reduce the risk (marginally at least) of another systemic risk crisis for the immediate future. Predictably, capital adequacy standards will be raised and leverage ratios marginally restricted at TBTF institutions. But the pursuit of higher leverage has not yet been checked. The acid test for meaningful reform is likely to lie in

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[185] The Securities Exchange Act does contain several such prophylactic rules. For example, Section 16(b) of that Act broadly prohibits "short swing" trading without any need to prove scienter or the possession of material information. See 15 U.S.C. § 78p. The Public Utility Company Act of 1935's infamous "death sentence" for holding companies would be another example. See supra note 17.

[186] For such a proposal, see Coffee, supra note 126.

[187] See text and note supra at note 93 (discussing Judge Rakoff's refusal to accept proposed SEC settlements).

the outcomes in three areas: (1) the implementation of the Volcker Rule,[188] (2) the fate of the Dodd-Frank Act's preference for trading OTC derivatives through exchanges and clearinghouses, and (3) the strength of the capital adequacy rules for TBTF banks.[189] In each case, the exceptions may overwhelm the rule.

Across all the financial regulatory agencies, the deep seated preference is to depend upon bureaucratic oversight and monitoring in preference to more prophylactic rules. But, as prior market crashes have shown, the same cognitive limitations that blind market participants also cloud the vision of regulators. More objective, market-based tests are possible and desirable,[190] but they have no constituency supporting them. As a result, the same regulators who missed the Long-Term Capital Management crisis in 1998, the IPO Bubble in 2000, the Enron and WorldCom failures in 2001-2002, the market timing scandal in mutual funds in 2004, Bernie Madoff in 2008 and the Lehman and AIG collapses in 2008 seem likely in time to do it again. Bounded rationality compounded by the Regulatory Sine Curve implies that eventually we will face another systemic risk crisis.

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[188] Two experienced partners at Davis, Polk (one a former SEC Commissioner) have recently predicted that financial regulators will be forced to withdraw their 298 page proposal to implement the Volcker Rule and in effect start over by reproposing it. See Annette L. Nazareth and Gabriel D. Rosenberg, "Comment: 12 regulatory reform predictions for '12," Financial Times, December 23, 2011. If this happens, a significantly weaker rule will likely follow.

[189] The Federal Reserve has announced enhanced capital adequacy rules, but not more stringent than those that would be required by Basel III. The New York Times described the proposal as "a small victory for banks." See Edward Wyatt, "Fed Unveils Plan to Limit Chance of a Banking Crisis," New York Times, December 21, 2011 at B-1.

[190] For a discussion of possible market-based tests to supplement regulatory oversight, see Coffee, supra note 126, at 828-846.