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**SYMPOSIUM:
NEW PARADIGMS FOR FINANCIAL REGULATION IN THE
UNITED STATES AND THE EUROPEAN UNION**

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FINANCIAL REGULATION REFORM: MAINTAINING THE STATUS QUO

*James A. Fanto**

INTRODUCTION

We have been living through one of the worst financial and economic crises since the Great Depression. Several storied financial institutions collapsed or disappeared through mergers, in the space of weeks. Major banking conglomerates Citigroup and Bank of America, and the largest insurance conglomerate, American International Group, remain in trouble and have been propped up by massive government aid. The federal government had also to assume control of the government sponsored entities, Fannie Mae and Freddie Mac, which are financial institutions that fund home mortgages. In the crisis, financial firms essentially stopped financing consumer and commercial activities because of concern over their own solvency and that of their counterparties; this situation of systemic risk in turn led to a severe economic downturn. When the financial system and the economy stopped functioning, the federal government provided emergency capital to financial firms and instituted programs to take troubled assets off of their books, and additionally instituted a stimulus to kick-start the economy.

The initial and emergency government legislation was spearheaded by the Bush Administration and was then continued by the Obama Administration.¹ However, amid the financial and economic chaos, there were

* Professor of Law, Brooklyn Law School. © All Rights Reserved. I would like to thank the participants in the two conferences where this Article was presented for their comments on it: Brooklyn Law School Dennis J. Block Center for the Study of International Business Law Symposium, New Paradigms for Financial Regulation in the United States and the European Union (2009); Centre for Commercial Law Studies, Queen Mary School of Law, University of London (2009).

1. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008) (“EESA”). EESA established the Troubled Asset Relief Program (“TARP”) that gives the U.S. Treasury the authority to purchase or guarantee up to \$700 billion in troubled assets held by financial institutions. Under the authority of EESA, the Treasury established the Capital Purchase Program, which allowed it to provide direct capital support to financial institutions. When the Obama Administration took over in 2009, it continued the approach of shoring up the capital positions of major financial conglomerates. Moreover, the Treasury instituted the “Financial Stability Plan” to put financial institutions and the financial system back on a sound footing. See *U.S. Dep’t of the Treasury*, <http://www.financialstability.gov> (last visited Apr. 1, 2010) (describing the plan’s projects). This plan included a program of continuing to provide capital to financial institutions (now renamed the “Capital Assistance Program”) and to “stress test” the largest, most systematically important financial institutions to ensure that they had enough resources to weather the crisis. For the stimulus legislation that the Obama Ad-

clearly problems in financial institutions and with financial regulation that had contributed to the massive crisis; these would take considerable time and thought to address. After over nine months in office, the Obama Administration finally proposed a reform plan for the financial system (the "Plan"), the implementing legislation of which is working its way through Congress.² I contend that, in its initial outline, the Plan let pass a unique opportunity to address the failings of finance and financial institutions that contributed to the current crisis and that will generate future financial cataclysms. The Plan does this by maintaining the existence, and emphasizing the importance, of the large diversified financial conglomerates that are engaged in an array of financial activities and that typify modern finance. At most, it extends regulation to the "shadow banking system," i.e., the financial institutions, like hedge fund groups, that are the unregulated counterparts to the financial conglomerates. The obvious question is why the Plan does not propose significant reform of the financial conglomerate itself. Like others, I believe that this administration, just as other administrations before it, has been "captured" by finance in a complex, ideological way.³ However, as Congress has been debating and revising the legislation implementing the Plan, the Administration and financial regulators have adopted a more critical stance towards the financial conglomerates. This may suggest that fissures are beginning to form in the dominant ideological straightjacket concerning finance and financial conglomerates that has constrained the views of senior policy-makers in recent years.

The Article proceeds as follows. Part I briefly outlines the story of the triumph of finance over the last three decades, which has been accepted by senior policy-makers and regulators, and the creation and dominance of the large financial conglomerates. It then contrasts this story with an alternative account of the harms caused by finance and the conglomerates. Part II explains how several proposals in the Plan—its enhancement of the power of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), its reform of risk management, and the establishment of a consumer financial protection agency—reinforce the dominance of financial conglomerates in our financial system and the significant risks that such dominance poses to the system and the econo-

ministration proposed and saw enacted, which included regulation of compensation in financial firms receiving government aid, see American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009) ("ARRA").

2. See DEP'T OF THE TREASURY, A NEW FOUNDATION: REBUILDING FIN. SUPERVISION AND REG. (2009) [hereinafter A NEW FOUNDATION].

3. See, e.g., Simon Johnson, *The Quiet Coup*, THE ATLANTIC ONLINE (May 2009), <http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/>.

my. Part III outlines an alternative approach that would counter the power of, and put an end to, the financial conglomerates. This approach includes removing government support from the large financial firms while providing bank regulators with the power to place the conglomerates into conservatorship and receivership. This Part also explains why the Obama Administration's preference for incremental reform of the financial conglomerates will not succeed, because the firms will control and thus undermine the reforms. Part V concludes.

I. BACKGROUND

A. The Triumph of Finance

The last two decades of the 20th century and the first decade of the 21st century represent a triumph of finance, at least until the current financial crisis.⁴ First, during this period, there has been a tremendous growth in theoretical and empirical understanding about financial institutions, markets, and instruments. To name just a few examples, one thinks of the theory of efficient markets and the related concept of optimal investment portfolios, the financial and disciplinary value of debt, and the understanding and pricing of options. This understanding partly responded to demand: during this period, massive amounts of funds flowed into the financial sector from individuals who had to pay for their retirement from their own investments.⁵

As the story goes, finance triumphed because it benefited ordinary citizens and businesses, and thus the larger economy. It made investing scientific, primarily by offering strategies to deal efficiently with risks. For example, investors were taught that they could create a diversified portfolio that would eliminate many of the risks associated with investing in securities and that would be cost efficient.⁶ They were also offered a wide, and sometimes bewildering, array of financial instruments (chiefly derivatives) to address other risks in an investment portfolio. Moreover,

4. For a scholarly account of this transformation, see ROBERT J. SHILLER, *THE NEW FINANCIAL ORDER: RISK IN THE 21ST CENTURY* (2003). For a journalistic account, see JUSTIN FOX, *THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET* (2003).

5. See *e.g.* STEVEN A. SASS, *THE PROMISE OF PRIVATE PENSIONS: THE FIRST HUNDRED YEARS* 252 (1997).

6. The diversified risks would eliminate the unsystematic risks associated with individual securities, leaving for investors only the fundamental risks associated with all securities. See *generally* BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (1996). This insight spawned the index fund, made famous by Vanguard. See JOHN C. BOGLE, *THE BATTLE FOR THE SOUL OF CAPITALISM* 139–214 (2005).

finance gave firms new ways to think about capital structure and numerous tools to deal with their risks (again, derivatives).⁷ Finance also espoused agency theory and, as a result, provided new perspectives on firm governance, particularly to address longstanding problems of management.⁸ For instance, paying executives in stock options was based upon a financial assumption that the problem of managers acting contrary to shareholder wealth would best be solved if the interests of the two groups were aligned. Securitization, which sparked the current crisis, was also an invention of finance—it allowed persons to invest confidently in risky assets through a diversification strategy (i.e., the assets, such as home loans, were numerous, geographically diverse, and pooled).⁹

According to the story, finance benefited everyone. With the help of hard-edged financiers, American industry became more focused on its task of delivering wealth to shareholders as it embraced the lessons of finance.¹⁰ Ordinary investors found that they were no longer limited in their choice of investments, for now they had an array of old and new financial products to pick from, depending upon their preferences and investment goals.¹¹ Significantly for the purposes of evaluating the causes of the crisis, almost any consumer could take advantage of financial products that allowed him or her to purchase homes and consumer goods and that could be tailored to meet the consumer's personal circumstances.¹²

The U.S. financial industry became one of the most significant sectors in the country and the envy of the rest of the world. It grew significantly,

7. See JAMES C. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 258–86 (10th ed. 1995).

8. See, e.g., MICHAEL C. JENSEN, *FOUNDATIONS OF ORGANIZATIONAL STRATEGY* 51–102 (1998).

9. Securitization, or structured finance, is simply the process whereby long-term receivables, such as loans, are transformed into securities. This occurs when the receivables are pooled in a legal vehicle and securities (generally debt) are issued on the basis of the pool. For example, an investor who would be reluctant to fund one home mortgage can purchase debt securities whose payment of principal and interest is funded by thousands of home mortgages on properties throughout the country. See generally Dwight Jaffee et al., *Mortgage Origination and Securitization in the Financial Crisis*, in VIRAL V. ACHARYA & MATTHEW RICHARDSON, *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 61, 68 (2009).

10. See GEORGE P. BAKER & GEORGE DAVID SMITH, *THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE* 91–123 (1998).

11. See ROBERT E. LITAN & JONATHAN RAUCH, *AMERICAN FINANCE FOR THE 21ST CENTURY* 161–81 (1998).

12. On the growth in mortgage loans prior to the crisis, see Jaffee et al., *supra* note 9, at 61–82.

occupying an increasing share of the gross domestic product and employing large numbers of people, particularly from elite educational backgrounds.¹³ The paradigm of the financial industry was the financial conglomerate, which combined financial sectors such as commercial banking, investment banking, and insurance. Since all financial institutions deal with investment and risks, it seemed to make sense to create an institution that offered the full array of financial products and services.¹⁴ This conglomerate could be created only when legal restrictions dating from the aftermath of the Great Depression that separated commercial banking from other kinds of finance were finally changed to allow the linking of financial services.¹⁵ Participants in the financial services industry became wealthy as a result of the triumph of finance, but this outcome was justified (so the story went), for they were receiving their share of the wealth and benefits that they produced for the country.¹⁶

B. Another Perspective on Finance

There is another story of modern finance than this one of unalloyed benefits—and the financial crisis has brought this alternative account to the foreground. Without entering into longstanding debates, I contend that there is a valid argument that the financial industry destroyed, rather than improved, many companies and industries under the guise of financial rationalization.¹⁷ Financial specialists took control of companies, saddled them with debt, and ensured that—through fees, dividends, and other payouts—the specialists would be enriched no matter the ultimate fate of the firms. Finance’s view of the firm as a financial puzzle for value maximization was adopted by company senior executives, who participated in going private or sales transactions. Executives also embraced the finance model of stock option-based compensation, which allowed

13. It is reported that, before the crisis, the financial sector produced approximately 40% of U.S. corporate profits. See Johnson, *supra* note 3, at 4.

14. See LITAN & RAUCH, *supra* note 11, at 50–86.

15. For a brief discussion of these institutions and the legal background to their formation, see Anthony Saunders et al., Enhanced Regulation of Large, Complex Financial Institutions, in VIRAL V. ACHARYA & MATTHEW RICHARDSON, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 139–56 (2009).

16. See generally Thomas Philippon & Ariel Reshef, *Wages and Human Capital in the U.S. Financial Services Industry: 1909–2006* (Nat’l Bureau of Econ. Research, Working Paper No. 14644, 2009) (arguing that during two periods in the last century, compensation in the financial industry has been overly generous compared to what the market can support).

17. See PHILIP AUGAR, THE GREED MERCHANTS: HOW THE INVESTMENT BANKS PLAYED THE FREE MARKET GAME 204–21 (2005).

them to propel their compensation into the stratosphere.¹⁸ Thus, rather than Wall Street being a service provider and thus subservient to the capital raising purposes of Main Street businesses, the roles were reversed, which contributed to a “hollowing out” of management and industry in this country.¹⁹

The story about the benefits of finance to ordinary investors and consumers is also less convincing now in light of the losses caused by the financial crisis. The crisis brought to the forefront new examples of the repeated practice of financial professionals pushing investors into investments that often have higher commissions and higher risks than were represented: auction-rate securities and collateralized debt obligations that lost significant value in the financial meltdown come to mind.²⁰ Moreover, the crisis resulted in staggering investment and household wealth losses, which might take years to recoup.²¹ In addition, many of the financial products that were offered to consumers proved to be toxic to them and eroded their household wealth, yet were a bonanza for the financial industry. For example, many consumers were sold loan products that were unsustainable in likely scenarios, e.g. when real estate prices failed to rise.²² Once again, finance offered consumers an illusion

18. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 159–73 (2004) (discussing stock option practices that have increased executive compensation without regard to performance). Executives also used tools offered by bankers to hedge their returns on this compensation or to benefit in other ways from their executive positions (e.g., to receive shares from other companies doing initial public offerings). *See* NORMAN POSER & JAMES FANTO, BROKER-DEALER LAW AND REGULATION § 13.07[H] (4th ed. 2007).

19. *See* LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY (2007) (explaining the shift from practical business improvements to market manipulation as stock came to be the driving force of the American economy over the course of the 20th century).

20. *See, e.g.*, POSER & FANTO, *supra* note 18, § 1.02.

21. *See* INTERNATIONAL MONETARY FUND, WORLD ECONOMIC OUTLOOK: SUSTAINING THE RECOVERY 68 (Oct. 2009). As an aside, financial professionals offer favored investors trading strategies to obtain “alpha,” which is based upon, among other things, inefficiencies and trading patterns in the market. According to finance theory, the sophisticated trading makes the market more efficient and thus ultimately beneficial to investors. Yet financial professionals spend an inordinate amount of time and effort, and reap significant profits, from this active trading based on market inefficiencies, which they conduct also for themselves as principals with high leverage. *See* JONATHAN A. KNEE, THE ACCIDENTAL INVESTMENT BANKER: INSIDE THE DECADE THAT TRANSFORMED WALL STREET 225 (2006). This suggests that, even when ordinary investors are not being pushed into expensive financial products, they are still passively investing in a market that is a profit source for the financial professionals.

22. *See generally* JOINT ECON. COMM., THE U.S. HOUSING BUBBLE AND THE GLOBAL FINANCIAL CRISIS: HOUSING AND HOUSING-RELATED FINANCE (2008).

of well-being with devastating consequences, such as personal bankruptcy, loss of credit scores, and other personal hardships.²³

Furthermore, as the financial crisis has shown, the financial industry (particularly through financial conglomerates) creates economic and social instability by its activities. As a result of their involvement in asset-backed securities and related derivatives, financial conglomerates, which control most of the financial assets in the country, had to be bailed out by the federal government in multiple and costly ways so that the financial system would not collapse and the funding necessary for basic economic functions would go on through these institutions.²⁴ The crisis created a risk of collapse of the financial system (known as systemic risk) and arrested economic activity, pushing the world economy into a significant recession.²⁵ The government support came at a significant cost to taxpayers, who themselves came to be the guarantors of the financial institutions. In other words, financial conglomerates made the economic situation in this country highly precarious, with consequences of job loss and personal devastation to many individuals, while the institutions were bailed out by the government.²⁶

Finally, rather than producing a society where all boats rise through wealth it creates, finance arguably has led to an economic system that is politically destabilizing. In the words of economist Simon Johnson, as a result of finance the United States is increasingly a “banana republic” with a financial elite that owns or controls most of the country’s wealth, a growing impoverished underclass, and a shrinking middle class that is threatened with falling into the second group.²⁷ This is a potentially unst-

23. See generally CHARLES R. MORRIS, *THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH* (2008).

24. The importance of these financial conglomerates as providers of basic financial services was the justification used by the Obama Administration for their preservation. See Timothy Geithner, Treasury Sec’y, Secretary Geithner Introduces Financial Stability Plan (Feb. 10, 2009), available at www.ustreas.gov/pres/releases/tg18.htm. This is why federal financial regulators conducted a stress test only on the nineteen largest U.S. financial institutions (it focused on banks with greater than \$100 billion of assets, which are two-thirds of holding company assets today). See U.S. DEP’T OF THE TREASURY, *FACT SHEET FINANCIAL STABILITY PLAN*, at 2 (Feb. 10, 2009), available at <http://www.financialstability.gov>; see also CONG. OVERSIGHT PANEL, *AUGUST OVERSIGHT REPORT: THE CONTINUED RISK OF TROUBLED ASSETS*, at 4 (Aug. 11, 2009).

25. See Viral V. Acharya et al., *A Bird’s-Eye View: The Financial Crisis of 2007–2009: Causes and Remedies*, in VIRAL V. ACHARYA & MATTHEW RICHARDSON, *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 1–8 (2009).

26. The financial conglomerates and other financial institutions still hold troubled assets, which pose continuing problems to the institutions. See CONG. OVERSIGHT PANEL, *supra* note 24, at 3–4.

27. See Johnson, *supra* note 3.

able political outcome for a democracy, since, as seen in many Latin American countries, a country with such uneven wealth distribution is prone to slide into fascism, whether of the left or the right.²⁸ This movement into extreme wealth disparity corresponds with the last three decades of the triumph of finance.

II. THE OBAMA ADMINISTRATION'S FINANCIAL REFORM PLAN AND ITS LIMITATIONS

Given fundamental problems with the dominance of finance and with the financial conglomerates that constitute its paradigm, as outlined above, it is understandable that the initial Plan is a disappointment. The Plan preserves the status quo of large financial conglomerates and arguably even enhances their importance in the United States. It thus reflects a relatively positive outlook on finance and financial professionals, a position that strongly contrasts with the Administration's stricter attitude towards other nonfinancial industries that are experiencing trouble, such as the automobile industry. That is, even though financial firms brought the financial system to near collapse and the economy to its knees whereas the failure of automotive companies had no such systemic effects, the Administration initially took a supportive approach to the former and critical one to the latter.²⁹ Recently, however, Treasury officials and financial regulators, perhaps pushed by the growing criticism of the Administration's initial favorable treatment of financial conglomerates, have begun to be more critical of the conglomerates.³⁰

28. See, e.g., Johnson, *supra* note 3; *Too Big to Fail or Too Big to Save? Examining the Systematic Threats of Large Financial Institutions: Hearing before the Joint Econ. Comm.*, 111th Cong. (Apr. 21, 2009) (testimony of Simon Johnson, Professor, MIT Sloan Sch. Mgmt.).

29. For an outline of the Administration's support of the U.S. automobile industry, see U.S. DEP'T OF THE TREASURY, ROAD TO STABILITY: AUTOMOTIVE INDUSTRY FINANCING PROGRAM (Mar. 18, 2010), available at <http://www.financialstability.gov/roadtostability/autoprogram.html>. It is curious that the stated justification for the automobile rescue package is "financial market stability," but that reason has not prevented the government from allowing automobile companies to fail, although it has been reluctant to do the same for financial conglomerates.

30. This essay was written and revised in the latter half of 2009. Since that time, the Administration has become increasingly critical of financial conglomerates and has even made proposals dealing with limiting their size and activities. See, e.g., Press Release, White House, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers (Jan. 21, 2010), available at <http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e>.

The following discussion highlights several examples of the orientation and limitations of the Plan. The examples are the proposed expanded role of the Federal Reserve as systemic risk regulator, risk management and related capital regulation reform, and the proposal to establish a consumer financial protection agency. This Part explains how each of these proposals, even one potentially beneficial to consumers of financial products, reinforces the dominance of finance and financial conglomerates. It also refers to the emerging fissures in the Administration's favorable view of financial conglomerates.

A. The Expanded Role of the Federal Reserve

A central part of the Plan would enhance the role of the Federal Reserve. Under current law, the Federal Reserve is the supervisor of the financial conglomerates, which in technical terms means that it is the designated regulator of bank and financial holding companies.³¹ Before the crisis, these included all the commercial banking conglomerates, such as Citigroup and Bank of America.³² However, the Federal Reserve's supervisory role over the bank or financial holding company is limited by what is called "functional regulation."³³ That is, although the Federal Reserve is the regulator of the holding company, its supervisory role over the holding company's subsidiaries is limited: the Federal Reserve is the primary regulator of a subsidiary only if that subsidiary does not have a "functional regulator."³⁴ For example, a commercial bank owned by a financial holding company would be regulated by the Office of the Comptroller of the Currency ("OCC") or a state bank regulator, depending upon whether it is chartered as a national or state bank; an investment bank subsidiary would be regulated as a broker-dealer by the Securities and Exchange Commission ("SEC"); any insurance subsidiary would be regulated by a state insurance regulator. In this scheme of regulation, the Federal Reserve must defer to a functional regulator with respect to regulation of many of the most important parts of a financial conglomerate.³⁵

31. See 12 U.S.C. § 1844(a) (2009). Since all the financial conglomerates have elected financial holding company status, my discussion focuses on the financial holding company regulatory status, not the bank holding company option.

32. For a list of financial holding companies, see *The Federal Reserve Board: Financial Holding Companies*, <http://www.federalreserve.gov/generalinfo/fhc/> (last visited Feb. 25, 2010).

33. See 12 U.S.C. § 1844(c) (2009).

34. See 12 U.S.C. § 1844(c)(5).

35. Essentially, under § 1844 the Federal Reserve must defer to the functional regulator's overall regulation of the functionally-regulated subsidiary, to its examination of that subsidiary, to reports made by the subsidiary to the functional regulator, and to capital

The Plan would make the Federal Reserve a “super-regulator” for an expanded number of financial conglomerates, which would include both certain financial holding companies and also conglomerates currently outside its jurisdiction. In some cases, the Plan extends the Federal Reserve’s authority to include otherwise unregulated entities, such as hedge fund advisors, private equity firms, any of their funds, insurance groups, or any financial group the failure of which would pose a systemic risk to the financial system.³⁶ Together, these conglomerates and other entities would be known as “Tier 1” financial holding companies.³⁷ Under the Plan, the Federal Reserve would have direct supervision over these firms and their parts, with its supervisory power no longer circumscribed by the authority of functional regulators like the SEC.³⁸ The legislation implementing this part of the Plan, which is working its way through Congress, establishes this primacy of the Federal Reserve in the regulation of these Tier 1 institutions, even though it has the Federal Reserve working cooperatively with other financial regulators.³⁹

The basic justification for expanding the Federal Reserve’s power is that the demise of any of the financial conglomerates, as seen in the financial crisis, threatens the financial system, i.e., it creates “systemic risk.”⁴⁰ Having numerous, independent regulators for the various parts of a financial conglomerate means that no one of them is responsible for the overall financial position and stability of the conglomerate itself and for its effects on the financial system as a whole. Moreover, without a “regulator in chief,” exposures, activities, and risks within the conglomerate could escape regulation and oversight altogether. The Plan would remedy this regulatory failure by giving the Federal Reserve this regulatory task, although, as discussed below, the Federal Reserve would be helped in its

standards for such subsidiary set by the functional regulator. *See* 12 U.S.C. § 1844 (2009).

36. *See* A NEW FOUNDATION, *supra* note 2, at 10–11, 21–24. Under current law, the Federal Reserve has jurisdiction over bank and financial holding companies only if a federally insured bank is a subsidiary of the holding company. *See* 12 U.S.C. § 1841 (2009).

37. *See* A NEW FOUNDATION, *supra* note 2, at 22–24.

38. *See id.* at 19–22, 25–26.

39. *See, e.g.*, H. COMM. ON FIN. SERV., FINANCIAL STABILITY IMPROVEMENT ACT § 1104 (discussion draft, Oct. 27, 2009) [hereinafter Discussion Draft]. Again, since the time of writing and revising this essay, new legislation has been introduced with respect to financial reform. *See, e.g.*, Senate Committee on Banking, Housing and Urban Affairs, Summary: Restoring American Financial Stability (summarizing new Senate bill). This proposed legislation will not be discussed in this essay.

40. *See* A NEW FOUNDATION, *supra* note 2, at 21–22.

efforts with respect to risk oversight by a council of the chief financial regulators.⁴¹

There are several ways in which enhancing the role of the Federal Reserve supports and extends the dominance of financial conglomerates in the United States. First and obviously, this part of the Plan accepts the existence of the conglomerates as an unchangeable reality and implicitly rejects a logical alternative, which is to break them up. In other words, the Plan asserts that the status of the conglomerates cannot be questioned, and therefore that the only justifiable policy is to stabilize them and to deal with the risks that they pose to the financial system. Giving these institutions a special regulator reinforces the financial conglomerate as the norm. Moreover, expanding beyond financial holding companies the kinds of financial groups that would be Tier 1 holding companies only supports this perspective, since they, like the regulated conglomerates, are involved in complex and diverse financial activities. In sum, the status of the financial conglomerates is never questioned, even though the destruction caused by financial conglomerates has resulted in losses not only to shareholders but to many in the United States who have suffered from the recession and now bear the increased tax burden of the rescue programs.⁴²

In addition, giving the Federal Reserve this expanded regulatory role promotes financial conglomerates and thus “big” finance because, historically, the Federal Reserve has been the regulator that championed the creation of the conglomerate. The complete story of the erosion and demise of the former legal structure in which financial services had to be kept apart is beyond the scope of this Article. A significant chapter in the story is the Federal Reserve’s support for ending the separation between commercial and investment banking, as well as between insurance and banking, and aggressively encouraging the formation of the U.S. financial conglomerate.⁴³ Moreover, as has been abundantly clear throughout

41. Another part of the Plan (to be discussed in passing later) would give the Treasury, aided by the Federal Reserve and other banking authorities the related power to take over and “resolve” a failing large financial group. *See id.* at 76–78.

It must be emphasized that, in proposing the concept of a systemic risk regulator and primary supervisor of financial groups, the Administration drew support from scholars of financial regulation. *See, e.g.,* Saunders et al., *supra* note 15, at 139.

42. It is odd that financial conglomerates have been treated much more gently than the industrial conglomerates that were takeover targets in the 1980s because the latter were seen to be destructive of shareholder value. For a critical summary of this perspective, see MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 94–115 (1995).

43. *See, e.g.,* LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 53–55 (3d ed. 2008). For a pano-

the financial crisis, the Federal Reserve is inclined to protect large financial groups—even those that were previously outside its regulatory ambit, such as the large investment banks. The Federal Reserve has protected these groups even where this protection meant that it had to pick the survivors among the groups. It allowed Goldman Sachs and Morgan Stanley to become financial holding companies on an emergency basis in order to preserve their very existence;⁴⁴ it helped engineer the sales of Merrill Lynch to Bank of America (a transaction that remains subject to litigation)⁴⁵ and Bear Stearns to JP Morgan Chase;⁴⁶ and it contributed to the efforts to keep insurance conglomerate American International Group afloat.⁴⁷ Most of the programs in which the Federal Reserve participated during the financial crisis, such as those for reestablishing the market for asset-backed securities and removing toxic loans and securities from the books of financial firms, have been primarily designed to improve the financial position of the financial conglomerates.⁴⁸

ramic view of the regulatory and industry changes that produced the financial conglomerate, and their dangers, see Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215 (2002).

44. See, e.g., Jon Hilsenrath et al., *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J., Sept. 22, 2008, at A1.

45. See SEC v. Bank of America, 653 F. Supp. 2d 507, 509, 512 (S.D.N.Y. 2009) (a district court refused to accept a \$33 million dollar settlement between the SEC and Bank of America on the issue of disclosure violations regarding the bonuses because the settlement was “neither fair, nor reasonable, nor adequate”); see also SEC v. Bank of America, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010) (the same district court accepted a revised settlement).

46. In particular, the Federal Reserve made a \$29 billion loan as part of J.P. Morgan’s purchase of Bear Stearns, with the loan being “non recourse” as to J.P. Morgan and only collateralized by \$30 billion of Bear Stearns assets placed in a separate vehicle (with J.P. Morgan agreeing to take the first \$1 billion loss on the collateral). See *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators Before the S. Comm. on Banking, Hous. and Urban Affairs*, 110th Cong. (2008) (testimony of Jamie Dimon, CEO, JP Morgan Chase). See generally Stephen G. Cecchetti, *Crisis and Responses: The Federal Reserve and the Financial Crisis of 2007–2008* (Nat’l Bureau of Econ. Research Working Paper No. 14, 134, 2008), available at <http://www.nber.org/papers/w14134>.

47. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-09-975, *TROUBLED ASSET RELIEF PROGRAM: STATUS OF GOVERNMENT ASSISTANCE PROVIDED TO AIG 28–30* (2009) (summarizing the Federal Reserve’s assistance to AIG).

48. One program, the Term Asset-Backed Securities Loan Facility or “TALF,” is designed to restart loan securitization outside the home mortgage context, an activity engaged in by the conglomerates. For complete information on this program, see BD. OF GOVERNORS OF THE FED. RESERVE, *TERM ASSET-BACKED SECURITIES LOAN FACILITIES*, (2009), <http://www.federalreserve.gov/monetarypolicy/talf.htm> (last visited Mar. 18, 2010). Another is the public-private investment partnership, which is designed to fund

The Federal Reserve has consistently given the following public interest defense for its actions with respect to the financial conglomerates: if one of them fails, the financial system and the economy may collapse, which will be destructive for everyone. It never explains why the financial system and the economy are dependent on this current configuration of financial institutions, other than the unspoken justification that this *is* the outcome that the “market” has given us.⁴⁹ That the Administration’s point man for the Plan, Timothy Geithner, is an important Federal Reserve alumnus (former president of the Federal Reserve Bank of New York,) underscores how the Plan’s support of the current state of finance is overdetermined.⁵⁰

The Plan proposes that the Federal Reserve will enhance its oversight of Tier 1 financial groups or institutions using accepted methods of regulating financial firms—improved capital, liquidity, and risk management standards.⁵¹ Capital requirements, the chief form of regulation, are based upon agency theory (again, the paradigmatic theoretical framework in finance) insofar as they require owners of a financial institution to have their own assets invested in the venture. This is thought to ensure that out of self-interest the owners will prevent their institution from participating in excessively risky investments and activities, for the owners would suffer the initial losses. Capital requirements in financial institutions are “risk-based,” which simply means that the amount of capital required is determined by the risk of the institution’s investments and activities, as either measured by the risk models of the firm or in accordance with a risk determination pre-set by regulators.⁵² Yet risk models can be flawed and capital can turn out to be insufficient, as was seen during the crisis

private investors so that they can remove toxic assets from financial institutions’ books (again, the financial conglomerates are holders of many of these assets). For a description of this program, see *U.S. Dep’t of Treasury—Road to Stability: Public-Private Investment Program*, <http://www.financialstability.gov/roadtostability/publicprivatefund.html> (last visited May 23, 2010). Under the first program, which now can reach troubled assets as well as securities backed by new loans, the Federal Reserve provides low-interest loans to the private investors. For a critical discussion, see Office of the Special Inspector Gen. for the Troubled Asset Relief Program, *Quarterly Rep. to Cong.* 72–76 (2009).

49. See, e.g., *Regulatory Reform Before the H.R. Comm. on Financial Serv.*, 111th Cong. (2009) [hereinafter *Regulatory Reform Hearing*] (testimony of Daniel K. Tarullo, Member of the Board of Governors of the Fed. Reserve Sys.).

50. *Biography of Timothy F. Geithner, Secretary of the Treasury*, U.S. DEP’T OF TREASURY, <http://www.ustreas.gov/organization/bios/geithner-e.shtml> (last visited Mar. 26, 2010).

51. See A NEW FOUNDATION, *supra* note 2, at 24–25.

52. The subject of capital determination in financial firms is beyond the scope of this Article. See generally PETER S. ROSE & SYLVIA C. HUDGINS, *BANK MANAGEMENT & FINANCIAL SERVICES* 475–98 (7th ed. 2008).

when numerous financial institutions proved to be inadequately capitalized in face of the losses triggered by the subprime loan meltdown.⁵³ Thus, enhanced capital regulation by the Federal Reserve is hardly comforting as a way to deal with the risks posed by the Tier 1 institutions, particularly since the Federal Reserve oversaw the capital positions of financial holding companies, like Bank of America and Citigroup, that nearly failed in the crisis.⁵⁴ Moreover, one wonders how heightening capital requirements on financial conglomerates can ameliorate agency conflicts at all if, as is now clear, the federal government will not allow a Tier 1 institution to fail. The owners assume that their firm will never be allowed to fail, and their equity position will not be wiped out, thus making the risk-exposure function of capital requirements almost meaningless.⁵⁵

Requiring a financial conglomerate to have adequate sources of liquidity is a response to the phenomenon that occurred during the crisis: firms collapsed or nearly did because they relied excessively on short-term financing, which vanished in the crisis. International financial standard setters are now cautioning financial firms to be prepared for this “liquidity risk” by having funding that can see them through several years of hard times.⁵⁶ This means that a firm has to alter its debt financing structure to make most of its funding long term. However, it is questionable whether any financial conglomerate can have enough liquidity to withstand a systemic crisis, which occurs because of its and other firms’ risky investments and because of their opaque relationships with each other. It must be remembered that even the “best” of the financial conglomerates, including Golden Sachs (which has occasionally asserted

53. See James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 741–42 (2009) [hereinafter Fanto, *Anticipating the Unthinkable*].

54. The Federal Reserve claims that its supervision has always focused on the financial institutions that pose the greatest risk to the financial system. See FED. RESERVE BD., SUPERVISORY LETTER SR 08-9/CA 08-12, CONSOLIDATED SUPERVISION OF BANK HOLDING COMPANIES AND THE COMBINED U.S. OPERATIONS OF FOREIGN BANKING ORGANIZATIONS (2008), available at <http://www.federalreserve.gov/boarddocs/srletters/2008/sr0809.htm>.

55. As discussed below, the Plan does call for a plan for winding up financial conglomerates, but one has to wonder if this is legislative window dressing.

56. See, e.g., BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND LIQUIDITY RISK MANAGEMENT AND SUPERVISION 3 (2008).

that it never needed a government rescue),⁵⁷ would have collapsed in October 2008 without all of the government protections given to them.⁵⁸

The above discussion returns repeatedly to the concept of risk, which is the province of risk management and deserves a section of its own. However, as noted earlier, it is important to point out that the monolith mindset about the status quo of financial conglomerates is beginning to exhibit fissures. One example of the growing skepticism about the conglomerates is appearing in recent reflections on capital regulation for them. For example, Federal Reserve Governor Tarullo mentioned as a possibility a new “special capital requirement,” which would be in addition to capital requirements determined on a risk basis, to be imposed on the Tier 1 institutions.⁵⁹ Such a charge, he implies, would in essence penalize large firms and discourage institutions, through this cost, from becoming conglomerates.⁶⁰ Even Treasury Secretary Geithner discussed the possibility of limiting firm size when providing his views on a discussion draft of the proposed legislation enhancing the Federal Reserve’s powers. He made the following somewhat startling statement: “Regulators must be empowered with explicit authority to force major financial firms to reduce their size or restrict the scope of their activities when necessary to limit risk to the system. This is an important tool to deal with the risks posed by the largest, most interconnected financial firms.”⁶¹

57. See Joe Nocera, *Short Memories at Goldman*, N.Y. TIMES, Oct. 23, 2009, at B1.

58. Beyond the government’s capital infusion, these included the ban on short selling of the stock of financial institutions, access to discounted Federal Reserve loans, guarantees of debt issued by financial conglomerates, and the rescue of AIG, which had financial conglomerates (like Goldman) as its counterparties. See Press Release, S.E.C., S.E.C. Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 18, 2008), available at <http://www.sec.gov/news/press/2008/2008-211.htm>; Press Release, Fed. Reserve, FOMC Statement (Oct. 29, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081029a.htm>; Press Release, U.S. Dep’t of Treasury, Fed. Reserve, and Fed. Deposit Insurance Corp., (Oct. 14, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081014a.htm>; Christine Seib, *AIG Rescued by U.S. Fed. Reserve with \$85bn bailout*, TIMES ONLINE, Sept. 17, 2008, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4771465.

59. See *Regulatory Reform Hearing*, *supra* note 49, at 4. Governor Tarullo described the charge as also being risk-based insofar as the charge would increase the more systemic risk an institution posed.

60. Governor Tarullo also referred to another possible reform related to capital: require financial conglomerates to have “contingent capital,” which means debt that, in certain circumstances, changes to equity. See *id.* at 4–5.

61. *Hearing Before the H. Comm. on . Fin. Serv. 4*, 111th Cong. (Oct. 29, 2009) [hereinafter Geithner Testimony] (Testimony of Timothy F. Geithner, Sec’y of the Treasury). Indeed, the Discussion Draft includes a provision allowing the Federal Reserve to

B. Risk Management, Centralization of Regulation, and Complexity

As noted above, the Plan promises that the Federal Reserve will enhance risk management in the Tier 1 conglomerates or institutions. Additionally, the Plan proposes that a Financial Services Oversight Council be organized, which will, among other things, replace the President's Working Group on financial markets. The Oversight Council will identify emerging risks in the financial industry.⁶²

A few words about risk management are in order here. The system commonly known as risk management in fact comprises both risk assessment and risk management. Risk assessment is designed to identify the risks a financial institution faces from its investments and activities. The firm's board and executives use the risk assessment to decide upon the appropriate risk profile for the firm and to ensure that the institution keeps within these boundaries and takes actions to minimize the losses associated with, and otherwise to address, these risks—this is risk management proper.⁶³ Risk management is critical for financial institutions because the adequacy of a financial institution's capital, which is the primary device for keeping the firm's activities in check, is determined in accordance with a risk assessment of these activities and assets.⁶⁴ Indeed, financial regulators permit financial conglomerates, such as those that would be designated Tier 1 under the Plan, to conduct this risk assessment using the conglomerates' own risk models and methods, rather than having to use the risk framework established by the regulators.⁶⁵ The Federal Reserve and other financial regulators now supervise this risk

force a financial conglomerate to reduce its size. *See* Discussion Draft, *supra* note 39, at 19.

62. *See* A NEW FOUNDATION, *supra* note 2, at 20–21. In the Discussion Draft, the Council is composed of the Secretary of the Treasury and the heads of the Federal Reserve, the OCC, the SEC, the FDIC, the CFTC, the Federal Housing Finance Agency, and the National Credit Union Administration, and has two nonvoting members (a state banking commissioner and a state insurance regulator). *See* Discussion Draft, *supra* note 39, at 5–7. Among other things, the Council would issue prudential regulations dealing with systemic risk that financial regulators would have to adopt and it would identify financial firms and financial practices to be subject to heightened financial regulation by the Federal Reserve. *See id.* at 8–11.

63. *See generally* Rose & Hudgins, *supra* note 52, at 30.

64. *See id.* at 483–84.

65. *See* Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II, 72 Fed. Reg. 69,288, 69294–98 (Dec. 7, 2007) (explaining how the internal model approach, which was used to measure market risk, is now extended to credit and operational risk).

assessment and all the risk management practices of the firms under their regulatory authority.⁶⁶

I have argued elsewhere that, for several reasons, risk management in the large financial groups and regulatory supervision of it failed greatly contributing to the financial crisis; indeed, this crisis is one of risk management.⁶⁷ Risk management models for predicting losses in assets and from activities were often programmed with incomplete or faulty data that downplayed potential losses; risk managers ignored established methods, such as stress testing and scenario analysis, to evaluate an institution's preparedness for extreme scenarios; results were ignored or not taken seriously by financial institution executives and board members; and financial regulators accepted without criticism the risk models and processes of institutions and did not insist that they be improved when problems were found. In addition, risk managers and financial regulators ignored certain risks, such as the liquidity risk and risk from compensation design that became apparent in the crisis.

Certainly, financial institutions and regulators now have "got religion" on risk management. Model shortcomings are being rectified; stress testing and scenario analysis are being undertaken (indeed, the 19 largest financial groups had to undergo a government-designed stress test);⁶⁸ executives and boards are meeting with risk managers, who have assumed new importance in their organizations; and regulators are examining the risk management practices of firms (this is what the government stress testing was designed to accomplish). Therefore, the Plan's proposal that the Federal Reserve and the Oversight Council monitor risk management in financial institutions more closely must be understood as part of ongoing risk management reform efforts.

Yet there are problems with the Plan's reform of risk management because its fundamental approach is misguided and because it underestimates the dangers arising from financial conglomerates. The solution of having an Oversight Council on the lookout for emerging risks is based upon an assumption that a group of regulators at the summit of the regu-

66. See DIV. OF BANKING SUPERVISION & REG., FED. RESERVE BD., BANK HOLDING COMPANY SUPERVISION MANUAL supp. 28 § 4070 (2005) (discussing the Bank Holding Company Rating System that includes a rating on an "R" component, which represents risk management).

67. See Fanto, *Anticipating the Unthinkable*, *supra* note 53, at 739–45.

68. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: DESIGN AND IMPLEMENTATION 2–4 (2009) (discussing the methodology of the stress test); BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS (2009) (discussing its results).

latory structure can rationally and panoramically survey financial institutions and financial practices, detect emerging risks therein, and then require firms to eliminate or lessen the destructive effects of these risks. This perspective is the same one that characterizes current risk management in Tier 1 financial institutions (and in most other financial institutions, for that matter), where a risk oversight committee (of directors, executives, or a combination of both), with the help of a firm's risk management department and its internal control department, assesses the risks of an enormous financial group and then manages them within risk parameters set down by the entire board. This perspective is thus "top down" and highly rationalist in nature.

The financial crisis showed that this approach to risk analysis and management, when it is used exclusively, is faulty. Almost without exception, financial firms and regulators failed to see the risks of the asset-backed securities that sparked the financial cataclysm. More importantly, they failed to anticipate the widespread illiquidity of assets and freezing up of transactions that followed the meltdown in the asset-backed securities market. They were unprepared for a phenomenon that is known as "tail dependence" in the risk literature.⁶⁹ This means that an extreme event in one domain (such as a failure in the market for securities backed by subprime loans) can lead, in unexpected ways, to equally extreme consequences in other domains, such as in all asset-backed securities and then in all loans and securities, which in turn aggravates the decline in the original domain.

Certainly, as mentioned above, risk management has improved in financial institutions, and regulators are taking it more seriously. However, the top down approach may prevent both firms and regulators from dealing with catastrophic risks, which matter the most and whose identification is the whole point of the reform. It is likely that these risks will be identified in two ways: (i) by risk managers who are working closely with specific financial activities and are attuned to developments in the market and (ii) by risk managers who play out counterfactual or counterintuitive scenarios with respect to their financial institutions and the financial system. It appears that an Oversight Council, like a firm's risk committee, is simply too removed from group (i) and must depend upon an extended chain of reporting, which may well attenuate any message about risk that it receives. It is also difficult to imagine that an Oversight Council (again like a firm's risk committee) will take the time to serious-

69. See BANK FOR INT'L SETTLEMENTS, BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND STRESS TESTING PRACTICES AND SUPERVISION 9–10 (2009).

ly consider imaginative scenarios, as opposed to standard risks with which its members are familiar.

Moreover, even if the Oversight Council established reliable access to the risk managers “on the ground” and had the initiative to run, and take seriously, an analysis of unlikely scenarios, it is still unclear whether the Council would be able to predict with any accuracy the catastrophic risks arising from financial conglomerates. The Tier 1 groups are involved in so many financial activities and are interconnected in such complex ways that it is difficult for any person, firm, regulator or council of regulators to see all the emerging risks in them and to predict the consequences of acute negative events. As the crisis has shown, the tail dependence phenomenon in this part of the financial sector and in the international financial system in which the conglomerates play such a great role is both particularly hard to predict and extremely destructive. In risk management, the financial conglomerates may be too complex to manage.

Furthermore, the Oversight Council’s “top down” perspective on risk management maintains and even valorizes the status quo of financial conglomerates in the financial system. The message of the Plan is that risk management in these institutions can best be supervised only by a government body that is as centralized and powerful in regulation as they are in finance.⁷⁰ From this perspective there is little acknowledgement of the possibility that, since catastrophic risks are difficult to identify and their consequences in the complex financial institutions are almost impossible to predict, the financial conglomerate might be too dangerous an institutional form of providing financial services.⁷¹

C. Consumer Financial Protection

A final example of the Plan’s financial reforms is the proposed creation of a Consumer Financial Protection Agency (“CFPA”), which, as its name suggests, would be charged with protecting consumers in their acquisition of financial products, such as credit, savings, payment, and other consumer financial products and services.⁷² This federal agency would

70. In reality, the Council is a political accommodation by the Obama Administration, which initially wanted to place the major power with respect to financial conglomerates with the Federal Reserve and to give the Council only an advisory role. The Discussion Draft increases the importance of the Council. Yet my point about the reform as valorizing financial conglomerates holds, whether the Federal Reserve or the Oversight Council is in charge.

71. Again, as discussed earlier, there are signs that this alternative perspective on the financial conglomerates is beginning to be acknowledged, even in the Discussion Draft. See Discussion Draft, *supra* note 39.

72. See A NEW FOUNDATION, *supra* note 2, at 55–63.

have the sole rule-making authority under existing consumer protection financial laws and have supervisory, examination, and enforcement authority over financial institutions (even unregulated ones) in this domain. It would set a floor for consumer protection for the states, which could still impose higher standards, and it would cooperate with them in consumer protection and enforcement efforts. Among other things, the CFPA would be directed to improve the financial industry's disclosure on consumer financial products, to require that there be "plain vanilla" products in each financial area,⁷³ to restrict unfair, abusive, or deceptive terms in consumer financial contracts (and, if necessary, to ban mandatory arbitration in consumer financial contracts), and to impose fiduciary duties upon financial services providers.⁷⁴

The CFPA is inspired by the work of Professor Elizabeth Warren of Harvard Law School, one of the foremost consumer finance scholars and currently a member of the Congressional Oversight Panel of the Treasury's Troubled Asset Relief Program.⁷⁵ It is intended to replicate at the federal level the consumer protection and paternalistic orientation of the states. Under federal financial law, consumer protection is generally limited to disclosure: for example, consumers must receive considerable disclosure about loan terms or savings or other account terms from banks, and banks are penalized if this disclosure is inadequate.⁷⁶ The CFPA's approach would be different and more along the lines of product safety regulation. The agency would evaluate a financial product, such as a loan, on its merits in order to determine whether it is beneficial to consumers and whether its potential harms outweigh its benefits.⁷⁷ If the regulator were to determine that the product or features of it were too toxic, it would not allow financial institutions to sell the product to consumers, or it would require them to eliminate the product's toxic features.⁷⁸ This approach echoes the traditional focus of state securities and

73. *See id.* at 70–71.

74. Under the Plan, the SEC's consumer protection authority in investment products would also be enhanced, primarily with respect to disclosure before sale. *See id.* at 71–72.

75. *See, e.g.*, Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY: A J. OF IDEAS, (Summer 2007) (detailing the reasons we need a consumer financial safety commission).

76. This simplifies a complex area of the law. *See, e.g.*, Truth in Lending Act, 15 U.S.C. §§ 1601–93 (2006); Truth in Savings Act, 12 U.S.C. §§ 4301–13 (2006). Similarly, SEC regulation of financial products is essentially disclosure-based: under this theory investors should receive material information about an investment, no matter how speculative it is, but should not be prohibited from investing in it.

77. *See* A NEW FOUNDATION, *supra* note 2, at 55–58.

78. One thinks in this regards of certain home mortgages that were made to borrowers on the basis of no investment and no documented income, and that had higher interest rates that would kick in after an initial teaser rate. Such loans were almost certain to harm

banking departments that evaluate the merits of investments and loan products offered to their citizens.⁷⁹

It may seem inappropriate to lump the CFPA with the centralization of regulatory power in the Federal Reserve and the flawed approach to risk management as an additional example of problems in the Plan. Certainly, the focus on the consumer is a welcome political recognition that financial regulators failed in their consumer protection mission and were devoted almost solely to the well-being of the financial firms over which they have supervisory responsibility. The CFPA provides consumers with a regulator whose mandate is only to protect their interests, rather than those of certain members of the financial industry. Under the Plan the CFPA would be a regulatory counterpart to the Federal Reserve, for it would be the “super-regulator” of consumer interests in finance just as the Federal Reserve would be for financial firms and the system. One obvious criticism (which I have expressed elsewhere)⁸⁰ is that, even though financial regulators would continue their consumer protection activities under the direction and guidance of the CFPA, that role may atrophy. The establishment of the CFPA “liberates” financial regulators by reinforcing their belief that their primary focus should be on their part of the financial industry.⁸¹

the consumer, except in the limited circumstances of a continued rise in real estate values. *See, e.g.*, U.S. Gov’t Accountability Office, GAO-09-848R, *Characteristics and Performance of Nonprime Mortgages*, (2009).

79. *See* Broome & Markham, *supra* note 43, at 419–33 (discussing Georgia’s efforts to regulate subprime loans).

80. *See* James Fanto, *The Rationale and Cautionary Remarks on the Proposed Federal Consumer Financial Product Regulator*, 2009 EMERGING ISSUES 3652 (2009).

81. This may be no great loss, given the existing orientation of the regulators and the fact that this Administration is more consumer-oriented than the last Administration. However, the country’s political orientation will inevitably shift over time. If a future Administration were less devoted to consumer financial protection, it could weaken the power of the CFPA by senior level appointments. By then, no financial regulator could step up to fill the consumer protection role.

It should also be noted that the enactment of legislation authorizing the CFPA is by no means certain. There were initially two bills in the House with differences in the structure and mandate of the CFPA. *See* Jewel Edwards, *Energy and Commerce Passes CFPA Bill, Splits with Financial Services Panel’s Version*, 93 BANKR. L. REP. (BNA) 841 (2009). The version from the House Financial Services Committee was H.R. 3126. As such, it is different in important respects from the version originally introduced on behalf of the Administration. For example, H.R. 3126 does not allow the CFPA to require financial institutions to offer consumers “plain vanilla” financial products and the bill excludes certain parties (e.g., automobile dealers who offer credit to consumers) from coverage. *Consumer Financial Protection Agency Act, H.R. 3126, 111th Cong.* (2009).

Yet the centralization of consumer protection in the CFPA raises a criticism that is related to the earlier discussion of risk management. Many consumer financial and investment abuses, just as many risks to financial firms, can be detected best by people who are “close to the action” of the firm. In the case of consumer abuses, this means by regulators who deal directly with consumers. That is why state regulators, rather than federal financial regulators, have generally identified financial abuses of consumers first. The CFPA proposal thus suffers from the same “top down” perspective as does the proposal for expanding the Federal Reserve’s systemic risk authority. That is, it reflects the belief that a centralizing authority with panoramic vision is best at dealing with consumer financial abuses. It is true that the Plan does not threaten or undercut state power in consumer protection. It explicitly discourages preemption, permits states to offer greater consumer protection than what would be provided under federal law, encourages state and federal cooperation in consumer protection, and even allows states to enforce provisions of new consumer financial protection laws that would be enacted with the establishment of the CFPA.⁸² That approach to consumer protection would be “bottom up,” which would be much more valuable in detecting and addressing consumer abuses.⁸³

Finally, in a perverse way the CFPA reaffirms the importance of the financial conglomerates, just as do other aspects of the Plan. Advocates for the CFPA clearly believe that consumers need such an agency to protect them from the conglomerates, which have their protectors in the current federal financial regulators and in a strengthened Federal Reserve. The assumption behind the CFPA is that the Tier 1 institutions are the status quo and here to stay, and therefore the only recourse for consumers is to seek protection in a powerful, consumer-oriented federal agency. Another option, such as keeping financial institutions smaller (as discussed below), would obviate the need for a supercharged federal consumer regulator.⁸⁴

82. See A NEW FOUNDATION, *supra* note 2, at 60–61. H.R. 3126 preserves this initial thrust of the Plan. See Subtitle D—Preservation of State Law, H.R. 3126, at §§ 141–50.

83. A concern remains that a centralized, powerful federal regulator would gradually assert more and more authority and could eventually encroach upon the jurisdiction of state regulators. Then, if political winds change and the CFPA becomes less assertive as to consumer protection, state financial regulators might not be ready and capable of dealing with consumer abuses.

84. Legislation might still be needed, as in H.R. 3126, to reaffirm the importance of state consumer protection and to protect it against preemption efforts by federal financial regulators.

III. AN ALTERNATIVE PERSPECTIVE

It is fair to ask whether the Obama Administration will propose any transformational reform of financial institutions if there is no further meltdown in the financial markets. Many financial conglomerates that survived the financial collapse with the extraordinary help of the Treasury, the Federal Reserve, and other federal financial regulators are boasting about their profits (generally made from proprietary trading on the basis of cheap funds available from the Federal Reserve and leverage), have paid back their TARP funds,⁸⁵ and are reasserting themselves by offering a revisionist history of the meltdown (“we never needed government support”).⁸⁶ They are now trying to remove the teeth from proposed regulation.⁸⁷ The crisis has in fact made the financial sector even more concentrated with the new class of Tier 1 institutions that would receive the government’s designation as “systemically important,” are implicitly regarded as “too big to fail,” and can thus raise funds at a discount.⁸⁸ Financial regulators and those in the current Administration responsible for financial policy come from or have close ties to financial conglomerates and are steeped in the ideology of finance.⁸⁹ Thus, as explained in the previous part, the reforms proposed in the Plan reflect this ideology and reinforce the position of the financial conglomerates.⁹⁰

I offer below one thought for reform that comes from a perspective that is critical of the current dominance of financial conglomerates and that is skeptical of the virtues of finance in the United States. The primary goal of this reform would be to break up the financial conglomerates on the ground that, because of their complexity and rent-seeking, they pose too many risks to the financial system, the economy and political well-being of this country. This proposal would benefit the market for financial ser-

85. See, e.g., *Morgan Stanley Buys TARP Warrants from Treasury for \$950 Million*, 21 BANK. REP. (BNA) 1160 (2009).

86. See Joe Nocera, *Short Memories at Goldman*, N.Y. TIMES, Oct. 23, 2009, at B1 (discussing revisionist history of financial crisis espoused by Goldman). *But see* Letter from Lloyd C. Blankfein, Chairman & CEO, Goldman Sachs Group, to Barney Frank, Chairman, and Spencer Bachus, Ranking Member, H. Fin. Serv. Comm. (June 16, 2009) (expressing Goldman’s appreciation for government support).

87. See Joe Nocera, *Have Banks No Shame?*, N.Y. TIMES, Oct. 9, 2009, at B1 (discussing bank resistance to reform).

88. See David A. Moss, *An Ounce of Prevention*, HARV. MAG., Sept.–Oct. 2009, AT 25, 27.

89. See, e.g., Jackie Calmes, *Obama Aide Declines Visit to Bank Board*, N.Y. TIMES, July 20, 2009, at B1 (discussing ties between Obama’s Chief of Staff and close friend, Rahm Emmanuel, and financiers, particularly the CEO of JP Morgan Chase).

90. As noted above, however, there are those in the Administration who are beginning to look more critically at the conglomerates.

VICES because the break-up of these institutions would allow for the growth and development of smaller, more specialized financial institutions. As will be explained below, this reform goal does accept the necessity of one of the proposals in the Plan, which is to empower a federal regulator to wind up the Tier 1 institutions. Following the discussion of this goal, this Part briefly emphasizes key disadvantages of the Plan's alternative reform approach of allowing the conglomerates to continue to exist as such while regulating them more.

A. The End of the Financial Conglomerate

The goal of reform should be to break up the financial conglomerates, given the unacceptable economic and social destruction that they cause, unless—what is unlikely—they can survive without government subsidies. The reform would have to include legislation that would undo, wholly or partially, the creation of the financial holding company that ratified the existence of the financial conglomerate. The legislation would separate the parts of a conglomerate with a deposit-taking function⁹¹ from many of the investment banking, insurance, financial instrument trading, and proprietary trading activities that have proven to add to the complexity and thus to pose the most danger to the conglomerates.⁹² It would give bank holding company status, and the benefits of Federal Reserve support that comes with it, only to institutions with this traditional banking focus. This legislation would thus return banking regulation to the pre-Gramm-Leach-Bliley situation of separate, often limited purpose financial institutions and would require financial regulators again to engage in line-drawing about the permissible functions of the regulated firms.⁹³ These restrictions and regulatory assertiveness, rather

91. Conglomerate parts with deposit-taking functions include banks or savings and loans, or the equivalent of consumer deposits in money market funds, and the government insurance that goes with them.

92. Naturally, this legislation would be complicated, for it would have to decide which financial activities (e.g., selling asset-backed securities) would be permissible to the new, restricted bank holding companies.

93. This proposal echoes those made by others (particularly Simon Johnson) who argue for a separation between “simpler” financial firms receiving government support and another financial sector that would not have this support, but would be regulated. *See, e.g.*, Mervyn King, Governor of the Bank of England, Address to Scottish business organizations at Edinborough, Scotland (Oct. 20, 2009), available at www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf; ALEXANDER G. HALDANE & PIERGIORGIO ALESSANDRI, BANKING ON THE STATE (Sept. 25, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech409.pdf>; Moss, *supra* note 88; Ingo Walter, *The New Case for Functional Separation in Wholesale Financial Services*, 30–31 (N.Y.U. Stern School Bus., Working Paper, 2009), available at

than market freedom in financial services as exemplified by risk-based capital regulation, are the price that must be paid for financial and economic stability.

Pending legislative change, financial regulators have the authority to impose onerous regulations upon financial conglomerates so that they will be forced to pay for the numerous kinds of support that they receive and for the risks that they create, and so that they will find themselves more restricted in their activities.⁹⁴ The purpose of this changed regulatory approach is to push the conglomerates to transform themselves. On the basis of their federal subsidies and the risks that the conglomerates pose to the financial system, the Federal Deposit Insurance Corporation (“FDIC”) would also impose a high deposit insurance premium on the institutions that receive FDIC insurance.⁹⁵ For similar reasons, the Treasury and federal financial regulators would impose higher fees for the conglomerates’ participation in the support programs for financial institutions, which include the guarantee on debt issued by the firms, and their participation in such programs as the Term-Asset Backed Loan Facility and the Public-Private Investment Partnership (which removes troubled loans and securities from the banks’ books).⁹⁶ Additionally, if financial regulators accept that it is difficult, if not impossible, to set adequate risk-based capital requirements “scientifically” for these conglomerates, given their complexity and the accompanying uncertainty about “tail risks,” regulators could impose a special capital charge on the conglomerates as a safeguard.⁹⁷ In other words, the financial conglome-

<http://ssrn.com/abstract=1442148>. *But see* CARMINE DI NOIA ET AL., KEEP IT SIMPLE: POLICY RESPONSES TO THE FINANCIAL CRISIS 75 (2009); Lawrence White, *Lesson From the Debacle of '07-'08 for Financial Regulation and Its Overhaul*, 21–22 (N.Y.U. Stern School Bus., Working Paper, 2008).

94. *See* 12 U.S.C. § 1844(e).

95. *See* 12 U.S.C. § 1817(b) (2010). The FDIC has relative freedom here since the assessments are risk-based, but it would have to deal with a statute that requires it not to discriminate among banks on the basis of their size. *See* 12 U.S.C. § 1817(b)(2)(D) (2010).

96. Many of the initiatives are discussed on the Dep’t of Treasury’s website. *See* U.S. DEP’T. OF THE TREASURY, FINANCIAL SECURITY FACT SHEET 1, <http://www.financialstability.gov/docs/fact-sheet.pdf>. *See also* James Fanto, *The Treasury’s Efforts to Jumpstart Small Business Lending and TALF*, 2009 EMERGING ISSUES 3399 (2009). For a discussion of the FDIC’s guarantee program of senior unsecured debt, *see* FDIC: *Temporary Liquidity Guarantee Program Frequently Asked Questions*, <http://www.fdic.gov/regulations/resources/TLGP/faq.html> (last visited Mar. 18, 2010). Again, it would be difficult to justify legally a complete restriction on the conglomerates’ participation in these programs.

97. This could be done through the imposition of a higher basic capital ratio, often known as a leverage ratio, that is set based on an institution’s assets, without any adjust-

rates would not be able to control the capital determination process through their own risk-based models. With the imposition of these measures, among others,⁹⁸ rather than being at the receiving end of numerous kinds of government support, the financial conglomerates would have to make significant payments for the privilege of their existence. This might well cause them to shrink in size.⁹⁹

The government's gradual withdrawal of support from the conglomerates and the imposition of more exacting regulations and capital charges upon them would likely result in a gradual break-up of the firms. In a worst case scenario, it would lead to a sell-off of the shares and debt of these institutions, when the market perceives that the conglomerates now have to pay for the government guarantee that they receive, and perhaps a collapse of the weakest among them.¹⁰⁰ As was seen in the financial crisis, there will likely be serious disruptions to the financial system, if one or more of the financial conglomerates fail without an orderly resolution process. This would suggest that the part of the Plan that is designed to give the Treasury, with the assistance of the Federal Reserve, the FDIC, and the SEC, the power to take over and wind up financial conglomerates that pose systemic risk should take precedence in financial reform.¹⁰¹ Again, from this Article's perspective, a special resolution regime for the conglomerates would only highlight their importance in the financial system. However, if, in effect, government regulation con-

ment for risk. *See, e.g.*, 12 C.F.R. § 3.6(b) (2009) (leverage ratio for national banks). On a special leverage ratio proposal, *see, e.g.*, FINANCIAL STABILITY BOARD, OVERVIEW OF PROGRESS IN IMPLEMENTING THE LONDON SUMMIT RECOMMENDATIONS FOR STRENGTHENING FINANCIAL STABILITY 5–6 (2009). Alternatively, a special capital charge for complexity and risk could be added to the capital amount determined through the risk-based capital process. *See* DI NOIA, *supra* note 93, at 58–60; OLIVER HART & LUIGI ZINGALES, A NEW CAPITAL REGULATION FOR LARGE FINANCIAL INSTITUTIONS 21–23 (Chicago Booth Working Paper No. 09-36, Sept. 2009).

98. Another measure would be to have financial conglomerates issue “contingent” debt, which could be transformed into equity in certain events (e.g., when a firm’s regulatory capital fell below a certain threshold). For a critical article on this concept, *see* Gillian Tett, *The Sweet Fix of CoCos?*, FIN. TIMES, Nov. 13, 2009.

99. As noted earlier, even the Treasury Secretary has announced support for this capital approach that would have this effect. *See, e.g.*, *Geithner Testimony*, *supra* note 61, at 3–4. *See also* TREASURY DEPARTMENT, PRINCIPLES FOR REFORMING THE U.S. AND INTERNATIONAL REGULATORY CAPITAL REQUIREMENTS FOR BANKING FIRMS 10–11 (2009) (supporting both a special capital assessment on large firms and the increased leverage ratio concept).

100. On the other hand, the market may perceive that the financial conglomerates, like industrial conglomerates, obscure the value of their parts, which would make break-ups financially attractive.

101. *See* A NEW FOUNDATION, *supra* note 2, at 76–78.

tributed to the creation of the conglomerates in the first place, it should be responsible for dealing with the fallout from their demise.¹⁰²

As a result of these reforms, we shall return to a time of smaller, more focused financial institutions. But this is likely to be for the better. For, then, the financial sector will be what it is supposed to be: a provider of capital raising, risk management, and other financial services to businesses and to consumers, rather than being rent seeking and economically and politically destabilizing.¹⁰³ It will also not be allowed continuously to produce crises that have destructive effects on the economy.¹⁰⁴

B. A Second Best Approach

One could, of course, argue that the above reform should not be attempted because of the threat to systemic stability. Financial institutions (and the economy) have just emerged from a crisis and remain in a precarious situation. It would therefore be foolhardy to trigger a new upheaval and potentially a recurrence of systemic risk. Therefore, it could be contended that it makes sense to pursue reforms that are incremental and thus less drastic than a break-up of financial conglomerates. This approach to reform would include many of those ideas proposed by the Plan and the implementing legislation, as discussed above. The Obama Administration appears to be taking this approach and to accept the conglomerates as a reality in finance. More recently, as also explained above, the Administration is taking a harder line on the conglomerates and contemplating that at least some of them could eventually be reduced in size and even eliminated.¹⁰⁵ From a pragmatic perspective, it wants the dismantling to happen gradually and in an orderly way.

The main problem with this approach, as attractive as it may seem in its pragmatism and middle-of-the-road quality, is that it is unlikely to reduce the influence of and thus the dangers posed by the financial conglomerates to the financial system, the economy, and the polity. As financial institutions and the financial system have stabilized, the conglomerates argue that no significant reforms to financial institutions are needed, because the crisis was due to external (i.e., exogenous) factors. Accordingly, they show their cooperation by agreeing to technical re-

102. This is not the place to discuss the resolution provisions of the bills moving through Congress. See H.R. 3126, 111th Cong. §§ 171–72 (2009); Restoring American Financial Stability Act, 111th Cong. §§ 201–10 (S. Banking Comm. 2009).

103. On the rent seeking of finance, see, e.g., Augar, *supra* note 17, at 204–21.

104. On the crises generated by the financial system, see the classic account by Hyman Minsky. See HYMAN P. MINSKY, *STABILIZING AN UNSTABLE ECONOMY* 77–106 (1986, rereleased 2008).

105. See *supra* notes 32, 65–67 and accompanying text.

forms, which arguably respond to regulatory lacunae revealed by the financial crisis. These are, for example, the Plan's enhancements to the Federal Reserve's oversight, risk management improvements, and revisions to capital standards. These reforms can be "sold" to the public as the necessary technological solutions for complex activities. They can also be politically satisfying to financial regulators and even legislators, who can then present themselves as responding to the crisis without directly confronting the power of the financial conglomerates. Moreover, it is likely that, rather than cynically protecting financial conglomerates, regulators and legislators believe that this is the best and most principled approach to take, for they have been indoctrinated by the ideology of finance.

The basic problem with this approach is that it gives the financial conglomerates the time to take control of the reform process. For example, in general they will likely agree to refinements to capital requirements for liquidity and other issues arising from the crisis. Yet reforms to capital alone still allow conglomerates considerable operational freedom and do not eliminate the dangers posed by their size and complexity. Since capital will remain risk-based and will be calculated on the basis of the firms' own risk models, they will ultimately control the capital determination, however much it is reformed (unless a high non-risk-based leverage ratio is imposed). Moreover, the ever increasing complexity of the products and activities engaged in by financial conglomerates plays into their hands when they are modeling their risk and determining their capital, since regulators cannot offer any credible alternatives to these models to evaluate the risks of a conglomerate's activities and investments. In sum, the catastrophic risks arising from the size of the firms and the complexities of their interconnected activities would not be addressed by this gradualist approach to reform. This result would argue for the alternative reform discussed in the preceding sub-Part, which is to break up the conglomerates as the only way to address their power and to eliminate the dangers posed by them.

CONCLUSION

In this Article, I have argued that the Plan maintains, and emphasizes the importance of, financial conglomerates engaged in a broad array of financial activities and would extend regulation to similar, but now unregulated, financial institutions like hedge fund groups, private equity firms, and insurance groups. The Article explained that the Plan is animated by an ideology of finance, which the major political parties and financial regulators have come to accept over the past three decades despite the economic and social destruction that finance has caused to the

country. It discussed how several features of the Plan—its enhancement of the Federal Reserve’s power, its proposed improvements to risk management and even the establishment of the CFPA—all reinforce the current dominance of financial conglomerates in our financial system. The Article then outlined an alternative reform approach that would have as its goal the breakup of these conglomerates, an approach that would demand legislation in the long term, but that could be undertaken now by financial regulators. The Article also argued that this reform would produce smaller, but less troubling, financial institutions. It finally contended that an alternative to this kind of reform, which would impose restrictions upon the conglomerates and eliminate the weaker of them—an approach now being espoused by the Obama Administration—would not eliminate the dangers that they pose, because the conglomerates would likely control regulations emerging from the reform, based as the regulations are on the conglomerates’ own risk models.

Several assumptions animate this Article. The first is that the financial conglomerates destabilize the financial system and the economy because they are involved in so many financial activities and have such interconnections with other firms that it is impossible for them to manage their risks effectively and thus to prevent dramatic spillovers and externalities into that system and the economy. A second, which has been alluded to but not explored at length, is that the conglomerates are also politically troubling because many of their activities have little to do with financing businesses and consumers, but with producing rents for themselves, and that they have thus contributed to significant economic disparities in the country, which are ultimately not conducive to a stable political system. It is therefore unfortunate that the Plan, and the Obama Administration, accept financial conglomerates as the status quo and appear, at least until recently, oblivious to their dangers and reluctant to rein them in. Therefore, additional crises generated by the conglomerates, likely even worse than the one we have just lived through, await us in the future, unless these institutions are broken up.

RETHINKING THE FUTURE OF SELF-REGULATION IN THE FINANCIAL INDUSTRY

*Saule T. Omarova**

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INTRODUCTION

In many respects, the global financial crisis of 2008–2009 marked the beginning of a new era. It forcefully demonstrated that today's financial markets pose extremely serious potential risks to every national economy as well as the entire global economic system. What started initially as tremors in the U.S. subprime mortgage market, in a matter of months, turned into a full-blown turmoil that nearly incapacitated the global financial system and resulted in massive economic and social dislocation in virtually every corner of the world.¹ It is hardly surprising, therefore, that the crisis brought to the forefront of the public policy debate the need for a fundamental reform of the existing system of regulation and supervision of the financial services sector. The objectives, scope, and elements of such wide-reaching financial regulatory reforms are at the heart of intense ongoing discussions among policy-makers, academics, and industry experts in the U.S.² and abroad.³

1. There is a vast and growing body of academic literature detailing the causes, timeline, and consequences of the recent financial crisis, in the context of specific countries, regions, or the international economy as a whole. *See, e.g.*, Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Legal and Economic Issues in Litigation Arising From 2007-2008 Credit Crisis* 1, 5 (Harv. L. Sch. John M. Olin Ctr. for Law, Economics and Business Discussion Paper, Paper No. 612, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096582; Yuliya S. Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, (Dec. 5, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396&rec=1&srcabs=1096582; Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 493 (2009); Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT. 10, 15 (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1320704.

2. *See, e.g.*, U.S. DEP'T OF TREAS., BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), available at <http://www.ustreas.gov/press/releases/report/blueprint.pdf>; Markus Brunnermeier, et al., *Fundamental Principles of Financial Regulation* ix (Int'l Ctr. for Monetary and Banking Studies, Prelim. Conf. Draft, Jan. 24, 2009), available at <http://www.voxeu.org/reports/Geneva11.pdf>; CONGRESSIONAL OVERSIGHT PANEL, MODERNIZING THE AMERICAN FINANCIAL REGULATORY SYSTEM: RECOMMENDATIONS FOR IMPROVING OVERSIGHT, PROTECTING CONSUMERS, AND ENSURING STABILITY (2009), available at <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf>; GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), available at http://www.group30.org/pubs/pub_1460.htm; U.S. GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM GAO-09-216 (Jan. 2009); U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf. On July 21, 2010,

Numerous proposals, coming from the official sector and various non-governmental sources in response to the crisis, have advocated regulatory reforms of differing magnitude.⁴ Such proposed reform measures generally range from a complete overhaul of the regulatory structure to more discrete steps aimed at regulating specific market products or segments.⁵ The majority of these proposals focus primarily on designing the structure of the regulatory and supervisory apparatus in the financial sector and reallocating functions among various government agencies overseeing financial markets. To the extent these proposals deal with substantive revisions to the existing regulatory scheme, they tend to focus on regulation of specific products or market participants, such as over-the-counter (“OTC”) derivatives or credit rating agencies, directly implicated in the crisis. Many substantive reform proposals seek to strengthen some of the existing regulatory tools, such as capital adequacy or liquidity requirements applicable to banks and other regulated financial institutions. Many proposals also call for closer and more effective coordination and cooperation among national financial regulatory and supervisory authorities and creation of transnational regulatory bodies whose primary task

President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which incorporated many of the ideas advanced in various reform proposals. See The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

3. For key proposals debated in the United Kingdom, see, e.g., HER MAJESTY’S TREASURY, REFORMING FINANCIAL MARKETS (2009), available at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf; FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL FINANCIAL CRISIS (2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

4. In July 2010, U.S. Congress passed the Dodd-Frank Act introducing significant changes in the existing system of financial sector regulation and supervision. See *supra* note 2. Although frequently referred to as the most sweeping financial sector reform in the United States since the New Deal, the Dodd-Frank Act leaves many fundamental policy issues to be resolved through the regulatory agencies’ action in implementing the statute’s broadly phrased mandates. See, e.g., Stacy Kaper, *Now for the Hard Part: The Top Five Challenges of Reg Reform*, AM. BANKER, July 22, 2010, available at http://www.americanbanker.com/issues/175_139/now-for-the-hard-part-1022715-1.html. This Article’s primary focus is not on the details of the Dodd-Frank Act, or any other specific legislative or regulatory proposal, but rather on the key trends in the broader debate on financial regulation reform in the aftermath of the recent financial crisis.

5. See *supra* note 2. For critical analyses of the key trends in the debate, see, e.g., Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009); Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009).

would be detection and prevention of systemic risk in the financial sector.⁶

These reform proposals tackle extremely important issues and contain a wide range of highly valuable and insightful ideas, some of which are incorporated into the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law by President Obama on July 21, 2010.⁷ However, despite the depth and diversity of current approaches to reform, neither the newly adopted U.S. reform legislation nor the broader theoretical discussions on the future of financial sector regulation address explicitly one vitally important issue: the role of industry self-regulation in the post-crisis world of finance.⁸ This Article seeks to cure this omission by bringing the problem of self-regulation into the focus of the ongoing policy debate.

The recent crisis has profoundly changed the face of the global financial industry. Some of the biggest players in the financial markets ceased to exist as independent enterprises,⁹ while others came perilously close to failure and had to be rescued by their governments.¹⁰ The public opinion

6. Systemic risk may be defined as a "risk that a disturbance will impair the efficient functioning of the financial system and, at the extreme, cause its complete breakdown." See Kimberly Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 IOWA J. CORP. L. 1, 47 (1997). For an in-depth treatment of the nature of systemic risk in the financial sector, see, e.g., Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

7. See *supra* note 2.

8. Recently, a few legal scholars began incorporating the notion of self-regulation in their reform proposals. See, e.g., Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777, 836 (2010) (proposing an industry organization comprising systemically important financial institutions and designed specifically to provide a cost-sharing mechanism in the event of a financial crisis); Kristin N. Johnson, *Things Fall Apart: Regulating Credit Default Swaps in the Battle of Man vs. the Gods of Risk* (March 16, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572467 (proposing an establishment of a self-regulatory organization focusing on the regulation of credit default swaps). However, these recent proposals tend to focus on specific areas of potential application of a more traditional concept of a self-regulatory organization rather than a broader shift in the paradigm of financial industry self-regulation.

9. The best-known examples in this respect are two venerable U.S. investment banks: Bear Stearns, which was acquired by J.P. Morgan, and Lehman Brothers, which was forced into bankruptcy in September 2008.

10. For instance, as a result of its bail-out efforts, the U.K. government currently owns more than 70% of shares in the Royal Bank of Scotland. See HM TREASURY, ROYAL BANK OF SCOTLAND: DETAILS OF ASSET PROTECTION SCHEME AND LAUNCH OF ASSET PROTECTION AGENCY (2009), available at http://www.hm-treasury.gov.uk/d/rbs_aps_apa.pdf. Similarly, as of April 2010, the U.S. government owned about 27% of Citigroup's stock. See *Treasury Plans First Citigroup Stock Sale*,

around the world turned decidedly anti-industry,¹¹ especially amid the revelations that the firms that received taxpayers' money to help them stay afloat granted their executives and traders lavish bonuses.¹² The prevailing theoretical and ideological paradigm, which viewed deregulation of financial activities and financial innovation as unconditionally beneficial,¹³ has been publicly discredited and lost its pre-crisis intellectual dominance.¹⁴ In light of these developments, it may seem counter-intuitive, if not outright misguided, to suggest that part of the solution is giving more regulatory power to the very industry that manufactured the crisis.

Nevertheless, this Article argues that any meaningful long-term regulatory reform in the financial services sector must seriously consider the potential role of industry self-regulation as a key mechanism of controlling and minimizing systemic risk. Industry self-regulation has two important potential advantages over both direct government regulation of the financial services sector and pure market-based regulatory mechan-

WASH. POST, April 26, 2010, available at <http://www.washingtontimes.com/news/2010/apr/26/treasury-plans-first-citigroup-stock-sale/>.

11. Matt Taibbi's famous quote describing Goldman Sachs as "a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money" provides one of the most vivid, albeit extreme, examples of the strong anti-industry public opinion. Matt Taibbi, *The Great American Bubble Machine*, THE ROLLING STONE, July 13, 2009, available at http://www.rollingstone.com/politics/story/29127316/the_great_american_bubble_machine/print.

In November 2009, Goldman Sachs CEO Lloyd Blankfein's ill-timed statement that he was "doing God's work" spurred a wave of small but vocal public protests around the country. See Kevin Sieff, *Protesters Lash Out at Goldman*, FIN. TIMES, Nov. 16, 2009.

12. Thus, in late 2009, it was reported that Goldman Sachs was setting aside \$16.7 billion for compensation in the first nine months of 2009, after earning record profits in a sharp rebound from financial turmoil. See Francesco Guerrera & Justin Baer, *Goldman Apologises for Role in Crisis*, FIN. TIMES, Nov. 17, 2009.

13. See, e.g., Peter Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008; Anthony Faiola, Ellen Nakashima & Jill Drew, *What Went Wrong*, WASH. POST, Oct. 15, 2008, at A1.

14. Thus, the former Chairman of the Board of Governors of the Federal Reserve System (the Federal Reserve), Alan Greenspan, perhaps the most famous proponent of this philosophy, publicly admitted its fundamental mistake in essentially assuming risks away. See Alan Greenspan, *We Will Never Have a Perfect Model of Risk*, FIN. TIMES, Mar. 16, 2008. Interestingly, a world-famous financier, George Soros, recently announced his decision to fund a new think tank whose mission would be to re-conceive the field of economics, which is too deeply entrenched in the free-market ideology. See Alan Rappeport, *Soros to Invest \$50m in Economic Think-tank*, FIN. TIMES, Oct. 27, 2009, available at <http://www.ft.com/cms/s/0/e45b353a-c2f3-11de-8eca-00144feab49a.html>.

isms. One such potential advantage is the industry's superior ability to access and assess, in a timely and efficient manner, the relevant market information. This informational advantage is critical to effective regulation of the increasingly complex financial markets and activities. The other potential advantage of private industry actors over government regulators is their ability to monitor and regulate their own business operations on a truly global basis, without regard to national borders and jurisdictional limitations. Financial globalization, which poses serious challenges for government agencies constrained by their formal jurisdictional mandates, makes a seamlessly integrated approach to regulating financial activities across national borders an indispensable condition for effective reduction of systemic risk.

However, in order to realize these potential advantages, the very foundation of the concept of self-regulation in the financial services industry has to be revisited. As this Article argues, the currently existing system of self-regulation in the U.S. securities industry falls far short of a model that fully utilizes the potential benefits of private industry regulation. The statutorily authorized system of securities self-regulatory organizations, or SROs, serves mainly as the means of delegating certain narrowly drawn governmental functions to the industry and occupies an awkward position between the government and private sector.¹⁵ The U.S. securities SROs were not designed to address effectively the issues of systemic risk control in today's financial markets.¹⁶ Accomplishing this goal by leveraging financial sector's self-regulatory potential requires a fundamental shift in the very paradigm of financial industry self-regulation, its purpose, scope, and the broader institutional context within which it operates.

As the first step in this direction, this Article argues for a new model of financial sector self-regulation, one that focuses explicitly on prevention of systemic failure and is firmly embedded in the broader public interests and policy goals. This new normative approach to self-regulation in the financial services sector—what this Article refers to as “embedded self-regulation”—seeks to redefine the broader social role of the private financial sector and impose the primary responsibility for guarding financial stability against excessive risks directly on the financial services industry that created them. Importantly, this approach recognizes that a strong and effective system of government regulation, which defines key policy objectives and monitors performance of self-regulatory institu-

15. See, e.g., Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151 (2008).

16. See *infra* Part III.A.

tions, is critical to the proper functioning of financial sector self-regulation. This Article argues that an effective model of embedded self-regulation should serve as an important supplement to the ongoing quest for an optimal design of the government regulation and supervision of financial institutions and activities.

This Article proceeds as follows. Part I sets broader theoretical context for further discussion by highlighting some of the key insights that the growing body of academic literature on New Governance has to offer with respect to the general nature of regulatory challenges in the 21st century. It also addresses some of the principal definitional issues in the ongoing academic debate on self-regulation. Part II shifts focus directly to self-regulation in the financial sector. It examines the rationale for the renewed importance of industry self-regulation in the wake of the recent global financial crisis and argues that financial sector self-regulation has significant potential benefits from the perspective of managing global systemic risk. Part III analyzes the limitations of the currently existing system of the U.S. securities SROs and proposes a new concept of “embedded self-regulation,” which represents a fundamental shift in the normative basis for self-regulation in the financial sector. Finally, the Article ends with brief concluding remarks.

I. NEW GOVERNANCE AND SELF-REGULATION

Self-regulation as a form of social organization has a long history, which can be traced back to religious fraternities and medieval merchant and trade guilds.¹⁷ In today’s world, self-regulatory regimes exist in a variety of different areas, including professional self-regulation in law and medicine, private accreditation and product certification schemes, and formal self-regulatory organizations in many industries. It is hardly surprising that, given the wide variety of self-regulatory institutions, the meaning of the term “self-regulation” defies simple definitions. This Part seeks to place the search for a new self-regulatory model in the financial sector in a broader intellectual and theoretical context by outlining the ongoing debate on New Governance approaches to regulatory issues. It also addresses some of the definitional and conceptual complexities in the academic debate on self-regulation.

17. See, e.g., SELF-REGULATION IN TODAY’S SECURITIES MARKETS: OUTDATED SYSTEM OR WORK IN PROGRESS? 1 (CFA Inst. Ctr. for Fin. Mkt. Integrity, 2007), available at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n7.4819>.

A. New Governance Theories: A Brief Overview

Legal scholars and social scientists working within the so-called New Governance paradigm have long recognized the fundamental inadequacy of a purely top-down, centralized state regulation of complex systems.¹⁸ Working across many academic disciplines and analyzing regulatory processes in various empirical settings,¹⁹ these scholars generally argue that the complexity and fluidity of informational flows in today's society pose insurmountable challenges to so-called command and control regulation.²⁰ Thus, one of the central criticisms aimed at the top-down regulatory approaches, whereby the government exercises full monopoly on making and enforcing the rules, is that the government "has insufficient knowledge to be able to identify the causes of problems, to design solutions that are appropriate, and to identify non-compliance (information failure)."²¹ In addition, the failings of the government regulation include the inability to design appropriately sophisticated and effective legal and policy instruments to address complex social problems (instrument failure), inadequate implementation of the rules (implementation failure), and failure to motivate the regulated entities and individuals to comply with the rules (motivational failure).²²

While these criticisms are often directed at what may be viewed as a caricature of direct government regulation, rather than a far more complex reality of how state and non-state actors interact in making and implementing rules and regulations,²³ they bring home a fundamentally important point. Relying on the government as the sole source of regulation applicable to complex systems, including the global financial system,

18. See e.g., Orly Lobel, *The Renew Deal; The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004). For a cross-disciplinary review of New Governance scholarship, see Scott Burris, Michael Kempa & Clifford Shearing, *Changes in Governance: A Cross-Disciplinary Review of Current Scholarship*, 41 AKRON L. REV. 1 (2008).

19. For a recent overview of the governance scholarship across various academic disciplines, see VASUDHA CHHOTRAY & GERRY STOKER, *GOVERNANCE THEORY AND PRACTICE: A CROSS-DISCIPLINARY APPROACH* (2009).

20. The term "command and control regulation" generally denotes a strictly centralized system of government rule-making and enforcement. See, e.g., Darren Sinclair, *Self-Regulation Versus Command and Control? Beyond False Dichotomies*, 19 LAW & POL'Y 529, 531-32 (1997).

21. Julia Black, *Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a "Post-Regulatory" World*, 54 CURRENT LEGAL PROBS. 103, 106 (2001).

22. *Id.*

23. The New Governance scholarship generally recognizes that a pure form of command and control regulation does not exist in practice, much like there is no pure form of complete private industry self-regulation. See, e.g., Sinclair, *supra* note 20, at 531-32.

suffers from the important built-in handicaps of informational asymmetry and expertise deficit. These handicaps are likely to render financial regulation inherently reactive, rather than proactive, and thus incapable of addressing financial systemic risk *ex ante*, as opposed to trying to remedy it *ex post*.

The New Governance scholars seek to understand how regulatory decisions are made in practice and how both power and responsibility are allocated among different public and private actors interacting in real life. One of the key insights of this school of thought is the realization that regulation is a multi-layered process that takes place on many different levels and in many different fora.²⁴ It recognizes that technological progress and advances in communication fundamentally change the very context in which regulation operates by creating a new demand for openness and encouraging self-regulation by private actors empowered to act collectively and to form norm-generating institutions.²⁵

However, it is important to emphasize that the New Governance scholars do not simply advocate dismantling the regulatory state in favor of free market and purely private mechanisms of social ordering.²⁶ Proponents of the New Governance approach view the world as a complex, dynamic, and intricately interconnected system in which multiple governmental and non-governmental forces constantly negotiate, and renegotiate, the boundaries between public and private spheres of economic and social life.²⁷ In this world, the key objective of the regulatory state is not to control the regulated by imposing externally generated rules on them but to “harness[...] private capacity to serve public goals.”²⁸

This Article seeks to build upon this general approach as it examines the concept of self-regulation and its potential role in the post-crisis financial regulation reform.

24. Black, *supra* note 21, at 108.

25. Lobel, *supra* note 18, at 359–60.

26. See, e.g., Lobel, *supra* note 18, at 468 (“There is a tendency to equate shifts from top-down regulation with deregulation, privatization, and devolution. The new governance paradigm resists this dichotomized world and requires ongoing roles for government and law.”).

27. See, e.g., Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 548 (2000) (proposing an “alternative conception of administration as a set of negotiated relationships” whereby “public and private actors negotiate over policy making, implementation, and enforcement.”).

28. *Id.* at 549.

B. Self-Regulation in Academic Debate: A Multi-Faceted Concept

To the extent self-regulation denotes devolution of regulatory authority to private industry actors, it can be viewed as a particular form, or an element, of a broader model of New Governance. However, because the concept of self-regulation is both deceptively simple and heavily normatively loaded, it is worth examining its meaning and boundaries in some detail.

Policy-makers and academics debating the pros and cons of self-regulation frequently equate that concept with “deregulation” and directly juxtapose it to the concept of government regulation of private economic activities. Both the staunchest proponents and the most adamant opponents of self-regulation often share this fundamental view of self-regulation and regulation as mutually exclusive alternatives.²⁹

Supporters of the idea of self-regulation by market actors claim that it offers significant advantages over direct government regulation. They tend to stress that self-regulation is considerably more flexible and context-driven. Because private entities actively participating in the regulated market activities are able to respond faster and better to the changes in market conditions, self-regulation is said to be inherently more efficient, less costly, and less complicated than government regulation. From this perspective, self-regulation exemplifies a regulatory approach that is “responsive, flexible, informed, targeted, which prompts greater compliance, and which at once stimulates and draws on the internal morality of the sector or organization being regulated.”³⁰ Importantly, the advocates of self-regulation emphasize its potential for fostering shared values among private actors, cultivating their sense of ownership and participation in the rule-making process reflecting those values, and facilitating voluntary compliance with the resulting rules.

The skeptics, on the other hand, view self-regulation as fundamentally “self-serving, self-interested, lacking in sanctions, beset with free rider problems, and simply a sham.”³¹ The critics argue that private profit-seeking enterprises cannot be trusted to regulate their own activities in a manner conducive to promotion of publicly desirable goals. From this perspective, private industry self-regulation is unlikely to amount to anything more than a mere smokescreen intended to create an illusion of

29. The ideological content and rhetoric of self-regulation can also influence the practical policy decisions with respect to regulatory design. *See, e.g.*, JULIA BLACK, RULES AND REGULATORS 1, 46–80 (1997) (discussing the role of political rhetoric in the actual design of the self-regulatory system set up in the U.K. under the Financial Services Act 1986).

30. Black, *supra* note 21, at 115.

31. *Id.*

regulation. In addition to the deeply seated conflict of interest, the opponents of self-regulation point to its inherent inefficiencies, including widespread collective action problems, lack of effective enforcement capabilities, inability of self-regulatory organizations to gain or maintain legitimacy, and, ultimately, the failure of accountability.³²

Despite the powerful rhetoric both for and against self-regulation, the concept itself lacks definitional clarity. In practice, there are many different forms of self-regulatory arrangements and institutions, depending on the specific context in which they evolve.³³ Partially as a reflection of this reality, participants in theoretical and policy debates often employ different definitions of self-regulation, both in a positive and a normative sense. Thus, self-regulation is often used interchangeably with terms, such as “self-governance,” “collaborative governance,” “negotiated governance,” “co-regulation,” “voluntarism,” “private regulation,” “soft law,” “quasi-regulation,” “enforced self-regulation,” “communitarian regulation,” and so on. Each of these terms places the emphasis on a particular characteristic that arguably distinguishes true “self-regulation” from direct government regulation: the purely voluntary nature of regulation, the concentration of rule-making authority solely in the hands of non-governmental actors, or the non-binding or non-legal nature of the rules themselves.³⁴

Many of these concepts attempt to overcome the one-sidedness of the traditional dichotomy between regulation and self-regulation and introduce various hybrid solutions combining self-regulatory mechanisms with some degree of government involvement or oversight. These more sophisticated accounts view “command and control” and self-regulation as extreme points on a single regulatory continuum, with the majority of real-life regulatory regimes falling somewhere between them.³⁵ For example, an increasingly popular notion of “co-regulation” envisions a system in which the public agencies and private market actors cooperate in

32. According to one such critic, “Self-regulation is frequently an attempt to deceive the public into believing in the responsibility of a[n] irresponsible industry. Sometimes it is a strategy to give the government an excuse for not doing its job.” John Braithwaite, *Responsive Regulation in Australia*, in *BUSINESS REGULATION AND AUSTRALIA’S FUTURE* 91 (Peter Grabosky & John Braithwaite eds., 1993).

33. For example, various self-regulatory or public-private regulatory arrangements exist in such diverse fields and sectors of the economy as nuclear power industry, chemical manufacturing, healthcare, food safety, occupational safety, labor regulation, environmental compliance, and corporate governance.

34. Black, *supra* note 21, at 116–117.

35. See Robyn Fairman & Charlotte Yapp, *Enforced Self-Regulation, Prescription, and Conceptions of Compliance within Small Businesses: The Impact of Enforcement*, 27 *LAW & POL’Y* 491, 492 (2005).

the creation, implementation, and enforcement of rules.³⁶ According to the proponents of the co-regulation model, Co-regulation is an approach in which a mixture of instruments is brought to bear on a specific problem [...] typically involving both primary legislation and self-regulation or, if not self-regulation, at least some form of direct participation of bodies representing stakeholders in the regulatory decision-making process. Co-regulation aims to combine the advantages of the predictability and binding nature of legislation with the flexibility of self-regulatory approaches.³⁷

Another popular approach, “enforced self-regulation,”³⁸ advocates a system under which private businesses are required to assess, monitor, and regulate the risks they create, while the government enforces such privately made rules alongside with its enforcement of the direct administrative rules and regulations.³⁹ In this regime, the government places the key responsibility for risk management directly on individual private entities, which results in a fundamental shift in the focus of the government’s enforcement activity from discovering instances of non-compliance with specific rules toward assessing the firms’ internal compliance and risk management systems. Importantly, however, enforced self-regulation generally “differs from true self-regulation in that the standards to be achieved are determined by the regulator and not from within the industry.”⁴⁰

Even when scholars seem to agree on the definitional boundaries of self-regulation setting it apart from other forms of regulatory arrangements, such as co-regulation or enforced self-regulation, they often part company when it comes to drawing more subtle internal distinctions among different kinds of self-regulation. Once again, multiple typologies of self-regulation developed in the academic literature reflect the wide

36. See, e.g., Marian Garcia Martinez, et al., *Co-regulation as a Possible Model for Food Safety Governance: Opportunities for Public-private Partnerships*, 32 FOOD POL'Y 299 (2007); Edward Balleisen, *The Prospects for Effective Coregulation in the United States: An Historian's View from the Early Twenty-First Century*, in GOVERNMENTS AND MARKETS: TOWARD A NEW THEORY OF REGULATION 443 (Edward Balleisen & David Moss eds., 2009).

37. Martinez et al., *supra* note 36, at 302.

38. The term “enforced self-regulation” was coined by John Braithwaite. See John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 U. MICH. L. REV. 1466 (1982). Braithwaite’s concept of “enforced self-regulation” is an integral part of the famous pyramidal regime of so-called “responsive regulation.” See IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992).

39. See Fairman and Yapp, *supra* note 35, at 493.

40. *Id.*

variety of real-life self-regulatory arrangements and their highly context-sensitive nature. Generally, however, social scientists and legal academics tend to distinguish between systems of “voluntary” self-regulation, characterized by the absence of direct government intervention; “sanctioned” self-regulation, in which private actors formulate rules subject to government approval; and “mandated” self-regulation, in which private actors are required by the government to establish a self-regulatory framework.⁴¹

Another important nuance in the debate on self-regulation involves the choice of the main unit of analysis. Some authors examine self-regulatory arrangements and techniques on an individual entity level,⁴² as is often the case in the field of corporate governance or compliance with environmental regulations, while others focus on self-regulation at a variety of broader levels of collectivity—an industry, a region, or an administrative unit.⁴³

While resolving these definitional issues is beyond the scope of this Article, even the most cursory overview of the ongoing debate on the meaning and variety of self-regulation is helpful in framing the inquiry into the basic nature of a potentially desirable self-regulatory regime in the financial services sector. However, the threshold question in this respect is why, as a general matter, self-regulation may potentially be a valuable mechanism of financial sector regulation.

II. AFTER THE CRISIS: A NEW RATIONALE FOR SELF-REGULATION IN THE FINANCIAL SECTOR?

This Part focuses on the concept of self-regulation in the financial services sector and argues that redefining that concept should be a key element of our post-crisis quest for an optimal regulatory framework geared toward preventing future financial meltdowns.

41. See, e.g., Black, *supra* note 21, at 118–19; Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 *LAW & POL’Y* 363, 364–66 (1997). Some of the more granular typologies also refer to “accredited” self-regulation, in which privately established rules are accredited by another private body (such as, e.g., a technical committee); “verified” self-regulation, in which third parties (auditors, NGOs, labor unions, etc.) monitor compliance with the rules; “partial” self-regulation, in which private sector engages only in rule-making; or “full” self-regulation, in which both rule-making and enforcement are privatized. *Id.*

42. Some scholars refer to intra-firm self-regulatory activity as “management regulation.” See Cory Coglianese & David Lazer, *Management-Based Regulation: Prescribing Private Management to Achieve Public Goals*, 37 *LAW & SOC’Y REV.* 691 (2003).

43. See Black, *supra* note 21, at 120–21; Gunningham & Rees, *supra* note 41, at 364.

A. Financial Crisis and Regulatory Reform: A Brief Outline of the Debate

The recent global financial crisis brought the issues of long-term regulatory reform into the center of public debate in the U.S., as well as in other countries. Not surprisingly, in the past two years, academics and policy-makers advanced numerous proposals for reforming financial sector regulation. These proposals, ranging from abstract ideas to drafts of actual laws and regulations, address in a variety of ways the fundamental issue of translating the lessons of that last crisis into regulatory mechanisms designed to minimize the chances of similar crises in the future.⁴⁴ Responding to the mounting political pressure, lawmakers and government agencies around the world are presently working on legislative and regulatory reform packages, which reflect many of the ideas advanced in these proposals.⁴⁵ One of the key milestones in this process was the recent passage of the Dodd-Frank Act introducing major changes to the U.S. financial sector regulation.⁴⁶

However, even the successful adoption of wide-ranging financial reform legislation in the U.S., despite its undeniable importance, is unlikely to provide perfect solutions to main regulatory dilemmas and end the broader debate on the future of financial sector regulation and supervision.⁴⁷ Leaving aside the gaps and ambiguities in the new law, it is important to remember that financial regulation reform in the era of rapid technology-driven innovation is an inherently dynamic phenomenon. Conceptually, it should be viewed as an ongoing intellectual enterprise, a process of continuous collective deliberation and exchange of ideas, rather than a static set of rules enacted into law at any particular point. Effective prevention of financial crises and containment of systemic risk in the increasingly complex global financial markets will continue to be a

44. *See supra* notes 2–3.

45. Thus, the European Union is currently in the process of restructuring its system of overseeing financial institutions and setting up new European regulators with enhanced institutional capabilities and powers. *See, e.g.*, COMMISSION OF EUROPEAN COMMUNITIES, COMMUNICATION FROM THE COMMISSION: EUROPEAN FINANCIAL SUPERVISION (2009), available at http://ec.europa.eu/internal_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.

46. *See supra* note 2.

47. One of the key criticisms of the Dodd-Frank Act is its deliberate vagueness and failure to resolve many fundamentally important policy issues, leaving them instead to the discretion of implementing agencies. Thus, according to some estimates, the statute mandates that regulators enact 243 new rules, conduct 67 one-time studies and submit 22 periodic reports. This approach creates a great deal of uncertainty as to the ultimate effect of the reform. *See Kaper, supra* note 4.

moving target for regulators and policy-makers. The insights and approaches developed in today's discussions will continue to shape the search for more effective long-term policy solutions that go beyond the current legal and regulatory changes. From this perspective, mapping out the principal trends in the current debate on the form and substance of the financial sector regulation and identifying some of the key themes running through most of the recent proposals is an important step toward understanding potential gaps in this ongoing process.⁴⁸

The first unifying characteristic of the current debate on financial regulation reform is the strong focus on the structure, functions, and jurisdictional boundaries of regulatory agencies overseeing the financial services sector. Despite the vastly different substantive approaches to these issues, nearly all major proposals for redesigning financial regulation concentrate heavily on such issues as the role and organizational form of a regulatory agency directly charged with monitoring and prevention of systemic financial risk,⁴⁹ the proper role of central banks vis-à-vis prudential regulatory and supervisory bodies,⁵⁰ and creation of institutional mechanisms for stronger protection of retail investors and consumers of financial services.⁵¹ An important part of the discussion concerns the

48. For an analysis of some of the key trends in the reform debate, see also Cunningham & Zaring, *supra* note 5; Omarova & Feibelman, *supra* note 5.

49. While nearly all reform proposals seem to accept the need for a regulatory body charged with systemic risk oversight, there is some disagreement as to the form of such a regulator. In the U.S., the main debate centered around proposals to assign this function to the Federal Reserve, to a newly established separate federal agency, or a council comprising representatives of financial regulators. See, e.g., Roberta S. Karmel, *The Controversy Over Systemic Risk Regulation*, 35 BROOK. J. INT'L L. 823 (2010) (discussing in detail different approaches to the issue of systemic risk regulation). The Dodd-Frank Act mandates the establishment of the interagency Financial Stability Oversight Council, which will work closely with the Federal Reserve to monitor and minimize systemic risk.

50. The debate about whether or not central banks should perform regulatory and supervisory functions, in addition to their traditional monetary policy duties, is hardly a new one. In the post-crisis era, this issue was replayed not only in the context of the debate over the Federal Reserve's role in overseeing financial institutions, but also with respect to potential reallocation of regulatory and supervisory powers between the United Kingdom's Financial Services Authority ("FSA") and the Bank of England. See, e.g., Brooke Masters & George Parker, *Osborne Promises Caution Over FSA Reform*, FIN. TIMES, Sept. 9, 2009, available at www.ft.com/cms/s/ae5477a4-9d6d-11de-9f4a-00144feabdc02.html2.ncllick_check=1. On June 16, 2010, Chancellor Osborne announced his decision to abolish the FSA and transfer its bank regulatory and supervisory powers to the Bank of England. See, e.g., George Parker & Brooke Masters, *Osborne Abolishes FSA and Boosts Bank*, FIN. TIMES, June 16, 2010, available at <http://www.ft.com/cms/s/0/0203b99e-797f-11df-b063-00144feabdc0.html>.

51. Thus, creation of the new federal regulatory authority specifically dealing with consumer protection in the financial services sector has been at the center of an intense

formation of a new resolution authority that would be in charge of orderly unwinding of financial conglomerates falling outside the jurisdictional reach of any of the existing resolution authorities in the financial sector.⁵² In the U.S., the debate on specific regulatory structure also involves issues of consolidating multiple regulators in banking, securities, and commodities futures sectors,⁵³ introducing federal regulation of insurance industry,⁵⁴ and redefining the general balance of state and federal regulatory powers with respect to the provision of financial services.⁵⁵

debate among policy-makers, academics, and industry lobbyists in the U.S. *See, e.g.*, CONGRESSIONAL OVERSIGHT PANEL, *supra* note 2, at 34–37 (discussing potential alternatives for creation of a new consumer financial protection regulator); U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 55–70 (proposing the creation of the Consumer Financial Protection Agency). The Dodd-Frank Act mandates the creation of an independent Bureau of Consumer Financial Protection within the Federal Reserve, a result of political compromise reached in Congress after a prolonged battle over this issue.

52. The failure of Lehman Brothers, a major U.S. investment bank with worldwide assets and liabilities, has forcefully underscored the importance of regulatory coordination, and ideally preventive intervention, not only across geographic borders but also across sectoral and entity lines. In the wake of the crisis, many reform proposals focused on the need to allocate the authority to resolve large financial conglomerates to a single regulatory agency, such as the Federal Reserve, the Federal Deposit Insurance Corporation (“FDIC”), or a newly established separate resolution authority. The Dodd-Frank Act generally grants the FDIC new resolution authority over a broad range of financial institutions.

53. The U.S. federal system of regulation and supervision of the financial services sector is highly fragmented, with the regulatory authority split among five different agencies overseeing depository institutions (the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, and the National Credit Union Administration), the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (“CFTC”). Over the years, numerous proposals called for reducing the number of financial regulators by merging some or all of them. *See, e.g.*, U.S. GOV. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: INDUSTRY TRENDS CONTINUE TO CHALLENGE THE FEDERAL REGULATORY STRUCTURE GAO-08-32 (Oct. 2007). In the current debate, various proposals approached this issue in differing ways. *See, e.g.*, U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 32 (proposing the creation of a single National Bank Supervisor overseeing all federally-chartered banks). By contrast, the Dodd-Frank Act calls only for the elimination of the Office of Thrift Supervision (“OTS”).

54. One of the peculiar features of the U.S. system of financial regulation is that insurance industry is regulated and supervised by individual states. Numerous reform proposals over the years advocated the creation of a federal insurance charter and establishing a federal insurance regulator. *See, e.g.*, U.S. DEP'T OF TREAS., BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE, *supra* note 2, at 128–29 (proposing an optional federal insurance charter and the creation of the Office of National Insur-

Another important general theme running through the current debate on regulatory reform is regulatory oversight of presently unregulated, or under-regulated, financial markets and institutions. It is now common wisdom that one of the main causes of the recent crisis was the uncontrolled accumulation of financial risk in the so-called “shadow banking system” that operated entirely outside any governmental supervision.⁵⁶ To remedy this situation, many proposals call for introduction of some form of direct government regulation and supervision of OTC derivatives markets, as well as hedge funds and other private investment vehicles.⁵⁷ Similarly, many proposals seek to subject mortgage brokers and credit ratings agencies to greater oversight.⁵⁸

The third line of proposed reforms aims at strengthening certain existing rules and regulations and enhancing the quality of enforcement and compliance. One of the most prominent issues in this area involves revision of the current capital adequacy regime for banks and other financial

ance). The Dodd-Frank Act leaves the existing structure of insurance regulation largely intact.

55. Thus, one of the critical issues in the ongoing debate on bank regulation is the extent of federal preemption, especially with respect to states’ power to enforce their consumer protection laws in connection with national banks’ operations. *See, e.g.*, *Watters v. Wachovia Bank*, 550 U.S. 1 (2007) (holding that state authorities are precluded from enforcing states’ licensing, registration, and inspection laws against state-chartered subsidiaries of national banks); *Cuomo v. Clearing House Ass’n, LLC*, 129 S. Ct. 2710 (2009) (upholding states’ authority to seek judicial enforcement of applicable state laws against national banks).

56. For one of the early attempts to argue that the unchecked growth of the “shadow banking system” was at the core of the growing problems in the financial services sector, see Timothy F. Geithner, Remarks at the Economic Club of New York, Reducing Systemic Risk in a Dynamic Financial System, (June 9, 2008), *available at* <http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html> (referring to the expansion of a “parallel financial system” vulnerable to runs and other increased risks).

57. *See, e.g.*, U.S. DEP’T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 46–49. In the second half of 2009, proposals seeking to move the majority of OTC derivatives trading onto organized exchanges and to mandate centralized clearing for such instruments garnered a significant momentum and generated general support among policy-makers and financial institutions. The Dodd-Frank Act explicitly incorporated these proposals.

58. *See, e.g.*, U.S. DEP’T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 46; CONGRESSIONAL OVERSIGHT PANEL, *supra* note 2, at 7. *See also* Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective* (Univ. of San Diego Sch. of Law, Legal Studies Research Paper Series, 2009), *available at* <http://ssrn.com/abstract=1430608>; Cassandra Jones Havard, “Goin’ Round in Circles”... *And Letting the Bad Loans Win—When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV. 737 (2008).

institutions as a way to limit their leverage, enhance liquidity, and better align their capital with their actual risk profiles.⁵⁹ Another important topic that falls under the same broad rubric is the proposed creation of an enhanced regulatory and supervisory oversight of financial institutions deemed to be of systemic importance—so-called “systemically important financial institutions,” or SIFIs.⁶⁰

Finally, a significant recurring theme in the reform debate relates to the perceived need to strengthen global regulatory and supervisory cooperation and coordination of efforts to monitor cross-border markets and activities for potential accumulation of systemic risk and to adopt measures to deal with such risk effectively and on a timely basis.⁶¹ Although the critical importance of international aspects of regulatory reform is widely acknowledged, there is little clarity or consensus on the specific measures that would be both effective and politically feasible in resolving the deep underlying problems of sovereignty and national differences in regulatory approaches.⁶²

Many of the recently advanced regulatory reform proposals combine, in various ways, these key themes and offer highly valuable analytical insights and potential solutions to perceived problems. Nevertheless, the overall discussion of financial regulation reform seems excessively preoccupied with the issues of regulatory structure and architecture. With respect to substantive changes in legal and regulatory frameworks, the prevailing tendency is to focus debate on specific market products or actors directly implicated in the recent financial crisis. In pursuit of concrete, politically viable solutions to identifiable problems, the majority of approaches to regulatory reform tend to lose sight of the fundamental problems that such reforms ultimately seek to address. Characteristically,

59. See, e.g., U.S. GOV. ACCOUNTABILITY OFFICE, FINANCIAL MARKETS REGULATION: FINANCIAL CRISIS HIGHLIGHTS NEED TO IMPROVE OVERSIGHT OF LEVERAGE AT FINANCIAL INSTITUTIONS AND ACROSS SYSTEM, GAO-09-739 (July 2009).

60. See, e.g., U.S. DEP'T OF TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, *supra* note 2, at 51–54; CONGRESSIONAL OVERSIGHT PANEL, *supra* note 2, at 7; Brunnermeier, et al., *supra* note 2, at 24. The Dodd-Frank Act vests the power to identify systemically important financial institutions in the newly created Financial Stability Oversight Council but leaves it largely to the Federal Reserve to determine how such institutions are to be regulated and supervised.

61. See, e.g., GROUP OF THIRTY, *supra* note 2; FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW, *supra* note 3.

62. For a general overview of some of the key issues in this area, see, e.g., Douglas W. Amer & Michael W. Taylor, *The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of the International Financial Regulation?*, 32 U.N.S.W.L.J. 488 (2009).

none of the mainstream reform proposals has addressed explicitly the future of industry self-regulation as part of the long-term regulatory transformation in the financial services sector.

B. Potential Benefits of (Reinventing) Financial Sector Self-Regulation

As the recent financial crisis demonstrated, the most fundamental problems that a truly effective regulatory reform must address are the increasing complexity of financial markets and activities and their global reach.⁶³ The unprecedented speed with which the tremors in the U.S. subprime mortgage market spread worldwide exposed the fundamental vulnerabilities of the global financial system, including the ways in which numerous institutions and investors are intimately interconnected through a web of complex financial transactions and risk exposure.⁶⁴ The widespread use of complex financial instruments also greatly contributed to the dangerously high levels of leverage accumulated throughout the system.⁶⁵ Thus, in the post-crisis world of finance, the ability of regulatory authorities to detect and prevent, or at least minimize, systemic risk depends ultimately on their ability to manage the complexity and global nature of financial products, institutions, and activities.⁶⁶

This view of the financial crisis leads to two general conclusions. The first conclusion relates to the centrality of information flow to regulatory

63. See Saule Omarova, *The New Crisis for the New Century: Some Observations on the "Big-Picture" Lessons of the Global Financial Crisis of 2008*, 13 N.C. BANKING INST. 157 (2009).

64. The general issue of regulating complex systems is a fascinating and growing academic field. For some examples of these scholarly analyses, see, e.g., Donald T. Hornstein, *Complexity Theory, Adaptation, and Administrative Law*, 54 DUKE L.J. 913 (2005); Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211 (2010).

65. Thus, one of the key examples in this respect is the central role that trading in credit derivatives played in the near-failure and the resulting bailout of American International Group ("AIG"). See, e.g., Hugh Son & Zachary R. Mider, *AIG Rescue May Include Credit-Default Swap Backstop*, BLOOMBERG.COM, FEB 26, 2009. For a scholarly analysis of the AIG saga, see William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009).

66. The role of derivatives in creating or exacerbating the recent financial crisis is a complicated and hotly debated issue. See, e.g., Lynn Stout, *How De-Regulating Derivatives Led to Disaster, and Why Re-regulating Them Can Prevent Another*, LOMBARD STREET, Vol. 1, No. 7, at 4 (July 6, 2009), available at www.finreg21.com/system/files/Lombard+Street+-+Volume+1+Issue+7.pdf; Rene M. Stulz, *Credit Default Swaps and the Credit Crisis* (Eur. Corp. Governance Inst., Fin. Working Paper No. 264/2009, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1475323 (arguing that credit default swaps did not cause the credit crisis of 2007-2008).

success. It is clear that the key to managing an increasingly complex financial system is timely access to, and ability to process, relevant market information. In a world driven by the never-ending quest for faster and more sophisticated technology, it is critically important that financial regulators maintain their capacity to monitor, identify, evaluate, and promptly respond to the risks and challenges presented by the increasingly complex financial instruments and trading strategies.⁶⁷ The second observation concerns the effect of financial globalization on regulatory capacity. In today's increasingly interconnected and globalized financial markets, national governments face serious challenges in their efforts to regulate and supervise internationally active financial institutions. Monitoring cross-border financial activities and enforcing compliance with any single country's laws and regulations is a particularly delicate and complex political task because it raises numerous issues of state sovereignty and extraterritoriality. In the world of sovereign nation-states, national regulators' limited jurisdiction over financial matters is increasingly inconsistent with the seamlessly integrated cross-border operations of modern financial institutions. Despite the ongoing efforts to implement various forms of international coordination and market oversight,⁶⁸ this inherent limitation on regulatory capacity continues to com-

67. See, e.g., Henry T.C. Hu, *Misunderstood Derivatives: The Causes of International Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993); Schwarcz, *supra* note 64.

68. One of the best-known and studied examples of such efforts to institutionalize international regulatory coordination and harmonization is the international capital adequacy accord promulgated by the Basel Committee on Banking Supervision ("BCBS"), an organization comprising heads of central banks and bank supervisors from different countries. For more information on the BCBS and Basel capital adequacy regime, see About the Basel Committee, <http://www.bis.org/bcbs> (last visited Aug. 7, 2010). Another example of international cooperation in the area of monitoring and enforcing compliance by individual countries with various internationally adopted standards is the Financial Sector Assessment Program ("FSAP") established by the International Monetary Fund ("IMF") and the World Bank. For an analysis of the activities of, and challenges faced by, FSAP since its inception in the late 1990s, see THE FINANCIAL ASSESSMENT PROGRAM AFTER TEN YEARS: EXPERIENCE AND REFORM FOR THE NEXT DECADE (International Monetary Fund and The World Bank, 2009), available at <http://www.imf.org/external/np/pp/eng/2009/082809B.pdf>. However, despite their successes in addressing a variety of specific regulatory issues arising in the global financial marketplace, there remain important limitations on these institutions' ability to provide lasting and universal solutions to the underlying problems of effective regulation and supervision of global and increasingly complex financial markets and institutions. These institutions generally operate through non-mandatory, legally non-binding arrangements dubbed as "soft law." See generally, ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER (2004); David Zaring, *Informal Procedure, Hard and Soft*, in *International Administration*, 5 CHI. J. INT'L L. 547 (2005). Developing these regulatory norms and monitoring

plicate the detection and prevention of risk to the entire global financial system and broader economy.⁶⁹

These two general observations make it clear that, in order to be able to avoid systemic crises in the future, any reform of the financial sector regulation must address two fundamental issues: (1) assuring timely access to, and analysis of, key market information; and (2) regulating and monitoring financial activities and risks on a truly global, cross-border basis. This Article argues that industry self-regulation, as a form of regulatory intervention into the economy distinct from both direct government regulation and pure market discipline, holds significant promise in terms of addressing these challenges.

It is important to emphasize from the outset that industry self-regulation cannot, and should not fully replace government regulation and supervision of the financial services sector. Government oversight is crucial to ensuring that private financial activity promotes, or at least is consistent with, the broader public interest.⁷⁰ Learning the difficult les-

their implementation is of necessity a heavily negotiated, highly politicized and complex process, and the reach of these institutions is limited. For a recent scholarly discussion of the dilemmas and limitations of international financial regulation, see Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. (forthcoming 2010).

69. Thus, in response to the global financial crisis in 2008-2009, the governments of the Group of Twenty (G-20) began focusing on greater coordination of their regulatory and supervisory activities and called for a number of measures aimed at creating an institutional structure for overseeing financial markets across borders. GROUP OF TWENTY (G-20), DECLARATION SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY, Nov. 15, 2008, available at http://www.g20.org/Documents/g20_summit_declaration.pdf. One related proposal envisions an establishment of so-called cross-border supervisory "colleges" in charge of supervising individual financial conglomerates with operations in multiple countries. The G-20 leaders called for redefining the role of the International Monetary Fund as a *de facto* global "lender of last resort" monitoring financial stability on international level. Larry Wall, et al., *Creating an EU Level Supervisor for Cross-Border Banking Groups: Issues Raised by the U.S. Experience with Dual Banking* (unpublished manuscript, presented at Federal Reserve Bank of Dallas Conference, EU Economic Integration: Lessons of the Past, and What Does the Future Hold?, Mar. 18, 2010), available at www.dallasfed.org/institute/events/2010/10eu_mayes.pdf. The G-20 has also reinvented the existing Financial Stability Forum as the Financial Stability Board ("FSB"), a newly bolstered international regulatory body in charge of monitoring global systemic risk. See *About the Financial Stability Board*, <http://www.financialstabilityboard.org> (last visited Aug. 6, 2010). However, as the FSB's institutional structure and mode of operation are still largely in flux, it remains to be seen how well the FSB will be able to implement this mandate in practice. Similarly, at this stage in the process, it is difficult to predict whether, and to what extent, the IMF will be successful in its newly envisioned role as the global liquidity provider.

70. See *infra* notes 125-127 and accompanying text.

sons of the latest financial crisis, national governments and domestic and international regulatory bodies are actively working toward refining and improving financial regulators' and supervisors' capacity to access and manage market information, both domestically and across borders. Many of the currently contemplated regulatory reforms aim precisely at the principal weaknesses identified in these areas.

However, despite the fact that these reform efforts, without a doubt, are both important and necessary, government agencies may be ultimately facing an uphill battle in this respect. There are compelling reasons to believe that, in today's world, government regulators may be increasingly less effective in managing the complexity and internationalization of financial markets, particularly if they continue relying on the traditional regulatory methods and techniques. Involving private institutions in the process of actively regulating complex, information-intensive financial activities and markets may serve as an effective and efficient supplement to governments' efforts, thus offering an important potential solution to this fundamental regulatory problem.

With respect to access to market information, private actors have a significant potential advantage over government regulators in terms of their relative ability to identify, analyze, and evaluate potential systemic implications of the underlying trends in the global financial markets, particularly with respect to complex financial products and transactions. As a general matter, private investors and financial institutions are better equipped to access the key market data in real time and to process that information intelligently and efficiently. Their "insider" position enables private market participants to make potentially better-informed judgments as to what financial information is relevant to issues of systemic risk prevention, and how any particular piece of such information affects the broader picture. The industry actors' relatively greater potential ability to understand and analyze increasingly complex and overwhelmingly voluminous financial information represents a crucial advantage from the perspective of regulatory efficiency and efficacy.

It is important to keep in mind that this informational advantage is a relative phenomenon. It is meant to emphasize only that financial institutions, by virtue of their very position as key participants in financial markets and actual creators and users of complex financial instruments, are inherently in a better position to understand and analyze the bottom-up patterns of systemic financial risk than government regulators. Acknowledging the industry's relative informational advantage is not the same as claiming that financial institutions, in fact, always possess the perfect knowledge and understanding of system-wide trends and vulnerabilities and, therefore, should replace government as the sole source of

regulatory decision-making. As the recent crisis so aptly demonstrated, even the highest-level executives at the most sophisticated financial firms around the world have not always been able to detect and measure the true extent of risk their companies carried on, or off, their balance sheets.⁷¹

Nevertheless, even allowing for all these complexities in the modern-day fragmentation of knowledge,⁷² it is fair to say that government agencies in charge of the financial services sector suffer from serious built-in informational disadvantages vis-à-vis financial institutions. Under the existing legal and regulatory framework, U.S. financial regulators, as a general matter, do not require reporting of all trading data or other market information by financial institutions. The bulk of the most complex financial transactions take place in the over-the-counter, or OTC, markets, where individual counterparties enter in bilateral contracts that do not have to be publicly disclosed or reported to the regulators. To the extent the regulatory and supervisory authorities get access to this type of market information, it usually happens after the fact, at times significantly so, and on an aggregated basis, either with respect to a specific firm or an entire market segment.⁷³ While this information is very important for

71. See, e.g., *Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. (2010) (testimony of Richard S. Fuld, Jr.), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/fuld_4.20.10.pdf [hereinafter, Fuld Testimony]. In this statement, the former CEO of Lehman Brothers claimed that he had absolutely no recollection of ever hearing anything about the so-called “Repo 105” transactions used to hide the true extent of Lehman’s debt.

72. Thus, Julia Black describes this phenomenon as “fragmentation, and construction, of knowledge” in today’s complex society:

In the decentered understanding of regulation, however, the information problem is more complex. For unlike the traditional analysis, it does not assume that any one actor has all the information necessary to solve social problems: it is not a question of industry having, government needing. Rather, no single actor has all the knowledge required to solve complex, diverse, and dynamic problems, and no single actor has the overview necessary to employ all the instruments needed to make regulation effective.

Black, *supra* note 21, at 107.

73. For example, Office of the Comptroller of the Currency (“OCC”), the primary regulator of the U.S. federally chartered banks, collects information on U.S. banks’ OTC derivatives transactions mainly through the analysis of the mandatory quarterly financial reports and the process of on-site examination of individual banking institutions. The OCC then aggregates the information on an industry-wide basis and publishes, on a quarterly basis, a report on the total size and trends in the OTC derivatives activities of U.S. commercial banks. See, e.g., OCC’s Quarterly Report on Bank Trading & Derivatives

the purposes of gauging the overall size of, and trends in, the relevant markets, it is of a limited usefulness in terms of enabling the regulators to keep up with the developments in some of the most complex, and rapidly expanding, financial markets.

Of course, it is possible to change the law to mandate real-time reporting of all, or most, market information that currently goes unreported to financial regulators.⁷⁴ However, such a measure would hardly resolve the underlying issue of regulatory capacity to make efficient use of such information. For example, if all trade data in the OTC financial markets is collected and reported directly to the government agencies, the sheer amount of such data may prove to be overwhelming, especially given the perennial staffing and budgetary constraints at the agencies. Moreover, increasingly sophisticated trading strategies involving complex coordinated plays across many different asset classes may not be readily visible to the regulator's eye, even if the individual elements of a particular strategy are disclosed to such regulator as part of the mandatory reporting process. As a result, it may be extremely difficult, if not impossible in most cases, for the regulatory authorities to discern potentially troublesome signs of systemic vulnerabilities emerging in the markets for complex financial products in time to be able to respond to them.⁷⁵ Although U.S. financial regulators accumulated significant experience with monitoring securities and futures markets for potentially abusive or fraudulent activities, detecting potential systemic risk accumulation requires a much more nuanced and intimate understanding of how all pieces of this highly complicated puzzle fit together. Even the best and most efficient government agencies are unlikely to possess sufficient expertise—

Activities, Fourth Quarter 2009 1, 1 (Comptroller of the Currency Adm'r of Nat'l Banks, Mar. 19, 2010), *available at* <http://www.occ.treas.gov/ftp/release/2010-33a.pdf>.

74. In fact, several legislative proposals to require reporting of all OTC derivatives trades to regulatory agencies have been put forward in 2009. The Dodd-Frank Act, among other things, requires the SEC and CFTC to promulgate rules for public reporting of certain swap transaction and pricing data.

75. It is worth noting that the supervisory practice of placing resident examiners at the largest and most complex financial institutions, as it exists in the U.S. banking sector, is not necessarily effective in assessing systemic financial risks and vulnerabilities. Even if resident examiners may develop a thorough understanding of a particular firm's business operations and risk profile, they are hardly in a position to assess broader risks to the financial system because the focus of their examination remains on an individual enterprise. Thus, despite the fact that, beginning in March 2008, examiners from the SEC and the Federal Reserve were stationed at Lehman Brothers and monitored the firm's activities on a daily basis, they failed to foresee or avert the firm's ultimate failure. *See* Fuld Testimony, *supra* note 71, at 2.

as well as financial and organizational resources—to meet that challenge.⁷⁶

An obvious practical difficulty in this respect is that, in order to enhance their professional expertise, government agencies have to hire the best available specialists in the relevant areas and offer these experts compensation high enough to lure them away from potentially lucrative employment at investment banks and hedge funds. Competing with the private sector on these terms is hardly a viable proposition for government agencies. However, an even more fundamental issue with this approach to resolving the problem of informational asymmetry relates to the dynamic nature of the required expertise. In reality, the level of one's education or natural brilliance does not necessarily translate into the actual knowledge of the industry and market trends. In the fast-moving world of complex finance, the best, if not the only, way to develop and maintain such knowledge is to stay in the trenches, structuring and executing actual business transactions. Government employees, no matter how well trained or highly credentialed, cannot be expected to possess such intimate, and highly dynamic, transactional knowledge.

This expertise deficit, coupled with the resource limitations, is a significant disadvantage of a system relying exclusively on direct government oversight of systemic risk in an increasingly complex financial universe. In such a system, the regulators will always run the risk of staying at least a step behind the industry, not only in a temporal sense but also in terms of understanding substantive implications of market practices and trends for systemic risk prevention. At the same time, private industry actors, free of regulatory responsibility and armed with superior market knowledge and financial and technological resources, will keep finding new methods of circumventing government-imposed rules and regulations. The government agencies' attempts to gather more information and impose more onerous rules are likely to create further incentives for the industry to evade regulatory limits.⁷⁷ This self-perpetuating dynamic,

76. In fact, many commentators on financial regulation reform lament the fact of such informational lag and expertise deficit and call for strengthening the cadre of regulatory agencies by attracting the best and the brightest economists, lawyers, and other trained specialists to serve at government agencies. *See, e.g.,* Henry T.C. Hu, *Swaps, The Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 412 (1989); Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK J. CORP. FIN. & COM. L. 317, 331 (2007).

77. Regulatory arbitrage is the fundamental challenge facing regulators in an increasingly complex financial sector environment. *See, e.g.,* Edward J. Balleisen & Marc Eisner, *The Promise and Pitfalls of Co-Regulation: How Governments Can Draw on Private Governance for Public Purpose*, in NEW PERSPECTIVES ON REGULATION 127, 143 (David Moss & John Cisternino eds., 2009); WOLFGANG SCHULZ & THORSTEN HELD, REGULATED

putting the regulators and the private actors on opposite sides of a regulatory arbitrage game, is likely to elevate the level of complexity in the global financial markets and further exacerbate potential systemic risk.

In principle, the government can attempt to resolve this fundamental problem by pursuing a radical solution and imposing strict absolute limits on the level of risk in the financial system. One example of such regulatory strategy would be an outright prohibition on certain types of complex financial products, such as, credit default swaps.⁷⁸ Extending the application of state anti-gambling statutes and so-called “bucket shop” prohibitions to certain derivative instruments would also outlaw such products.⁷⁹ A less drastic alternative would be a requirement of prior regulatory approval for complex financial products. Although the mandatory approval system stops short of direct product prohibition, for many practical reasons, it is likely to have the same practical effect. While potential benefits and disadvantages of pursuing these options are the subject of ongoing academic debates, as a practical matter, they may not be feasible, at least in the foreseeable future. Part of the reason is the politi-

SELF-REGULATION AS A FORM OF MODERN GOVERNMENT B11–B12 (Interim Report for Study commissioned by the German Federal Commissioner for Cultural and Media Affairs, Oct. 2001), *available at* <http://www.humanrights.coe.int/media/documents/interim-report-self-regulation.pdf>; Sinclair, *supra* note 20, at 542.

78. A credit default swap (“CDS”) is a derivative instrument under which one party (seller) sells to another party (buyer) protection against default on a credit obligation of a third party (a reference entity). *See, e.g.*, PAUL C. HARDING., A PRACTICAL GUIDE TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 6 (2004). In 2009, various proposals to outlaw so-called “naked” CDS transactions, in which the buyer of protection does not have an actual credit exposure to the reference entity and essentially uses the CDS as a means of speculation, were under consideration. For instance, in November 2009, the National Conference of Insurance Legislators, an organization consisting of state legislators involved in oversight of their states’ insurance regulatory matters, voted to approve so-called Credit Default Insurance Model Legislation that prohibited “naked” CDS contracts. *See* Press Release, Nat’l Conf. of Ins. Legislators (NCOIL), NCOIL Approves CDI Legislation, Eliminates “Naked” Swaps (Nov. 25, 2009), *available at* <http://www.ncoil.org/HomePage/2009/11232009CDIPressRelease.pdf>.

79. *See, e.g.*, Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225, 256 (2001) (explaining the operation of state anti-gambling and anti-bucket shop statutes); Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 729 (1999); Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 395 (2005). For a more detailed discussion of the history of state anti-gambling statutes and “bucket shop” prohibitions, see Thomas Lee Hazen, *Rational Investment, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effects on the Underlying Capital Markets*, 86 NW. U. L. REV. 987 (1992).

cal difficulty of passing legislation that would essentially shut down a significant part of the U.S. financial markets. This type of legislation would likely draw fierce opposition and heavy lobbying by the financial industry. Even more importantly, even if lawmakers did adopt such drastic measures, it is unclear whether the regulators would be able to implement and enforce them effectively, especially given the financial institutions' cross-border mobility and arbitrage capacity.⁸⁰

With respect to globalization and cross-border fluidity of financial activities, industry self-regulation also has significant potential advantages over direct government regulation. In today's globalized world, cross-border arbitrage significantly undermines national governments' ability to implement and enforce laws and regulations they consider vital for the purposes of maintaining their domestic economic stability or meeting other socio-economic or political goals.⁸¹ Moreover, strict application and enforcement of domestic laws and regulations to internationally active financial institutions frequently raises thorny issues of extraterritoriality and jurisdictional overreach.⁸² In order to be able to monitor and enforce compliance with domestic law, government regulatory agencies are becoming increasingly dependent on cooperation and assistance of their foreign counterparts, most notably with respect to information-sharing and coordination of enforcement activities, and are searching for creative ways to ensure such cooperation.⁸³ Despite the ongoing efforts to ensure international regulatory cooperation in the formulation of rules,

80. In the aftermath of the recent financial crisis in Greece, which threatened stability of the entire Eurozone, the EU authorities began considering limiting the use of certain credit derivatives that were viewed as contributing factors in that crisis. See David Oakley, *Moves in Motion to Limit CDS Use*, FIN. TIMES, Feb. 24, 2010, available at <http://www.ft.com/cms/s/0/608abed2-218b-11df-830e-00144feab49a.html>.

81. See, e.g., Ethipois Tafara & Robert Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L. L.J. 31, 32 (2007).

82. See Chris Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327 (2010).

83. For instance, in addition to using traditional inter-agency Memoranda of Understanding establishing a framework for bilateral regulatory cooperation in specific areas, the U.S. financial regulators are increasingly relying on more subtle and indirect methods of actively encouraging foreign governments to adopt regulatory and supervisory approaches similar to those underlying the U.S. system. Among others, one such method involves lifting or easing barriers to entry into the U.S. financial markets for foreign market intermediaries. For an insightful analysis of the challenges national regulators face in their search for a greater and more effective international harmonization, see, for example, Brummer, *supra* note 82.

as well as their implementation and enforcement, significant problems continue to plague such efforts.⁸⁴

By contrast, private economic actors—financial institutions and investors—are not constrained by jurisdictional considerations and are able to oversee and manage their business affairs across national borders much more seamlessly than any government agency. In fact, the U.S. laws and regulations essentially mandate that large, internationally active financial institutions manage their business risk on a consolidated basis.⁸⁵ As a result, industry actors are potentially better situated to monitor and manage risk to the financial system on a truly global basis.⁸⁶

Importantly, this Article does not argue that the financial services industry can, or will, actually perform the regulatory functions better than the government. The argument here is merely that the financial industry has certain built-in potential advantages with respect to its ability to address the key regulatory challenges posed by the increasing complexity and globalization of financial markets and activities. Leveraging this uniquely advantageous position of private market participants for the purposes of addressing these challenges may offer an effective method of controlling systemic risks in global financial markets. Imposing responsibility for regulating and minimizing systemic risk directly on financial institutions can serve as a powerful addition to the ongoing efforts to strengthen the government regulatory framework and market-based incentives for more prudent financial conduct.

Whether or not, and to what extent, this regulatory potential is realized in practice depends ultimately on the institutional design and the broader incentive structure within which a self-regulatory regime exists. First and foremost, envisioning such a new regime requires a fundamental normative shift in our concept of self-regulation, especially in comparison to the existing SRO model in the U.S. securities industry.

84. See, e.g., THE FINANCIAL CRISIS AND INFORMATION GAPS: REPORT TO THE G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS (prepared by the Int'l Monetary Fund Staff and the Fin. Stability Bd. Secretariat, Oct. 29, 2009), available at http://www.financialstabilityboard.org/publications/r_091107e.pdf.

85. See, e.g., 12 C.F.R. § 225.200(b) (2009).

86. See, e.g., Balleisen, *supra* note 36, at 443 (“Whatever the limitations associated with private regulation, it sometimes offers the only practical means of constraining the behavior of multi-national corporations whose production facilities and distribution networks span the globe.”).

III. REINVENTING SELF-REGULATION IN THE FINANCIAL SECTOR: FROM SROs TO “EMBEDDED SELF-REGULATION”

Financial industry self-regulation is by no means a new concept. Various self-regulatory arrangements operate, with different degrees of success, in many countries and in multiple institutional settings. In the U.S., self-regulation is one of the defining characteristics of the existing regulatory scheme in the securities industry but is virtually absent in banking or insurance. This Part examines the existing self-regulatory regime in the U.S. securities industry and argues that a fundamental shift in the entire paradigm of financial sector self-regulation is necessary in order to overcome its current limitations from the perspective of monitoring and minimizing systemic risk.

A. The SRO System: Existing Self-Regulation in the U.S. Securities Industry

Self-regulation of market intermediaries through a system of statutorily established SROs is one of the core elements of the U.S. securities regulation framework. Under the Securities Exchange Act of 1934,⁸⁷ a variety of SROs, including national securities exchanges and the Financial Industry Regulatory Authority (“FINRA”), exercise extensive oversight over securities broker-dealers, stock exchange members and listed companies, and other market intermediaries.⁸⁸ Stock exchanges were the original self-regulatory organizations that governed the trading of securities and regulated their members well before the creation of the Securities Exchange Commission (“SEC”) and the current statutory framework formalizing their SRO status.⁸⁹ The New York Stock Exchange (“NYSE”) is the largest and most important SRO among the registered national securities exchanges.⁹⁰ However, it is FINRA, a national securities association formed in July 2007 by merging its predecessor, the National Association of Securities Dealers (“NASD”), with the NYSE’s

87. Securities Exchange Act of 1934, 48 Stat. 881(codified as amended at 15 U.S.C. § 78a–78mm (2000)).

88. See 15 U.S.C. § 78f; 15 U.S.C. § 78o-3.

89. See, e.g., Roberta S. Karmel, *The Future of Self-Regulatory Organizations*, N.Y. LAW J., June 18, 2009, at 3; Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for Accommodation*, 62 N.C. L. REV. 475, 481 (1984).

90. For general information on NYSE, see New York Stock Exchange Euronext, About Us, <http://www.nyse.com/about/1088808971270.html> (last visited Aug. 7, 2010).

regulatory arm, that is the single largest SRO regulating securities broker-dealers.⁹¹

Under the statutory scheme, SROs are primarily responsible for establishing the standards under which their members conduct business and monitoring the way their members conduct their business in practice. Securities SROs enforce compliance by their members with the U.S. securities laws and regulations and discipline their members for violating such laws and regulations, as well as SROs' own rules.⁹² The SRO regulatory oversight focuses heavily on monitoring and investigating suspicious activities in securities trading, detecting and preventing securities fraud and other forms of investor abuse, and generally acting as one of the key gatekeepers in the securities markets.⁹³ It is hardly an exaggeration to say that the fundamental objective of self-regulation in the U.S. securities industry is "investor protection and market integrity through effective and efficient regulation."⁹⁴

To fulfill their regulatory responsibilities, securities SROs maintain extensive rulebooks governing in detail the day-to-day conduct of business by their members. For example, FINRA Rules contain detailed provisions mandating how broker-dealers communicate with customers and what types of information they provide to them. Numerous standards govern how securities professionals segregate and safeguard customers' funds, collateralize extensions of credit to customers, and make recommendations to their clients with respect to securities transactions. Furthermore, a long list of FINRA rules deal with the members' duty to supervise the actions of their employees, maintain books and records, and

91. Under the statutory scheme, all U.S. securities broker-dealers are required to register with FINRA and are subject to its regulation and supervision. According to FINRA's official website, as of the end of 2009, it oversaw "nearly 4,800 brokerage firms, about 171,400 branch offices and approximately 644,000 registered securities representatives." *See About the Financial Industry Regulatory Authority*, <http://www.finra.org/AboutFINRA/index.htm> (last visited Aug. 8, 2010).

92. *See generally*, JERRY W. MARKHAM & THOMAS LEE HAZEN, *BROKER DEALER OPERATIONS AND REGULATION UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION, AND CUSTOMER PROTECTION* (2009).

93. For instance, FINRA administers the federal scheme of licensing and examinations for securities broker-dealers and their employees, while securities exchanges maintain listing requirements for companies issuing securities.

94. *See* 2008 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT: REFORMING REGULATION TO BETTER PROTECT INVESTORS 8 (Financial Industry Regulatory Authority, 2009), *available at* <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p119061.pdf>.

so forth.⁹⁵ Virtually every aspect of securities firms' everyday activities, down to the most detailed and mundane tasks, is subject to various, frequently overlapping, SRO rules.⁹⁶

The SEC exercises extensive oversight of SROs through a variety of mechanisms, including review and approval of SROs' rule proposals, as well as any changes or amendments to their policies and procedures, and periodic inspections of their operations.⁹⁷ The SEC has an independent statutory authority to regulate the activities of securities broker-dealers and other market intermediaries directly. However, in practice, the agency has fully delegated these regulatory functions to privately funded SROs, choosing instead to function as the watchful guard and supervisor ensuring that the SROs perform their statutory duties in an appropriate manner.⁹⁸

To a great extent, the U.S. system of securities SROs is a historical product of political compromise⁹⁹ and economic expediency.¹⁰⁰ In many respects, it represents "a peculiar mix of private sector self-regulation and delegated governmental regulation."¹⁰¹ This model of financial industry self-regulation, which constitutes an integral part of the post-Great Depression regulatory paradigm, is fundamentally limited in its scope. Effectively, securities SROs operate as quasi-governmental entities per-

95. See *Financial Industry Regulatory Authority (FINRA) Rules*, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=607 (last visited Aug. 8, 2010).

96. As part of the establishment of FINRA, the old NASD Rules and the NYSE Rules are in the process of being consolidated in a single rulebook, which is meant to streamline compliance and eliminate the unnecessary duplication of standards. See *Financial Industry Regulatory Authority (FINRA) Regulation – FINRA Rules*, <http://www.finra.org/Industry/Regulation/FINRARules/>.

97. See, e.g., 15 U.S.C. § 78s(b)-(c) (2000) (establishing procedures for filing with the SEC of any proposed rule or any proposed change to the existing rules of any SRO).

98. The SEC's Office of Compliance Inspections and Examinations ("OCIE") conducts routine and special inspections of SRO regulatory and enforcement programs. See U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examination, <http://www.sec.gov/about/offices/ocie.shtml> (last visited Aug. 8, 2010).

99. See, e.g., Smythe, *supra* note 89.

100. As one commentator put it,

Although the premises of self-regulation have regularly been called into question, the concept has endured because lawmakers have generally regarded self-regulation to be a practical and efficient way to outsource the burdens of regulation to the private sector.

Dombalagian, *supra* note 76, at 323.

101. Karmel, *supra* note 15, at 151.

forming the most resource-intensive tasks “outsourced” to them by the SEC.

In recent years, rapid increase in computerized trading across markets¹⁰² and a string of governance failures at major stock exchanges¹⁰³ led to what some observers describe as an “identity crisis” of the SROs in the securities industry.¹⁰⁴ A particularly intensely debated issue is the future of securities exchanges, which were historically the first self-regulatory membership associations in the industry. In the past decade or so, securities exchanges around the world have been going through demutualizations, cross-border mergers, and attempts to resolve the conflict of interest inherent in their dual function as a regulator and a profit-seeking economic enterprise.¹⁰⁵ In addition, commentators continue to raise serious questions about how effective and efficient the existing securities industry SROs really are, particularly in light of their increasing bureaucratization and close integration into the federal government regulatory scheme.¹⁰⁶

In late 2004, the SEC weighed in this debate by issuing a Concept Release discussing and soliciting public comments on the potential role, fairness, and efficiency of the existing SRO structure in the changing market context.¹⁰⁷ In its Concept Release, the SEC discussed several potential structural alternatives to the current SRO system. These alternatives included, among other things, the establishment of a single SRO or a non-industry self-regulatory body (similar to the Public Company Accounting Oversight Board formed pursuant to the Sarbanes-Oxley Act)

102. As a result of recent technological advances, securities exchanges around the world are facing increasingly stiff competition from various electronic communication networks (“ECNs”) that are attracting a growing share of trading in listed securities. See, e.g., Jeremy Grant, *Sweeping Changes are On the Way*, FIN. TIMES, Oct. 20, 2009; Michael Mackenzie, *U.S.: High Frequency Trading Dominates the Debate*, FIN. TIMES, Oct. 20, 2009.

103. See, e.g., Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW 1347 (2004).

104. See Dombalagian, *supra* note 76.

105. See, e.g., Karmel, *supra* note 89; Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435 (2008); Eric J. Pan, *A European Solution to Regulation of Cross-Border Markets*, 2 BROOK. J. CORP. FIN. & COM. L. 133 (2007); Roberta Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355 (2007); Jonathan R. Macey & Maureen O’Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563 (2005).

106. See, e.g., Dombalagian, *supra* note 76; Karmel, *supra* note 15.

107. Concept Release Concerning Self-Regulation, 69 Fed. Reg. 235, 71256–71282 (issued Dec. 8, 2004), available at <http://www.sec.gov/rules/concept/34-50700.pdf>.

overseeing the entire securities industry and even the abolishment of self-regulation in favor of direct SEC regulation and supervision.¹⁰⁸ While causing quite a stir within the securities industry at the time of its publication, the SEC's Concept Release did not lead to any fundamental changes in the SRO system. Serious concerns about the overall efficiency and legitimacy of securities SROs continue to persist, especially in light of the SROs' failure to detect and prevent major market abuses that led to, or were uncovered in the course of, the recent financial crisis.¹⁰⁹ As global financial markets evolve, driven by technological innovation, and as the traditional lines between financial products and institutions dissipate, policy-makers and academics debate the future of securities SROs and the ways to adapt their structure and functions to new challenges. However, these discussions generally do not address the broader conceptual issue of whether or not the very foundational premises of the existing SRO model continue to make sense in light of the regulatory challenges posed by the 21st century's financial marketplace.

B. Toward a New Paradigm of Financial Industry Self-Regulation

This Article argues for the reinvention of the old concept of self-regulation to fit the realities of today's financial markets and to tackle the fundamental challenge posed by the increasing complexity and global scope of financial activities and products. The purpose of the following discussion is quite modest: to start a broader long-term conversation on this critically important topic by calling for a fundamental shift in our conception of the principal goals, scope, and function of self-regulation in the post-crisis financial services sector.

1. Drawing conceptual boundaries

As a preliminary matter, it is helpful to address some fundamental definitional issues and state explicitly the basic assumptions that inform the following discussion.

First, it is important to re-emphasize that the notion of self-regulation used in this Article does not denote a system of pure private ordering of economic activity and complete absence of any government regulatory

108. *Id.*, at 71275–71282.

109. Perhaps the most infamous recent example of such failure on the part of SROs is the scandal involving Bernie Madoff's Ponzi scheme that was allowed to run for years despite the numerous warnings. See Diana B. Henriques, *Madoff Is Sentenced to 150 Years for Ponzi Scheme*, N.Y. TIMES, June 29, 2009, at B1, available at http://www.nytimes.com/2009/06/30/business/30madoff.html?pagewanted=1&_r=2&hp.

intervention. Contrary to a common misperception, self-regulation is not identical to “de-regulation.” The concept of self-regulation advocated here is a significantly more complex and flexible regime combining private rule-making by industry actors with direct government regulation.

Secondly, this Article advocates a system of self-regulation that fundamentally differs from various forms of public-private partnership arrangements, in which private firms participate in the process of rule-making ultimately exercised by the government.¹¹⁰ To utilize fully the potential benefits of financial sector self-regulation, it is essential to allow the financial services industry to engage in promulgating and enforcing the actual rules governing its members’ conduct. Similarly, self-regulation, as that term is used in this Article, is conceptually separate from so-called “private regulation” where a single member of a group of private entities (such as credit rating agencies or outside auditors) makes or enforces rules applicable to the rest of that group.

Finally, the concept of self-regulation, as used in this Article, refers to an industry-wide self-regulatory regime, as opposed to any form of intra-firm governance or internal risk management. This is a critically important distinction, because the underlying dynamics and the key factors determining potential success or failure of self-regulation may operate differently on the level of an entire industry, as opposed to an individual enterprise.¹¹¹

In this respect, the new model of industry self-regulation advocated here should not be confused with the arrangements envisioned under the recently revised international capital adequacy regime known as Basel

110. For a discussion of “negotiated rulemaking,” see, e.g., Freeman, *supra* note 27.

111. Of course, this is not to say that there are no significant parallels in this respect between these two forms of self-regulation. There is a rich body of scholarly analysis of some of the key incentives and disincentives to self-regulate on the part of individual firms, both in the financial sector and in other settings. See, e.g., Braithwaite, *supra* note 38; Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127 (2009); Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 1 (2009); Macey & O’Hara, *supra* note 105. However, the insights gained from these studies, while extremely valuable and informative, may not always be directly or fully applicable to analysis of industry-wide self-regulatory arrangements. Incentives and disincentives facing the managers and stakeholders in an individual enterprise—such as a corporation complying with corporate governance rules, a financial institution implementing regulators’ capital adequacy requirements, or a stock exchange juggling its regulatory responsibilities with its business interests as a profit-generating entity—may differ in certain significant respects from the incentives and disincentives that shape decision-making at the level of the industry as a collective actor.

II.¹¹² Adopted in 2004, the Basel II framework allows large, internationally active financial institutions to use so-called Internal Ratings-Based (“IRB”) approaches to calculate the amount of regulatory capital they must hold against their risk-weighted assets. In contrast to the original Basel Capital Accord of 1988 (“Basel I”), under which regulators assigned risk weights to specified categories of assets,¹¹³ the IRB methodology essentially enables financial institutions to exercise this previously governmental function on the basis of their internal modeling. This system is often viewed as an example of the New Governance approach to capital regulation enabling private market participants to manage their own risks,¹¹⁴ endorsed by some as encouraging financial innovation and criticized by others as effectively removing regulatory constraints on financial firms’ risk-taking.¹¹⁵ However, it is worth emphasizing that this particular type of regulatory devolution, while it may be conceptualized as a form of enterprise-level self-regulation by financial firms, is fundamentally different from a self-regulatory model aimed explicitly at managing systemic risk, rather than enterprise risk, through an industry-wide self-regulatory mechanism.

There are important practical reasons for focusing on an industry-wide self-regulatory regime, the most important of which relate fundamentally to the nature of the risk such regime is supposed to address. As the recent financial crisis so aptly demonstrated, placing the main regulatory focus solely on individual financial institutions’ internal risk management is not effective with respect to detection and prevention of systemic risk in the financial sphere.¹¹⁶ An individual firm managing its own risk and calculating its own capital requirements may very well engage in a form of “self-regulation” but it makes its regulatory decisions on the basis of

112. See BASEL II: INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK – COMPREHENSIVE VERSION (Basel Comm. on Banking Supervision, 2006), available at <http://www.bis.org/publ/bcbs128.htm>.

113. See INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (Basel Comm., 1998), available at <http://www.bis.org/publ/bcbs111.htm>.

114. See, e.g., Robert F. Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN. L. REV. (forthcoming 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1552013##.

115. See, e.g., Krawiec, *supra* note 111 (criticizing the Basel II approach to operational risk).

116. For a discussion of the shortcomings of individual financial firms’ risk management systems, see, e.g., James A. Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731(2009); Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127 (2009).

comparing potential costs and benefits of each action to the firm as an individual profit-seeking entity. However, in today's world of complex global financial transactions, potential sources of systemic crises are difficult to detect and often rooted in patterns of market interconnectedness that are outside any single firm's internal governance or business activities.¹¹⁷ From this perspective, even the most successful regime of entity-level self-regulation is inherently limited as a means of identifying and addressing the threats to the financial system as a whole.

To summarize, the following discussion is based on the working definition of self-regulation as a regime of collective rule-making, a "regulatory process whereby an industry-level (as opposed to a governmental or firm-level) organization sets rules and standards"¹¹⁸ governing the behavior of the members of that industry and exercises a degree of monitoring and enforcement of compliance with the rules.¹¹⁹

Of course, this attempt to delineate the universe of self-regulatory institutions relevant for the purposes of this Article allows for an extremely wide variety of specific forms such institutions may take.¹²⁰ Emphasizing collective rule-making and enforcement as the key elements of self-regulation may merely help to define the continuum along which numerous self-regulatory institutions co-exist. Nevertheless, at this initial stage of inquiry into the future of self-regulation in the financial services sector, attempts to develop a more specific (and therefore more rigid) definition of what constitutes self-regulation may be counterproductive and unnecessarily limiting. Ultimately, it is the specific design of the new system of financial self-regulation—its normative basis, core substantive principles, procedural mechanisms, and organizational structure—that would define its place along that continuum.

117. See, e.g., Schwarcz, *supra* note 64.

118. Gunningham & Rees, *supra* note 41, at 364–65.

119. The concept of industry self-regulation, as used in this Article, does not encompass activities of trade associations whose primary purpose and function is lobbying on behalf of the industry or representing the industry's interests in political process.

120. For example, numerous voluntary product certification programs also set standards for individual enterprises seeking to receive certifications for their products or processes. See, e.g., Tim Bartley, *Certifying Forests and Factories: States, Social Movements, and the Rise of Private Regulation in the Apparel and Forest Products Fields*, 31 POL. & SOC'Y 433 (2003). Different self-regulatory organizations may also differ in their use of coercion, or sanctions for non-compliance methods. See, e.g., Andrew A. King & Michael J. Lenox, *Industry Self-Regulation Without Sanctions: The Chemical Industry's Responsible Care Program*, 43 ACAD. MGMT. J. 698 (2000).

2. Making the normative shift: “embedded self-regulation”

From a normative perspective, the fundamental rationale for designing a new self-regulatory model in the financial services sector should be prevention of systemic risk on a global basis. As discussed above, the main flaw of the existing system of the U.S. securities SROs is its relatively narrow scope and its focus primarily on the mundane aspects of securities firms’ conduct of business. By contrast, the challenge of detecting and managing systemic risk in today’s complex global financial markets requires a qualitatively new model of financial sector self-regulation, one that is significantly more comprehensive and systemic in its scope and operation.

At the heart of the new model of financial sector self-regulation, advocated here, is a fundamentally new guiding principle of “embeddedness.” This model of “embedded self-regulation” seeks to redefine the delicate balance between financial institutions’ freedom to regulate their own increasingly complex activities in the most economically efficient way, on the one hand, and their duty to conduct their legitimate profit- and risk-generating business in accordance with the overarching public interest in preserving financial stability, on the other. The goal of this model is to enhance the ability of private market participants to adopt and enforce rules governing their business activities but combine it with a greater, and more explicit, responsibility for the broader economic and societal effects of such activities. In effect, this new approach to self-regulation seeks to “embed” financial practices in the broader social values and regulatory principles, instead of “disembedding” them from the public interest.¹²¹

The concept of embeddedness represents a qualitatively new approach to financial industry self-regulation.¹²² Empirical experience shows that

121. See Rawi Abdelal & John G. Ruggie, *The Principles of Embedded Liberalism: Social Legitimacy and Global Capitalism*, in *NEW PERSPECTIVES ON REGULATION* 151–62 (David Moss & John Cisternino eds., 2009).

122. To social scientists, the term “embedded self-regulation” may be reminiscent of Peter Evans’ classic concept of “embedded autonomy.” Examining the strategies of economic development pursued by the East Asian “tigers,” Evans argued that the key to their developmental success was those states’ ability to be at once autonomous from business interest groups and firmly “embedded” within domestic business elites. According to Evans, this “embeddedness” is the key to the developmental state’s capacity to tailor its economic policies to local business realities and to implement its policies more effectively and efficiently. See PETER EVANS, *EMBEDDED AUTONOMY: STATES AND INDUSTRIAL TRANSFORMATION* (1995). One may argue that, in parallel to Evans’ approach, this Article should use the term “embedded regulation,” instead of “embedded *self*-regulation,” to describe its normative goal. While there is a good basis for conceptualizing the envisioned self-regulatory regime as a system for “embedding” government regulation in the

private market participants may choose to regulate their activities, either on an individual entity-level or collectively, for a wide variety of reasons. In many contexts, private actors are motivated purely, or primarily, by their self-interest, such as where they introduce voluntary private regulatory mechanisms in order to increase their market share or minimize their transactions costs.¹²³ These underlying objectives shape the nature and functions of each particular self-regulatory regime. By injecting public policy interests directly and explicitly into the very center of the financial industry's self-regulatory arrangements, the model of embedded self-regulation seeks to redefine the broader social role of the private financial sector and impose the primary responsibility for guarding financial stability against excessive risks on the collective creator of such risks.

Of course, it may be argued that it is naïve to expect self-interested private parties to impose voluntary limitations on their own profit-seeking activities for the sake of the highly diffused and indeterminate public benefits. There must be strong incentives to induce financial institutions to accept collective responsibility for minimizing systemic risks and guarding financial stability, at the expense of their individual and immediate profit. Given what we know about the financial industry's compensation structure, governance, and overall culture, it is highly doubtful such incentives currently exist. In the absence of such incentives, allowing the greedy and unconscious Wall Street types to run their own affairs may lead to greater abuses and future calamities.¹²⁴

industry's institutional structure and culture, doing so would shift focus to direct government regulation as the primary object of the inquiry. In that sense, the term "embedded regulation" is inherently government-centered, while "embedded self-regulation" keeps the emphasis on the industry's regulatory process and culture. In this context, the "embeddedness" is inverted: it is the industry's governance of its own affairs that needs to be organically connected to, and more deeply reflective of, the broader social and regulatory environment in which the industry operates.

123. Thus, one of the best-known examples of such successful standard-setting is the derivatives documentation developed by the International Swaps and Derivatives Association ("ISDA"), a powerful trade association representing global derivatives industry. See *International Swaps and Derivatives Association, Inc. (ISDA)*, <http://www.isda.org/> (last visited Aug. 8, 2010). For a detailed examination of ISDA's development and market activities, see generally Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211 (2001).

124. While a healthy dose of skepticism in this respect is both justified and helpful, it may be overly pessimistic to dismiss entirely the potential effects of other-regarding behavior, which presents a powerful source of human motivation. See, e.g., Lynn A. Stout, *Social Norms and Other-Regarding Preferences*, in *NORMS AND THE LAW* 13 (John N. Drobak ed., 2006).

In order to guard against the many dangers associated with private regulation and to ensure proper functioning of this new public-minded model of financial sector self-regulation, it is critical to create and maintain a strong and effective system of government regulation, which defines key policy objectives and monitors performance of self-regulatory institutions. Successful and socially useful industry self-regulation cannot be entirely free from government intervention but must be firmly “embedded” within the system of government regulation and oversight.¹²⁵

The nature of the risk in the financial sector makes vigilant government oversight of the industry’s self-regulatory process particularly important. In the financial sphere, there is a strong correlation between individual actor’s risks and rewards, where riskier activities tend to increase a financial institution’s potential to reap higher short-term profits, creating powerful incentives for excessive risk-taking. Furthermore, the risk of a major financial meltdown is inherently systemic and may be triggered by events outside of any particular entity’s control.¹²⁶ Finally, the overall risk in the financial system tends to accumulate during the good times of rising asset prices and soaring investor confidence, which may seriously constrain the industry’s ability and resolve to detect and lower systemic risk.¹²⁷ Comprehensive government regulation and supervision are necessary as the principal external safeguard against these tendencies and a critical check on the financial industry’s ability to regulate its affairs. Therefore, the search for a new model of financial sector self-regulation, one that focuses explicitly on prevention of systemic failure and is embedded in the broader public interests and policy goals, should serve as a supplement, and not as an alternative, to the ongoing search for an optimal design of the government regulation and supervision of financial institutions and activities. Bringing these two processes together will allow for a more comprehensive approach to regulatory reform in the financial sector, which will focus on designing more effective and

125. It is often asserted that, to be successful, most systems of self-regulation have to operate “in the shadow of the law.” See, e.g., Michael Moran, *Understanding the Regulatory State*, 32 BRIT. J. POL. SCI. 391, 399 (2002) (describing John Braithwaite’s popular concept of “responsive regulation”).

126. See, e.g., George G. Kaufman, *Bank Failures, Systemic Risk, & Bank Regulation*, 16 CATO J. 17, 17–18 (1996).

127. See generally Esteban Pérez Caldentey, Daniel Titelman & Ramon Pineda, *The Current Global Financial Crisis: What Was Really ‘Purely Prime’?*, UNITED NATIONS, ECLAC (2009), available at <http://www.iadb.org/intal/intalcdi/PE/2009/03611.pdf>; Már Gudmundsson, Deputy Head of the Monetary and Econ. Dep’t, Bank for Int’l Settlements, *How Might the Current Financial Crisis Shape Financial Sector Regulation and Structure?*, Address at the Financial Technology Congress (Sept. 23, 2008), available at <http://www.bis.org/speeches/sp081119.htm>.

adaptable institutional mechanisms, organically linking the industry's self-regulatory regime with the broader system of government regulation and oversight.¹²⁸

Both the normative and the institutional aspects of "embeddedness" are equally important in defining the main features of the proposed new approach to financial sector self-regulation. However, these broad concepts cannot possibly capture the many nuances of, nor can they offer concrete solutions to, the many problems and questions that are bound to arise in the process of actually designing an embedded self-regulatory system.

In this regard, the normative ideal of embeddedness and the explicit focus on the prevention of systemic risk leave two fundamentally important sets of questions unanswered. The first such set of questions relates to the incentive structure and asks what would drive the financial services industry to establish or embrace a system of self-regulation envisioned in this Article. This line of inquiry comprises many questions. What are the general preconditions for the emergence of a self-regulatory regime seeking explicitly to minimize potentially harmful external effects of private economic actors' behavior? Do such preconditions exist in the context of today's financial services industry? Which specific factors may potentially facilitate or, conversely, impede the emergence of an industry-wide consensus on the necessity of self-regulation aimed at minimizing systemic risk? How can a broader regulatory reform create the missing incentives for the financial services industry to adopt, or accept, a shift toward embedded self-regulation?¹²⁹

128. Of course, this approach also introduces an element of complexity. Establishing a truly effective regime of embedded self-regulation in the financial sector may require a great deal of creativity and intricate regulatory "engineering" to overcome potential conflicts of interest inherent in a self-regulatory regime and to assure a sufficient degree of transparency and accountability. For instance, to make this self-regulatory model work, it may be necessary to reorder the existing division of regulatory and supervisory authority among government agencies overseeing financial sector and rewrite significantly numerous substantive rules and regulations governing delivery of financial services.

129. One example of potential structural reform aimed at creating incentives for self-regulation may be redrawing of regulatory boundaries within the financial services industry in such a way that would realign institutions based on the types of their business activities and the risks inherent in such activities. Such regulatory regrouping of financial institutions based on their risk profile, rather than the type of license or legal status (as, e.g., a commercial bank or a securities broker-dealer), could potentially help to ensure greater homogeneity of interests and create a stronger sense of common destiny among the relevant private industry actors. Another potential step in this direction may be elimination of, or imposition of strict limits on, explicit federal subsidies and implicit bailout guarantees to certain types of financial institutions whose activities generate the bulk of financial systemic risk. I explore these and related issues as part of a separate project that focuses more specifically on the issue of incentives for self-regulation in the financial

The second key inquiry aims at the efficacy of the proposed regime and asks how exactly that system should be structured and operated in order to achieve its proclaimed normative goals and not fall prey to conflicts of interest and abusive behavior on the part of the industry actors. This is perhaps the most challenging and complicated line of inquiry dealing with a wide variety of organizational as well as substantive regulatory issues. How should the new self-regulatory body be organized and governed? What is the optimal scope of its functions and powers, both with respect to rule-making and implementation and enforcement? What specific methods for monitoring and minimizing systemic risk will such a self-regulatory body employ and how will it ensure their efficacy? What institutional safeguards should be put in place to prevent “capture” of a self-regulatory authority by self-serving industry members threatening to subvert its normative goals? What is the optimal mechanism for linking the new self-regulatory regime with the broader government regulation? How much, and what type of, oversight should the government exercise over the industry self-regulatory body?

An important issue in this respect is to what extent the existing system of securities SROs can serve as the basis for the new, redesigned and refocused, self-regulatory regime. Is it possible, and indeed desirable, to retain the existing SRO system in some form alongside a new, more comprehensive self-regulatory scheme aimed explicitly at systemic risk concerns? If so, how would that affect the process of redrawing regulatory and supervisory boundaries in the post-crisis financial services sector?

Of course, these are only some of the fundamentally important and highly complex questions that must be addressed in the process of crafting a truly effective regime of embedded self-regulation in the financial services sector. Both of these broadly defined areas of inquiry defy easy answers and require a great deal of research and discussion, which is beyond the scope of this initial foray into the empirically rich and intellectually challenging topic of financial industry self-regulation.

This Article presents a case for radically broadening the scope of what we traditionally view, at least in this country, as financial industry self-regulation. Whatever its ultimate institutional shape, the basic concept of embedded self-regulation advanced here denotes a paradigmatic shift in that view. It calls for altering the primary focus of self-regulation from policing financial firms’ conduct of business, or even individual enterprise-level safety and soundness, to a much more comprehensive notion

industry. See Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PENN. L. REV. (forthcoming 2010).

of systemic risk prevention explicitly embedded in the broader public policy interests.

CONCLUSION

In today's post-crisis world, arguing in favor of self-regulation in the financial services industry is sure to raise many eyebrows and invite significant disagreement. Much of the skepticism in this respect may be fully justified: the lack of truly effective incentives or political obstacles may ultimately foreclose the possibility of creating a new regime of embedded self-regulation aimed at detection and prevention of systemic financial risks. Nevertheless, as this Article sought to demonstrate, the realities of today's financial marketplace make it critically important that we give the idea of industry self-regulation a full consideration.

The main goal of this Article was to start this deliberative process by making a general case for reinventing financial sector self-regulation. There are compelling reasons to believe that private financial market participants are potentially in a far better position to address the two principal regulatory challenges currently facing governments around the globe: the increasing complexity and global nature of financial transactions and instruments. Leveraging private industry's potential capacity to manage systemic risk would require giving financial institutions greater self-regulatory authority, while at the same time imposing direct, and very real, responsibility on the industry actors to curb their own profit-seeking activities to the extent they may endanger broader societal interest in preserving long-term financial stability. "Responsibilizing" the industry in this manner must be an inalienable element of any regulatory reform granting or expanding financial industry's freedom to regulate its own activities.

This Article does not offer a fully developed set of concrete reform proposals—a complicated and multi-faceted task that requires a great deal of further research and analysis. Instead, it represents a pure thought experiment seeking to broaden the scope of the ongoing debate on regulatory reform in the financial sector and to initiate a meaningful discussion of all potential solutions to the fundamental problem of containing systemic risk in global financial markets.

REFORMING FINANCIAL REGULATION TO ADDRESS THE TOO-BIG-TO-FAIL PROBLEM

Arthur E. Wilmarth, Jr.*

INTRODUCTION

The ongoing financial crisis—widely viewed as the worst since the Great Depression¹—has inflicted tremendous damage on financial markets and economies around the world. The crisis has revealed fundamental weaknesses in the financial regulatory systems of the United States (“U.S.”), the United Kingdom (“U.K.”), and other European nations, making regulatory reforms an urgent priority. Publicly-funded bailouts of “too big to fail” (“TBTF”) financial institutions have provided indisputable proof that (i) TBTF institutions benefit from large explicit and implicit public subsidies, and (ii) those subsidies distort economic incentives and encourage excessive risk-taking by large, complex financial institutions (“LCFIs”). Accordingly, the primary objective of regulatory reforms must be to eliminate (or at least greatly reduce) TBTF subsidies and to force LCFIs to internalize the risks and costs of their activities.

Parts I and II of this article survey the consequences and causes of the current financial crisis. As described in Part I, the financial crisis has

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1. Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Crisis*, 41 CONN. L. REV. 963, 966 n.3 (2009) (quoting views of regulators and analysts describing the current financial crisis as the worst since the Great Depression); see also *The Causes and Current State of the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission* 3, 4 tbl.1 (Jan. 13, 2010) (written testimony of Mark Zandi, Chief Economic and Co-founder of Moody’s Economy.com), available at <http://www.fcic.gov/hearings/pdfs/2010-0113-Zandi.pdf> [hereinafter 2010 Zandi Testimony] (stating that the current financial crisis caused a “Great Recession” that is “the longest, broadest and most severe since the Great Depression”); Michael McKee & Peter Cook, *Paulson Says U.S. Was ‘Close’ to Financial Collapse* (Update 3), BLOOMBERG.COM, Feb. 2, 2010 (reporting the view of former Treasury Secretary Henry Paulson that “[t]he U.S. economy came ‘very close’ to collapsing into a second Great Depression”).

caused governments around the globe to provide more than \$11 trillion of assistance to financial institutions and to spend more than \$6 trillion on economic stimulus programs. The bulk of those expenditures have occurred in the U.S., the U.K. and other nations in the European Union ("EU"), where the crisis has inflicted the greatest damage. In the U.S., the federal government provided \$6 trillion of assistance to financial institutions and guaranteed the survival of the nineteen largest banking organizations and the largest insurance company. The U.K. and other EU nations provided more than \$4 trillion of assistance and conducted similar bailouts of LCFIs. Notwithstanding these extraordinary measures, the economies and financial systems of the U.S., U.K., and EU remained fragile and vulnerable to further shocks in early 2010. In particular, analysts warned about the potential impact of widespread defaults and foreclosures on residential and commercial mortgages, as well as the risks posed by large budget deficits in many developed countries.

The severity of the financial crisis has alarmed the public and produced a strong consensus in favor of reforming financial regulation in the U.S. and other developed nations.² In order to identify the most critically needed reforms, Part II of this article summarizes the basic causes of the crisis in the U.S. The unsound residential and commercial mortgage loans that devastated the U.S. financial system shared a common set of problems with high-risk credit card loans and corporate leveraged buyout ("LBO") loans that banks also originated during the credit boom that precipitated the current crisis. As described in Part II.A., LCFIs followed an "originate-to-distribute" ("OTD") strategy in all four credit markets that led to the production and securitization of huge volumes of high-risk loans.³ This OTD strategy enabled LCFIs to earn large fees from (i) originating high-risk loans, (ii) pooling those loans to create a variety of structured-finance securities, and (iii) distributing those securities to in-

2. See, e.g., Jackie Calmes, *With Populist Stance, Obama Takes on Banks*, N.Y. TIMES, Jan. 22, 2010, at A1 (reporting that "big banks have miscalculated Americans' intensified resentment against the bailout [of LCFIs during the financial crisis]—anger stoked by persistent high unemployment, banks' stinginess in lending to small business and the revival of Wall Street's bonus culture"); Simon Clark, *'Lepers' in London Defend Right to Make Money as Election Looms*, BLOOMBERG.COM, Feb. 25, 2010 (reporting on public revulsion against large U.K. banks "after British taxpayers assumed liabilities of more than [\$1.23 trillion] to bail out the country's lenders").

3. Wilmarth, *supra* note 1, at 988–91, 1037–40 (reporting that, in 2007, residential mortgage-backed securities accounted for nearly two-thirds of all U.S. residential mortgages, while commercial mortgage-backed securities represented almost a quarter of domestic commercial mortgages, asset-backed securities accounted for more than a quarter of domestic consumer loans, and collateralized loan obligations included more than a tenth of global leveraged syndicated loans).

vestors. Bank managers and regulators operated under the illusion that the OTD business model would permit LCFIs to transfer the risks embedded in securitized loans to investors who bought the structured-finance securities derived from those loans.

However, as discussed in Part II.B, LCFIs in fact pursued an “originate to *not really* distribute” approach in two major respects. First, LCFIs kept large amounts of AAA-rated tranches of structured-finance securities on their balance sheets because (1) those tranches paid significantly higher yields than conventional AAA-rated investments, (2) federal regulations assessed very low capital charges against AAA-rated securities, and (3) LCFIs retained AAA-rated tranches that could not be sold immediately in order to complete more securitization deals, earn more fees and produce higher short-term profits. Second, LCFIs transferred large volumes of AAA-rated tranches to off-balance-sheet (“OBS”) conduits, which LCFIs supported by providing explicit and implicit liquidity guarantees. After the financial crisis erupted in mid-2007, many LCFI sponsors provided financial support to their sponsored conduits or brought the conduits’ assets back onto their balance sheets. Ultimately, LCFIs suffered devastating losses from structured-finance securities they retained on their balance sheets or parked in OBS conduits.

Part II.C explains that LCFIs were the primary, private-sector catalysts for the financial crisis because they generated most of the financing for the unsustainable bubbles that occurred in the residential and commercial real estate markets and in the corporate LBO market. Consequently, as shown in Part II.D, LCFIs also became the leading recipients of government support measures. In the U.S., U.K., and the EU, governments engineered massive bailouts of leading banks, securities firms and insurers, thereby cementing the TBTF status of those entities.

Thus, the financial crisis has provided dramatic evidence of the competitive and regulatory distortions created by TBTF financial institutions. Part III of the article proposes five regulatory reforms that are designed to eliminate (or at least greatly reduce) the extensive public subsidies currently enjoyed by LCFIs that are presumptively TBTF. First, as described in Part III, existing statutory limitations on growth by large banks should be strengthened. Second, LCFIs whose failure would pose a systemic threat to the stability of the financial system should be publicly designated as systemically important financial institutions (“SIFIs”). A special resolution regime should be established for handling each actual or threatened failure of a SIFI. This resolution regime, which would be administered by the FDIC, should follow the essential principles of a Chapter 11 bankruptcy proceeding, including (i) wiping out the investments of the SIFI’s shareholders; (ii) dismissing the SIFI’s senior execu-

tives and directors, and (iii) requiring the SIFI's creditors to accept "haircuts" in the form of less-than-full payment of their claims or conversion of their claims into equity interests in a successor institution.

The third proposed regulatory reform would subject each SIFI to consolidated supervision by the Federal Reserve Board ("FRB") and would require each SIFI to comply with systemic risk capital requirements ("SRCRs"). Fourth, each SIFI would be required to pay insurance premiums to create a systemic risk insurance fund ("SRIF") that would cover the future costs of resolving failed SIFIs. SRCRs and SRIF premiums should be established jointly by the FRB and the Federal Deposit Insurance Corporation ("FDIC"). The SRIF should be kept strictly separate from the existing Deposit Insurance Fund ("DIF"). To prevent the DIF from being used to support future bailouts of TBTF institutions, Congress should prohibit the DIF from making any payment to uninsured creditors of banking organizations.

Finally, to ensure that SIFIs cannot exploit the federal safety net to subsidize speculative activities in the capital markets, a two-tiered system of banking regulation and deposit insurance should be established. The first tier of "traditional" banking organizations could provide services that are "closely related" to banking. However, those entities would not be allowed to engage, or affiliate with firms engaged in securities underwriting or dealing, insurance underwriting, or derivatives dealing. First-tier banks would operate under their current supervisory arrangements, including their existing deposit insurance.

By contrast, the second tier of "nontraditional" banking organizations would be allowed to engage in securities underwriting and dealing, insurance underwriting, and derivatives dealing. However, second-tier banking organizations (which presumably would include the largest financial firms) would be required to organize their banking subsidiaries as "narrow banks." Narrow banks could offer FDIC-insured checking and savings accounts, but they could not offer uninsured deposits. Those banks would effectively operate as FDIC-insured Money Market Mutual Funds ("MMMFs"), and their assets would be limited to cash and marketable, short-term debt obligations such as qualifying government securities and highly-rated commercial paper. Narrow banks would be prohibited from making any loans or other transfers of funds to their affiliates, except for paying lawful dividends to their holding companies. In addition, narrow banks would be prohibited from purchasing derivatives, except for bona fide hedging purposes, or from dealing in derivatives. The primary objectives of the narrow bank concept, in conjunction with the other four proposed reforms, would be (i) to prevent financial conglomerates from using FDIC-insured deposits as a source of low-cost

funding for speculative activities in the capital markets, and (ii) to compel financial conglomerates to internalize the potential risks and costs of their capital markets activities. If financial conglomerates cannot produce attractive economic return without access to extensive public subsidies, they will face significant pressure from investors to break up voluntarily (in the same way that investors forced many industrial conglomerates to break up after 1980).

I. THE IMPACT OF THE FINANCIAL CRISIS

The financial crisis has caused “[g]overnments and central banks around the world [to spend] more than \$11 trillion to support the financial sector and about \$6 trillion on fiscal stimulus programs.”⁴ The largest financial support and economic stimulus programs have been implemented by the U.S., the U.K., and other EU nations, where the financial crisis has caused the greatest harm.⁵ By mid-2009, authorities in those nations furnished more than \$10 trillion of assistance to financial institutions through central bank loans and other governmental loans, guarantees, and capital infusions.⁶ The U.S. provided about \$6 trillion of that amount to support its domestic financial sector.⁷ Additionally, the U.S.

4. David M. Dickson, *Debate Rages Over Stimulus Fallout*, WASH. TIMES, Feb. 23, 2010, at A1 (quoting Ruth Stroppiana, chief international economist for Moody’s Economy.com); see also Adrian Blundell-Wignall et al., *The Elephant in the Room: The Need to Deal with What Banks Do*, 2009 ORG. FOR ECON. CO-OPERATION & DEV. J.: FIN. MKT. TRENDS VOL. 2, 1, 14, 15 tbl.4, available at <http://www.oecd.org/dataoecd/13/8/44357464.pdf> (showing that leading nations around the world provided an estimated \$11.4 trillion of capital infusions, asset purchases and guarantees, and debt guarantees and facilities to financial institutions through October 2009).

5. Int’l Monetary Fund, *Global Financial Stability Report: Navigating the Financial Challenges Ahead*, at 4–5, 6–10, 24–29 (2009), available at <http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/text.pdf> [hereinafter October 2009 IMF GFS Report]; *Withdrawing the Drugs: Tightening Economic Policy*, THE ECONOMIST, Feb. 13, 2010, [hereinafter *Tightening Economic Policy*].

6. See Blundell-Wignall et al., *supra* note 4, at 15 tbl.4.

7. In April 2009, the International Monetary Fund (“IMF”) reported that the U.S., the U.K., and European Union (“EU”) nations had provided \$9 trillion of support to financial institutions, including \$4.7 trillion provided by U.S. authorities and \$4.3 trillion provided by U.K. and other EU agencies. Int’l Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risk*, at 41, 44 tbl.1.7 (2009), available at <http://www.imf.org/External/Pubs/FT/GFSR/2009/01/pdf/text.pdf> [hereinafter April 2009 IMF GFS Report]. The IMF estimated that the \$4.7 trillion of financial sector support provided by U.S. authorities included \$1.8 trillion of government guarantees. *Id.* However, the IMF estimate evidently did not include additional guarantees that the U.S. government provided to support money market mutual funds (“MMMFs”) following the

Congress passed an \$800 billion economic stimulus bill in 2009, and other nations have adopted similar programs.⁸

Government agencies have acted most dramatically in rescuing LCFIs that were threatened with failure. U.S. authorities bailed out two of the three largest U.S. banks and the largest U.S. insurance company.⁹ In addition, federal regulators provided financial support for emergency acquisitions of two other major banks, the two largest thrifts, and two of the five largest securities firms, and regulators also approved emergency conversions of two other leading securities firms into bank holding companies (“BHCs”), thereby placing those institutions under the FRB’s pro-

failure of Lehman Brothers in September 2008. In June 2009, the Congressional Oversight Panel (“COP”) provided an estimate of U.S. financial sector assistance that was very close to the IMF estimate. The COP report stated that federal authorities had provided \$4.6 trillion of support to financial institutions, including \$500 billion of capital infusions, \$2.2 trillion of loans and \$1.8 trillion of guarantees. CONGRESSIONAL OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: STRESS TESTING AND SHORING UP BANK CAPITAL 142–48, June 9, 2009, available at <http://cop.senate.gov/documents/cop-060909-report.pdf> [hereinafter June 2009 COP Report]. However, the COP report noted that its estimate did not include the potential cost of the guarantee program established by the Treasury Department to support MMMFs. *Id.* at 148 n.272. In November 2009, COP reported that the Treasury guarantee program had covered up to \$3.2 trillion of MMMF customer accounts between the program’s initiation in September 2008 and its expiration in September 2009. COP estimated that the Treasury’s “practical exposure” under its guarantee program was probably less than half of the maximum potential exposure, because “a majority of the assets in covered [MMMF] accounts” consisted of Treasury bills or other federally-guaranteed securities. CONGRESSIONAL OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS 27, 35, Nov. 6, 2009, available at <http://cop.senate.gov/documents/cop-110609-report.pdf> [hereinafter November 2009 COP Report]. Assuming that the Treasury Department’s actual exposure under the MMMF guarantee program was less than half of the maximum \$3.2 trillion of assets held by MMMFs, it seems appropriate to add about \$1.4 trillion of MMMF guarantees to the \$4.6 trillion estimate developed by COP in June 2009. Based on that assumption, it appears that U.S. authorities provided approximately \$6 trillion of assistance to financial institutions in 2009, as compared with the \$4.3 trillion of financial sector support provided by U.K. and EU agencies as reported by the IMF. See Blundell-Wignall et al., *supra* note 4, at 15 tbl.4 (concluding that the U.S. provided approximately \$6.4 trillion of financial sector support through October 2009, while Europe provided nearly \$4.3 trillion of such support).

8. See Dickson, *supra* note 4; William Pesek, *After the Stimulus Binge, A Debt Hangover*, BLOOMBERG BUSINESS WEEK, Jan. 26, 2010, at 14; Tightening Economic Policy, *supra* note 5.

9. For discussions of the federal government’s bailouts of Citigroup, Bank of America (“BoFA”) and American International Group (“AIG”), see DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE’S WAR ON THE GREAT PANIC 3, 25–26, 189–97, 239–41, 259–63 (2009); Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1364–66 (2009); Wilmarth, *supra* note 1, at 1044–45.

tective umbrella.¹⁰ Federal regulators also conducted “stress tests” on the nineteen largest BHCs—each with more than \$100 billion of assets—and injected more than \$220 billion of capital into eighteen of those companies.¹¹ Before regulators performed the stress tests, they announced that the federal government would provide any additional capital that the nineteen banking firms needed but could not raise on their own. By giving that public assurance, regulators indicated that all nineteen firms were presumptively TBTF, at least for the duration of the current financial crisis.¹²

10. For descriptions of the federal government’s support for the acquisitions of Wachovia by Wells Fargo, of National City Bank by PNC, of Bear Stearns (“Bear”) and Washington Mutual (“WaMu”) by JP Morgan Chase (“Chase”), and of Countrywide and Merrill Lynch (“Merrill”) by BofA, as well as the rapid conversions of Goldman Sachs (“Goldman”) and Morgan Stanley into BHCs, see DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY: THE NEW PARADIGM 182–84, 398–405, 412–17 (2010); WESSEL, *supra* note 9, at 8–9, 18–19, 147–72, 217–26, 239–41, 259–63; Wilmarth, *supra* note 1, at 1044–45; Arthur E. Wilmarth, Jr., *Cuomo v. Clearing House: The Supreme Court Responds to the Subprime Financial Crisis and Delivers a Major Victory for the Dual Banking System and Consumer Protection* 27–30 (Geo. Wash. U. Law Sch. Pub. L. & Leg. Theory, Working Paper No. 479, 2009), available at <http://ssrn.com/abstract=1499216>.

11. June 2009 COP Report, *supra* note 7, at 7–8, 13–27, 51–52 fig.4 (reporting that the U.S. government provided \$217 billion of capital to 18 of the 19 largest U.S. bank holding companies, and describing the “stress tests” performed on those firms); Dakin Campbell, David Mildeberg & Robert Schmidt, *GMAC Gets \$3.8 Billion in Third U.S. Bailout Package* (Update 2), BLOOMBERG.COM, Dec. 31, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=agcYWuOIJVRg#> (describing the federal government’s infusion of \$3.8 billion of additional capital into GMAC).

12. In announcing the “stress test” for the 19 largest banking firms in early 2009, federal regulators “emphasized that none of the banks would be allowed to fail the test, because the government would provide any capital that was needed to ensure the survival of all nineteen banks.” Wilmarth, *supra* note 1, at 1050 n.449 (citing speech by Federal Reserve Bank of New York president William C. Dudley and congressional testimony by FRB chairman Ben Bernanke); Joe Adler, *In Focus: Stress Tests Complicate ‘Too Big to Fail’ Debate*, AM. BANKER, May 19, 2009, at 1, available at http://www.americanbanker.com/issues/174_98/-378732-1.html (stating that “[b]y drawing a line at \$100 billion of assets, and promising to give the 19 institutions over that mark enough capital to weather an economic downturn, the government appears to have defined which banks are indeed ‘too big to fail’”). Based on the stress tests, regulators determined that ten of the 19 firms required additional capital. June 2009 COP Report, *supra* note 7, at 25–27. Nine of those firms were successful in raising the needed funds, but the federal government provided \$11.3 billion of additional capital to GMAC when that company could not raise the required capital on its own. CONGRESSIONAL OVERSIGHT PANEL, JANUARY OVERSIGHT REPORT: EXITING TARP AND UNWINDING ITS IMPACT ON THE FINANCIAL MARKETS 100–04, 160 (Jan. 13, 2010), available at <http://cop.senate.gov/documents/cop-011410-report.pdf> [hereinafter January 2010 COP Report].

Similarly, the U.K. and other EU nations adopted more than eighty rescue programs to support their financial systems. Those programs included costly bailouts of several major EU banks—including ABN Amro, Commerzbank, Fortis, ING, Lloyds HBOS (“Lloyds”), and Royal Bank of Scotland (“RBS”)—while Switzerland financed a similar recapitalization of UBS.¹³

Despite these extraordinary measures of governmental support, financial institutions, commercial firms, and ordinary citizens suffered huge losses in the U.S. and other nations. Between the outbreak of the crisis in mid-2007 and the end of 2009, LCFIs around the world recorded \$1.5 trillion of losses on risky loans and investments made during the preceding credit boom.¹⁴ The financial crisis pushed the economies of the U.S., the U.K., and other EU nations into deep recessions during 2008 and the first half of 2009.¹⁵ Economies in all three regions began to improve in

13. For descriptions of governmental support measures for financial institutions in the U.K. and other European nations, see Fabio Panetta et al., *An Assessment of Financial Sector Rescue Programmes* (Bank of Int'l Settlements Paper No. 48, 2009), available at <http://ssrn.com/abstract-1457664>. Press Release, Eur. Comm'n Communications, State Aid: Overview of National Measures Adopted as a Response to the Financial/Economic Crisis (Jan. 26, 2010), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/13&format=HTML&aged=0&language=EN&guiLanguage=en> (listing 85 measures adopted by EU governments to support their financial sectors); John Goddard, Phil Molyneux & John O.S. Wilson, *The Financial Crisis in Europe: Evolution, Policy Responses and Lessons for the Future* (June 5, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1414935&rec=1&srcabs=1350022; Jann Bettings, *Commerzbank Net Loss Exceeds Estimates on Writedowns* (Update 4), BLOOMBERG.COM, Feb. 23, 2010; *EC Approves More Bailout Funding for Dutch Banks Fortis, ABN AMRO*, 94 BANKING REP. (BNA) 333 (2010); Bert Koster & Dan Fitzpatrick, *ING to Cut Itself in Two to Repay Dutch Aid*, WALL ST. J., Oct. 27, 2009, at C1; Jon Me-non & Andrew MacAskill, *RBS, Lloyds Get \$51 Billion in Second Bank Bailout* (Update 6), BLOOMBERG.COM, Nov. 3, 2009; Daniel Pruzin, *International Banking: Switzerland Aims Plan to Bail Out UBS, Shore Up Financial System*, 91 BANKING REP. (BNA) 686 (2008).

14. Rodney Yap & Dave Pierson, *Subprime Mortgage-Related Losses Exceed \$1.74 Trillion: Table*, BLOOMBERG NEWS, Jan. 25, 2010 (showing that banks, securities firms and insurers incurred \$1.49 trillion of writedowns and credit losses due to the financial crisis, while Fannie Mae and Freddie Mac suffered an additional \$250 billion of losses). As used in this article, the term “large, complex financial institution” (“LCFI”) includes major commercial banks, securities firms and insurance companies as well as “universal banks” (i.e., financial conglomerates that have authority to engage, either directly or through affiliates, in a combination of banking, securities, and insurance activities). See Wilmarth, *supra* note 1, at 968 n.15.

15. See Int'l Monetary Fund, *World Economic Outlook, April 2009: Crisis and Recovery*, at 1–96 (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf>.

the second half of 2009, but the recoveries were tentative and fragile.¹⁶ In early 2010, economies in all three areas continued to face significant challenges, including (i) high unemployment rates and shortages of bank credit that discouraged spending by consumers and investments by businesses; and (ii) large budget deficits that impaired the ability of governments to provide additional fiscal stimulus.¹⁷

The impact of the financial crisis on the U.S. has been especially severe. The collapse of housing and stock values inflicted devastating losses on homeowners and investors. Home prices nationwide fell by thirty percent from their peak in 2006 to their trough in 2009.¹⁸ At the beginning of 2010, more than a fifth of U.S. homeowners were “underwater”—owing more on their mortgages than the value of their homes—and nearly a seventh of all residential mortgages were delinquent or in foreclosure.¹⁹ Between October 2007 and March 2009, U.S. stock prices

16. Int’l Monetary Fund, *World Economic Outlook, October 2009: Sustaining the Recovery*, at 1–92 (2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/02/pdf/text.pdf>; Timothy R. Homan, *U.S. Economy Grew at 2.2% Annual Rate Last Quarter* (Update 2), BLOOMBERG.COM, Dec. 22, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601068&sid=aVeAMaVRygoM> (reporting that the U.S. economy grew during the third quarter of 2009 “at a slower pace than anticipated,” following a steep decline during the previous year); Marcus Walker & Brian Blackstone, *Euro-Zone Economy Returns to Expansion—Third-Quarter Growth Brings an End to Stretch of Contraction Dating to last Year, but Signals Fragility of Region’s Recovery*, WALL ST. J., Nov. 14, 2009, at A6 (reporting that “[t]he euro-zone economy returned to modest growth in the third quarter [of 2009], marking an apparent end to five quarters of recession, but the region’s recovery looks set to be anemic”).

17. See, e.g., Frank Ahrens, *Three Indicators Spell Trouble for the Recovery*, WASH. POST, Feb. 28, 2010, at G01; Mark Deen, *European Economy Risks Decoupling from Global Growth Recovery*, BLOOMBERG.COM, Feb. 26, 2010, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aD6mJGvUqkRE#>; Jon Hilsenrath, *U.S. News: Credit Remains Scarce in Hurdle to Recovery*, WALL ST. J., Feb. 27, 2010, at A2; Alistair MacDonald, *Big Deficits Cloud Britain’s Future*, WALL ST. J., Jan. 8, 2010, at A1; Simone Meier, *Europe’s Recovery Almost Stalls as Investment Drops* (Update 2), BLOOMBERG.COM, Mar. 4, 2010, <http://www.businessweek.com/news/2010-03-04/europe-s-recovery-almost-stalls-as-investment-drops-update1-.html>; Gretchen Morgenson, *This Crisis Won’t Stop Moving*, N.Y. TIMES, Feb. 7, 2010, § BU, at 1; Pesek, *supra* note 8; Buttonwood, *Finance and Economics: Stimulating debate*, ECONOMIST, Feb. 6, 2010, at 81.

18. Renae Merle, *Housing Recovery Could Take a Decade, Economists Warn*, WASH. POST, Jan. 27, 2010, at A12; see also 2010 Zandi Testimony, *supra* note 1, at 9 chart 7 (showing that a national index of housing prices rose from 100 at the end of 2000 to a high of 175 in 2006, before declining to a low of 120 in early 2009, and recovering slightly to 125 in late 2009).

19. See Daniel Taub, *One-Fifth of U.S. Homeowners Owe More Than Properties Are Worth*, BLOOMBERG.COM, Feb. 10, 2010,

fell by \$10 trillion.²⁰ Household wealth plummeted by \$17.5 trillion during the same period and less than a third of that loss was recovered during a subsequent increase in stock prices and home values.²¹ As the financial crisis deepened, consumers cut back on spending to reduce their heavy debt burdens and rebuild their depleted savings.²²

Rising rates of unemployment and consumer bankruptcies further discouraged household consumption. The national unemployment rate reached ten percent in 2009, reflecting a loss of 8.4 million jobs since the end of 2007.²³ Nearly 2.5 million individuals filed for bankruptcy in 2008 and 2009.²⁴ Falling demand by consumers for housing, goods, and services caused businesses to reduce production and lay off workers, thereby further depressing employment and economic activity.²⁵ Businesses also suffered from the steepest decline in bank credit since the 1940s.²⁶

<http://www.bloomberg.com/apps/news?pid=20603037&sid=at6VKvccpCzs#> (reporting that in the fourth quarter of 2009, “21.4 percent of owners of mortgaged homes were underwater”); *Seven Million Loans Are Behind on Payments*, NAT’L MORTGAGE NEWS, Feb. 15, 2010, at 18 (reporting that 13.3% of residential mortgages were delinquent or in foreclosure); CONGRESSIONAL OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT, TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF PROGRAM ACHIEVED? 68, 68 n.270 (Dec. 9, 2009), available at www.cop.senate.gov/gocuments/co-120909-report.pdf [hereinafter December 2009 COP Report] (reporting that 5.5 million home foreclosures were started, and two million foreclosures were completed, between July 2007 and September 2009).

20. David Henry et al., *Waiting for the Bull to Return*, BUS. WK., Mar. 16, 2009, at 24–25.

21. 2010 Zandi Testimony, *supra* note 1, at 8, 8 chart 6 (showing that U.S. household wealth declined from a peak of \$65.5 trillion in mid-2007 to a low of \$48 trillion in early 2009, before recovering to \$53 trillion in late 2009).

22. The ratio of U.S. household debt to personal income rose from 87% in 1990 to 139% in 2007, before declining to 131% in 2009. That decline in the household debt burden, along with a corresponding rise in the personal savings rate from zero to four percent, reflected a painful “deleveraging” by U.S. households in response to the financial crisis. See Wilmarth, *supra* note 1, at 1010; James C. Cooper, *Business Outlook: Consumers Won’t Drive a Recovery*, BUS. WK., June 29, 2009, at 14; Reuven Glick & Kevin J. Lansing, *U.S. Household Deleveraging and Future Consumption Growth*, FRBSF ECON. LETTER (Fed. Reserve Bank of S.F., Cal.), May 15, 2009, at 3, available at <http://www.frbsf.org/publications/economics/letter/2009/el2009-16.html>.

23. Neil Irwin et al., *White House Crafts Jobs Bill, a Year into Stimulus Effort*, WASH. POST, Feb. 18, 2010, at A1.

24. David M. Dickson, *Soaring Rate of Bankruptcies Expected to Continue in 2010*, WASH. TIMES, Jan. 8, 2010, at A1.

25. Michael McKee, *No Job Growth for Small Business Spurs Recovery Doubt* (Update 1), BLOOMBERG.COM, Feb. 8, 2010, <http://www.bloomberg.com/apps/news?pid=20601109&sid=apZULWyXpqhE#>; Paul Vigna & John Shipman, *The Upshot: The Great Corporate Pullback*, WALL ST. J., Jan.

In early 2010, regulators and analysts identified serious problems in the commercial real estate (“CRE”) market as a further obstacle to economic recovery. Commercial property values declined by more than forty percent between October 2007 and October 2009, and default rates more than doubled on CRE loans held by banks during 2009.²⁷ Banks held about half of the \$3.4 trillion in outstanding CRE debt, and analysts estimated that banks could suffer \$150 billion to \$300 billion of losses on those loans.²⁸ Many CRE loans fell into default because they were originated during the real estate boom, when lenders offered CRE loans with weak underwriting standards and lax payment terms that resembled the unsound features of subprime and Alt-A residential mortgages.²⁹ Analysts feared that losses on defaulted CRE loans would further weaken the capacity of banks to provide credit to consumers and businesses. Community and regional banks, the primary providers of relationship loans to small businesses, were especially threatened because they held heavy concentrations of CRE loans.³⁰

In February 2010, the Congressional Oversight Panel (“COP”) warned that rising CRE loan defaults threatened to create a “negative feedback loop that suppresses economic recovery” because (i) losses from CRE loan defaults were causing banks to cut back on their lending to small businesses and consumers, thereby causing (ii) lower rates of consumption and higher rates of business failures and unemployment, which would lead to (iii) higher vacancy rates in office buildings, stores, and

25, 2010, at B2; Editorial (United States), *The Economy: The Trap*, *ECONOMIST*, Jan. 16, 2010, at 32.

26. Binyamin Appelbaum, *Troubled Banking Industry Sharply Reduced Lending in 2009*, *WASH. POST*, Feb. 24, 2010, at A8 (reporting that U.S. banks cut their lending by \$587 billion, or 7.5%, in 2009, “the largest annual decline since the 1940s”).

27. Brian Louis, *U.S. Commercial Property Falls to Lowest in 7 Years* (Update 3), *BLOOMBERG.COM*, Dec. 21, 2009, <http://bloomberg.com/apps/news?pid=20601103&sid=aHtqsgJE35sU>; Dan Levy & David Henry, *Commercial Mortgage Default Rate in U.S. More Than Doubles*, *BLOOMBERG.COM*, Feb. 24, 2010, <http://www.bloomberg.com/apps/news?pid=20601206&sid=aExgk1dEfRrA#>.

28. CONGRESSIONAL OVERSIGHT PANEL, *FEBRUARY OVERSIGHT REPORT: COMMERCIAL REAL ESTATE LOSSES AND THE RISK TO FINANCIAL STABILITY* 36–38, 45–46, 102 (Feb. 10, 2010), available at <http://cop.senate.gov/documents/cop-021110-report.pdf> [hereinafter February 2010 COP Report]; Matthew Monks, *CRE Losses Could Pass \$150 Billion Next Year*, *AM. BANKER*, Feb. 8, 2010, at 12; see also Louis, *supra* note 27 (reporting that \$1.4 trillion of CRE loans were scheduled to mature within five years and half of those loans were “underwater” because property values were worth less than the outstanding loans).

29. Wilmarth, *supra* note 1, at 1037–39; February 2010 COP Report, *supra* note 28, at 19–28, 62–64.

30. February 2010 COP Report, *supra* note 28, at 36–38, 42–46, 62–64, 78–81.

apartment buildings, which in turn would produce (iv) additional CRE loan defaults and further downward pressure on the economy.³¹ The COP cautioned that CRE loan defaults could inflict “a second wave of property-based stress on the financial system—this time based on commercial rather than residential real estate.”³²

Losses from defaults on residential mortgages, CRE loans, and related securities have caused almost 200 FDIC-insured depository institutions to fail since 2007. Those failed institutions held assets of more than \$500 billion, and hundreds of additional banks are likely to fail in the near future.³³ Thus, in early 2010, the ability of the U.S. financial system and the general economy to recover from the financial crisis remained in serious doubt.

II. LCFIS' RESPONSIBILITY FOR THE FINANCIAL CRISIS

In order to design regulatory reforms that could prevent a similar crisis in the future, it is essential to understand that LCFIs were the primary private-sector catalysts for the current financial crisis. This Part analyzes the crucial role played by LCFIs in helping to produce the financial and economic conditions that led to the crisis. The discussion will briefly refer to governmental policies that compounded the disastrous errors of LCFIs, but its main focus will be on the LCFIs' responsibility for the crisis.

A. LCFIs Originated Huge Volumes of Risky Loans and Helped to Inflate a Massive Credit Boom That Precipitated the Crisis

1. LCFIs Used Securitization to Originate Risky Loans and to Distribute Hazardous Securities Derived from Those Loans

During the past two decades, and especially between 2000 and 2007, LCFIs helped to generate an enormous credit boom that set the stage for

31. *Id.* at 80; *see also* 2010 Zandi Testimony, *supra* note 1, at 10 (explaining that the threat of widespread defaults on CRE loans was causing many banks to “tighten lending standards, to the detriment of their small business customers” because “more than a third [of U.S. banks] had commercial mortgage loans outstanding worth more than 200% of their equity capital”).

32. February 2010 COP Report, *supra* note 28, at 6.

33. Fed. Deposit Ins. Corp., Q. Banking Profile, 4th Qtr. 2009, 17 tbl.II-B (showing that 165 FDIC-insured institutions, with \$540 billion of assets, failed during 2008 and 2009, while 702 additional institutions, with \$400 billion of assets, were on the FDIC's list of “problem institutions” at the end of 2009); Stephen Bernard, *FDIC Shuts Down Banks in Nevada and Washington*, ASSOCIATED PRESS FIN. WIRE, Feb. 27, 2010 (reporting that 22 additional banks failed during the first two months of 2010, and “[t]he pace of bank seizures this year is likely to accelerate in coming months, FDIC officials said”).

the current financial crisis. LCFIs adopted what appeared to be an “originate to distribute” (“OTD”) strategy based on the techniques of securitization. Securitization enabled LCFIs to earn large amounts of fee income by originating high-risk loans (including nonprime residential mortgages, credit card loans, commercial mortgages, and LBO loans) and pooling those loans to create structured-finance securities. Securitization also allowed LCFIs—with the blessing of regulators—to reduce their capital requirements and offload much of their apparent credit risk.³⁴ LCFIs constructed structured-finance securities that typically included senior, mezzanine and junior (or equity) “tranches.” Those tranches represented a hierarchy of rights (along a scale from the most senior to the most subordinated) to receive cash flows produced by the pooled loans. LCFIs marketed the tranches to satisfy the demands of various types of investors for different combinations of yield and risk. Structured-finance securities included (1) asset-backed securities (“ABS”), which represented interests in pools of credit card loans, auto loans, student loans and other consumer loans; (2) residential mortgage-backed securities (“RMBS”), which represented interests in pools of residential mortgages; and (3) commercial mortgage-backed securities (“CMBS”), which represented interests in pools of commercial mortgages.³⁵

LCFIs created “second-level securitizations” by bundling tranches of ABS and MBS into cash flow collateralized debt obligations (“CDOs”), and they similarly packaged syndicated LBO loans into collateralized loan obligations (“CLOs”).³⁶ LCFIs also created third-level securitiza-

34. Wilmarth, *supra* note 1, at 984–87, 994–97, 1008–43; *see also id.* at 995 (noting that “[f]ee income at the largest U.S. banks (including BofA, Chase and Citigroup) rose from 40% of total earnings in 1995 to 76% of total earnings in 2007”); Viral V. Acharya & Matthew Richardson, *Causes of the Financial Crisis*, 21 *CRITICAL REV.* 195, 198–200 (2009), available at <http://ssrn.com/abstract=1514984>; Viral V. Acharya, Thomas Philippon, Matthew Richardson & Nouriel Roubini, *Prologue: A Bird’s-Eye View: The Financial Crisis of 2007-2009: Causes and Remedies*, in *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 14–23 (Viral V. Acharya & Matthew Richardson eds., 2009).

35. Wilmarth, *supra* note 1, at 984–90; *see also* Joshua Coval et al., *The Economics of Structured Finance*, 23 *J. ECON. PERSPECTIVES* 3, 5–7 (2009); Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis* 3–6, (Nat’l Bureau of Econ. Research, Working Paper No. 15045, 2009); Kenneth E. Scott, *The Financial Crisis: Causes and Lessons: Ending Government Bailouts As We Know Them, Part I – The Crisis* 6–8 (Rock Center for Corp. Governance, Working Paper Ser. No. 67, 2009). RMBS and CMBS are sometimes hereinafter collectively referred to as “mortgage-backed securities” (“MBS”).

36. Wilmarth, *supra* note 1, at 990–91. The term “CDOs” is generally used to refer collectively to CDOs and CLOs as well as collateralized bond obligations (CBOs). STOWELL, *supra* note 10, at 105–06, 456. Frank Partnoy has noted that many CDOs functioned as “‘second-level’ securitizations of ‘first-level’ mortgage-backed securities

tions by assembling pools of tranches from cash flow CDOs to construct “CDOs-squared.”³⁷ The International Monetary Fund has estimated that private-sector financial institutions issued about \$15 trillion of ABS, MBS, and CDOs in global markets between 2000 and 2007, including \$9 trillion issued in the U.S.³⁸ Another study determined that \$11 trillion of structured-finance securities were outstanding in the U.S. market in 2008.³⁹

LCFIs intensified the risks of securitization by writing over-the-counter (“OTC”) credit derivatives known as “credit default swaps” (“CDS”), which provided “the equivalent of insurance against default events” that might occur with reference to loans in securitized pools or tranches of ABS, MBS and CDOs.⁴⁰ While CDS could be used for hedging purposes, financial institutions and other investors increasingly used CDS to speculate on the default risks of securitized loans and structured-finance securities.⁴¹ LCFIs further increased the financial system’s ag-

(which were securitizations of mortgages).” Frank Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis* 5 (U. San Diego Sch. of Law Legal Studies Research Paper No. 09-015, 2009), available at <http://ssrn.com/abstract=1430653>. CDOs consisting of tranches of MBS are sometimes referred to as collateralized mortgage obligations (CMOs) but are referred to herein as CDOs. Benmelech & Dlugosz, *supra* note 35, at 6.

37. LCFIs typically used mezzanine tranches of CDOs to create CDOs-squared, because the mezzanine tranches were the least attractive (in terms of their risk-yield tradeoff) to most investors. Wilmarth, *supra* note 1, at 990–91, 1027–30; see also Scott, *supra* note 35, at 7–8, 8 slide 3. CDOs and CDOs-squared are sometimes hereinafter collectively referred to as “CDOs.”

38. *October 2009 IMF GFS Report*, *supra* note 5, at 84, fig.2.2 & fig.2.3 (indicating that \$15.3 trillion of “private-label” issues of ABS, MBS, CDOs and CDOs-squared were issued in global markets between 2000 and 2007, of which \$9.4 trillion was issued in the U.S.). “Private-label” securitizations refer to asset-backed securities issued by private-sector financial institutions, in contrast to securitizations created by government-sponsored enterprises (“GSEs”) such as Fannie Mae (“Fannie”) and Freddie Mac (“Freddie”). *Id.* at 77; see also Wilmarth, *supra* note 1, at 988–89.

39. Benmelech & Dlugosz, *supra* note 35, at 1.

40. Jeffrey Manns, *Rating Risk After the Subprime Mortgage Crisis: A User Fee Approach for Rating Agency Accountability*, 87 N.C. L. REV. 1011, 1036–37 (2009); see also Viral V. Acharya et al., *Centralized Clearing for Credit Derivatives*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 254 (Viral V. Acharya & Matthew Richardson eds., 2009) (explaining that “a [CDS] is like an insurance contract”); Wilmarth, *supra* note 1, at 991–93, 1031–32.

41. James Crotty, *Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture’*, 33 CAMBRIDGE J. ECON. 563, 569 (2009) (citing (i) a 2007 report by Fitch Ratings, concluding that “58% of banks that buy and sell credit derivatives acknowledged that ‘trading’ or gambling is their ‘dominant’ motivation for operating in this market, whereas less than 30% said that ‘hedging/credit risk management’ was their primary motive,” and (ii) a statement by New York superintendent of

gregate exposure to the risks of securitized loans by using pools of CDS to construct synthetic CDOs. Synthetic CDOs were generally constructed to mimic the performance of cash flow CDOs, and synthetic CDOs issued yet another series of tranching, structured-finance securities to investors.⁴² By 2007, the total notional amounts of CDS and synthetic CDOs written with reference to securitized loans, ABS, MBS or cash flow CDOs may have exceeded \$15 trillion.⁴³

Thus, based on available estimates, approximately \$25 trillion of structured-finance securities and related derivatives were outstanding in the U.S. financial markets at the peak of the credit boom in 2007.⁴⁴ Eighteen giant LCFIs, including ten U.S. and eight foreign financial institutions (the “big eighteen LCFIs”), originated the lion’s share of those complex instruments.⁴⁵ Structured-finance securities and related derivatives not

insurance Eric Dinallo, concluding that “80% of the estimated \$62 trillion in CDS outstanding in 2008 were speculative”); Manns, *supra* note 40, at 1036–37 (noting the use of CDS as “speculative instruments”); Michael Lewis, *Betting on the Blind Side*, VANITY FAIR, April 2010 (explaining that “[i]n the beginning, credit-default swaps had been a tool for hedging Very quickly, however, the new derivatives became tools for speculation”).

42. Wilmarth, *supra* note 1, at 993–94, 1030–32.

43. *Id.* at 993–94, 1030–32 (citing estimates indicating that, at the peak of the credit boom, \$1.25 to \$6 trillion of synthetic CDOs were outstanding and that one-third of the \$45 trillion of outstanding CDS were written to protect holders of CDOs, CLOs and other structured-finance instruments).

44. *See supra* notes 38–39, 43 and accompanying text.

45. During the credit boom that led to the financial crisis, the 18 leading LCFIs in global and U.S. markets for securities underwriting, securitizations, structured-finance products, and OTC derivatives included the four largest U.S. banks (BoFA, Chase, Citigroup and Wachovia), the five largest U.S. securities firms (Bear, Goldman, Lehman Brothers, Merrill and Morgan Stanley), the largest U.S. insurer (AIG), and eight foreign universal banks (Barclays, BNP Paribas, Credit Suisse, Deutsche, HSBC, RBS, Société Générale and UBS). *See* Wilmarth, *supra* note 1, at 980–84, 989–90, 994–95, 1019–20, 1031–33; *see also* Dwight Jaffee et al., *Mortgage Origination and Securitization in the Financial Crisis*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 61, 69 tbl.1.4 (Viral V. Acharya & Matthew Richardson eds., 2009) (showing that 11 of those 18 LCFIs ranked among the top 12 global underwriters of CDOs between 2004 and 2008); Anthony Saunders, Roy C. Smith & Ingo Walter, *Enhanced Regulation of Large, Complex Financial Institutions*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 139, 142 tbl.5.2 (Viral V. Acharya & Matthew Richardson eds., 2009) (showing that all of the foregoing 18 LCFIs, except for AIG, ranked among the top 23 global providers of wholesale financial services in 2006 and 2007). In Wilmarth, *supra* note 1, at 994–95, I mistakenly omitted UBS from the list of leading LCFIs during the credit boom. UBS clearly belonged on that list, as shown at *id.* at 980–82, 989–90, 1019 n.280, 1032–33; *see also* Jaffee et al., *supra*, at 69 tbl.1.4 (listing UBS among the top 12 global underwriters of CDOs between 2004 and 2007); Saunders, Smith & Walter, *supra*,

only financed, but also far exceeded, about \$9 trillion of risky private-sector debt that was outstanding in U.S. financial markets when the credit crisis broke out.⁴⁶ The combined volume of MBS, cash flow CDOs, CDS, and synthetic CDOs created an “inverted pyramid of risk,” which enabled investors to place “multiple layers of financial bets” on the performance of high-risk loans in securitized pools.⁴⁷ Consequently, when the underlying loans began to default, the leverage inherent in this “pyramid of risk” produced losses that were far larger than the face amounts of the defaulted loans.⁴⁸

2. LCFIs Pressured Credit Ratings Agencies to Provide “AAA” Ratings to Promote the Sale of Risky Structured-Finance Securities

In view of the risks embodied in structured-finance securities, why did investors buy them? LCFIs made the securities attractive to investors by paying large fees to credit rating agencies (“CRAs”) in order to secure investment-grade ratings (BBB- and above) for most tranches of those securities. Many institutional investors (including banks and insurance companies) are obligated by law or contract to invest solely in securities that carry investment-grade ratings, and only a handful of CRAs possess the “regulatory imprimatur” to issue such ratings.⁴⁹

at 142 tbl.5.2 (showing that UBS was one of the eight largest global providers of wholesale financial services in 2006 and 2007).

46. About \$6.3 trillion of nonprime residential mortgage loans, credit card loans, and CRE loans were outstanding in the U.S. market in 2008, of which about \$2.8 trillion was held in securitized pools and other loans were referenced by CDS. See Wilmarth, *supra* note 1, at 988–94, 1024–41. In addition, about \$2.5 trillion of LBO loans and high-yield (“junk”) bonds were outstanding in the U.S. market in 2008, and a significant portion of that debt was securitized or referenced by CDS. *Id.* at 1039–43; see also CHARLES R. MORRIS, *THE TWO TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH* 123–26, 134–39 (2d ed. 2008).

47. Wilmarth, *supra* note 1, at 991–94, 1027–32.

48. See MORRIS, *supra* note 46, at 73–79, 113–14, 123–32; Michael Lewis, *The End, PORTFOLIO.COM* (Nov. 11, 2008), <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom/?print=true> (quoting hedge fund manager Steve Eisman, who explained that Wall Street firms built an “engine of doom” with cash flow CDOs and synthetic CDOs, because those instruments created “several towers of debt” on top of “the original subprime loans,” and “that’s why the losses are so much greater than the loans”).

49. Manns, *supra* note 40, at 1050–52; see also STOWELL, *supra* note 10, at 105–06, 125–28; Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 244–46 (2009); Matthew Richardson & Lawrence J. White, *The Ratings Agencies: Is Regulation the Answer?*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 101, 101–05 (Viral V. Acharya & Matthew Richardson eds., 2009); Benmelech & Dlugosz, *supra* note 35, at 3–4; Frank Partnoy, *Rethinking Regulation of Credit Rating Agencies: An*

CRA's charge fees for their ratings based on an "issuer pays" business model, which requires an issuer of securities to pay fees to one or more CRA's in order to secure credit ratings for its securities. The "issuer pays" model creates an obvious conflict of interest between a CRA's desire to earn fees from issuers of securities and the CRA's stake in preserving its reputation for making reliable risk assessments. Structured-finance securitizations heightened this conflict of interest because LCFIs often paid additional consulting fees to obtain CRA's advice on how to structure securitizations to produce the maximum percentage of AAA-rated securities.⁵⁰ Moreover, a small group of LCFIs dominated the securitization markets and were therefore significant repeat players in those markets. As a result, LCFIs could strongly influence a CRA's decision on whether to assign favorable ratings to an issue of structured-finance securities by threatening to seek higher ratings from other CRA's for the same issue.⁵¹

Moody's, one of the two leading CRA's, reported the highest profit margin of any company included in the S&P 500 index for five consecutive years during the early 2000s, while S&P, the other top CRA, "was similarly profitable."⁵² Moody's generated almost half of its total reve-

Institutional Investor Perspective 4–6 (U. San Diego Sch. of Law Legal Studies Research Paper No. 09-014,2009), available at <http://ssrn.com/abstract=1430608>.

50. For discussion of the conflicts of interest created by the CRA's "issuer pays" model, see, for example, Lynch, *supra* note 49, at 246–48, 256–61; Manns, *supra* note 40, at 1052; Partnoy, *supra* note 36, at 3–7; David Reiss, *Rating Agencies and Reputational Risk* 4–8 (Brook. L. Sch. Legal Studies Research Paper No. 136, 2009), available at <http://ssrn.com/abstract=1358316>. An investigative report issued by the Securities and Exchange Commission ("SEC") in 2008 discussed the CRA's conflicts of interest and quoted an email message sent by a CRA manager to a colleague on December 15, 2006. After complaining that CRA's were making the CDO market an "even bigger monster," the CRA manager remarked, "Let's hope we are all wealthy and retired by the time this house of cards falters." Lynch, *supra* note 49, at 258–60 (summarizing SEC report and quoting CRA manager's email message); see also Aaron Luchetti, *S&P Email: 'We Should Not Be Rating It'*, WALL ST. J., Aug. 2, 2008, at B1 (reporting that the quoted email message was sent by an analytical manager at Standard & Poor's ("S&P"), while an S&P staffer stated in another email message that "we rate every deal" and "it could be structured by cows and we would rate it").

51. Benmelech & Dlugosz, *supra* note 35, at 16–21, 25 (providing evidence of "rating shopping" by issuers of structured-finance securities); Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008, (Magazine), at 36; see also Lynch, *supra* note 49, at 256–58 (stating that a *Wall Street Journal* article and the SEC's 2008 investigative report on CRA's indicated that "the credit rating agencies were captured by MBS issuers and bent to the pressures inherent in the issuer-pays business model"); Wilmarth, *supra* note 1, at 988–94, 1011–12, 1017–20, 1027–42 (describing how a small group of LCFIs achieved dominance over the securitization markets).

52. Partnoy, *supra* note 49, at 5.

nues from rating structured-finance products during 2005 and 2006.⁵³ Given the generous fees CRAs received from LCFIs for rating structured-finance securities, it is not surprising that CRAs typically assigned AAA ratings to three-quarters or more of the tranches of ABS, RMBS, CDOs and CDOs-squared.⁵⁴

Investors relied heavily on credit ratings and usually did not perform any meaningful due diligence before deciding to buy structured-finance securities. SEC regulations allowed issuers to sell ABS, RMBS and CDOs to investors based on very limited disclosures beyond the instruments' credit ratings.⁵⁵ In addition, the complexity of structured-finance transactions made it difficult for investors to evaluate the risks of first-level securitizations and nearly impossible for investors to ascertain the risks of second- and third-level securitizations.⁵⁶

Investors also had strong incentives not to question the ratings assigned to structured-finance securities by CRAs. AAA-rated structured-finance securities paid yields that were significantly higher than other AAA-rated securities.⁵⁷ Structured-finance securities were therefore very

53. Coval et al., *supra* note 35, at 4–5; Crotty, *supra* note 41, at 566.

54. See Wilmarth, *supra* note 1, at 1028–29; Benmelech & Dlugosz, *supra* note 35, at 4 (stating that “[a] common feature of all structured finance deals, regardless of the type of underlying collateral, is that a large share of the securities issued (typically 70–85%) are carved out as AAA”); see also Jaffee et al., *supra* note 45, at 73–74 (showing that a typical securitization of subprime mortgages, followed by the creation of two cash flow CDOs and a CDO-squared, would produce an array of tranches of which more than 90% were rated AAA); cf. Coval et al., *supra* note 35, at 4 (stating that three-fifths of all outstanding issues of structured-finance products in 2007 carried AAA ratings, compared to less than one percent of outstanding issues of corporate debt).

55. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2070–73 (2007) (discussing limited disclosures given to institutional investors who bought structured-finance securities in private placements under SEC Rule 144A); Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulations Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 *U. ILL. L. REV.* 1359, 1360–62, 1373–87 (2009) (discussing additional reasons why SEC regulations failed to require adequate disclosures for offerings of CDOs and instead encouraged investors to rely on credit ratings).

56. Wilmarth, *supra* note 1, at 1026–28; Jaffee et al., *supra* note 45, at 73–74; Scott, *supra* note 35, at 7–8, 16; October 2009 IMF GFS Report, *supra* note 5, at 81.

57. AAA-rated structured finance securities paid higher yields than AAA-rated corporate bonds because they represented interests in large, diversified pools of risky loans and, therefore, were exposed to “enormous systematic risk” in the event of “large declines in the aggregate economy.” Coval et al., *supra* note 35, at 17–19 (quotes at 18). Structured-finance securities offered “payoffs essentially identical to a derivative security written against a broad economic index,” and securities with “[s]uch a risk profile should be expected to earn a higher rate of return than those available from single-name bonds, whose defaults are affected by firm-specific bad luck.” *Id.* at 18; see also Wilmarth, *su-*

attractive to investors who were seeking the highest available yields on “safe” debt securities during the low-interest, low-inflation environment of the pre-crisis period.⁵⁸

Thus, the investment-grade credit ratings issued by CRAs enabled LCFIs to transform “trillions of dollars of risky assets . . . into securities that were widely considered to be safe . . . [and] were eagerly bought up by investors around the world.”⁵⁹ LCFIs exploited the conflicts of interest inherent in the “issuer pays” model by paying copious fees that persuaded CRAs to “turn[] a blind eye” to the risks underlying structured-finance securities.⁶⁰ As a practical matter, LCFIs induced CRAs to issue corrupt ratings for structured-finance securities in much the same way that LCFIs had previously bribed and bullied in-house research analysts to provide corrupt recommendations to support dotcom and telecom stocks that LCFIs underwrote during the stock market boom of the late 1990s.⁶¹

Given the CRAs’ pervasive conflicts of interest, it is not surprising that their credit ratings misrepresented the true risks embedded in structured-finance securities. CRAs, like the LCFI issuers, either knowingly or recklessly made critical misjudgments by (i) giving too much weight to

pra note 1, at 1028 (noting that “AAA-rated senior tranches of RMBS . . . offered significantly higher yields than other types of AAA-rated investments and carried the same imprimatur from the [CRAs]”).

58. See Coval et al., *supra* note 35, at 4, 19; Wilmarth, *supra* note 1, at 1028–29; October 2009 IMF GFS Report, *supra* note 5, at 81; Acharya & Richardson, *supra* note 34, at 205 (stating that, in June 2006, “AAA-rated tranches of subprime CDOs offered twice the premium of the typical AAA credit-default swap of a corporation”); U.K. FIN. SERV. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 12–15 (March 2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter TURNER REVIEW] (explaining that LCFIs created novel types of securitized credit instruments to satisfy “a ferocious search for yield” by investors in the context of “very low medium- and long-term real interest rates”); Mark Astley et al., *Global Imbalances and the Financial Crisis* 178, 181, BANK OF ENGLAND Q. BULL., Q3, 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1478419 (concluding that “[t]he low interest rate environment seems to have interacted with strong competitive pressures on banks and asset managers to maintain returns, leading to a ‘search for yield’ in financial markets”) (footnote omitted).

59. Coval et al., *supra* note 35, at 3–4.

60. Manns, *supra* note 40, at 1043; see also Lynch, *supra* note 49, at 258–60; Manns, *supra* note 40, at 1041–47, 1052–53; Reiss, *supra* note 50, at 4–8.

61. FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 274–91 (2003); Wilmarth, *supra* note 1, at 1000. For a comprehensive journalistic account of the research analyst scandal, see CHARLES GASPARINO, BLOOD ON THE STREET: THE SENSATIONAL INSIDE STORY OF HOW WALL STREET ANALYSTS DUPED A GENERATION OF INVESTORS (2005).

the benefits of diversification from pooling large numbers of high-risk loans, (ii) failing to recognize that RMBS and CDOs became more risky as mortgage lending standards deteriorated between 2004 and 2007, (iii) failing to appreciate that RMBS and CDOs often contained dangerous concentrations of loans from high-risk states like California, (iv) underestimating the risk that a serious economic downturn would trigger widespread correlated defaults among pooled loans of similar types, (v) relying on historical data drawn from a relatively brief period in which benign economic conditions prevailed, and (vi) assuming that housing prices would never decline on a nationwide basis.⁶² By mid-2009, CRAs had cut their ratings on tens of thousands of investment-grade tranches of RMBS and CDOs, and securitization markets had collapsed.⁶³

3. LCFIs Promoted an Unsustainable Credit Boom that Set the Stage for the Financial Crisis

The LCFIs' large-scale securitizations of credit helped to create an enormous credit boom in the U.S. financial markets between 1991 and 2007. Nominal domestic private-sector debt nearly tripled, rising from \$10.3 trillion to \$39.9 trillion during that period, and the largest increases occurred in the financial and household sectors.⁶⁴ Total domestic private-sector debt as a percentage of gross domestic product ("GDP") rose from 150 percent in 1987 to almost 300 percent in 2007 and, by that measure, exceeded even the huge credit boom that led to the Great Depression.⁶⁵

62. See Coval et al., *supra* note 35, at 3–4, 8–21; Wilmarth, *supra* note 1, at 1034; Benmelech & Dlugosz, *supra* note 35, at 2, 13–15, 21–23, 25; Partnoy, *supra* note 36, at 6–11; Lowenstein, *supra* note 51.

63. October 2009 IMF GFS Report, *supra* note 5, at 93 fig.2.12 (reporting that, as of June 30, 2009, S&P had (i) cut its ratings on 90% of AAA-rated tranches of ABS CDOs issued from 2005 to 2007, and 80% of those tranches were reduced to noninvestment-grade ratings of BB or lower, and (ii) lowered its ratings on 63% of AAA-rated tranches of private-label RMBS issued during the same period, and 52% of those tranches were reduced to noninvestment-grade ratings); Benmelech & Dlugosz, *supra* note 35, at 8–9, 31 tbl.2 (reporting that Moody's issued 45,000 downgrades affecting 36,000 tranches of structured-finance securities during 2007 and the first nine months of 2008, and Moody's average downgrade during that period was 5.2 rating notches).

64. Wilmarth, *supra* note 1, at 1002 & nn.174–76 (reporting that financial sector debt accounted for \$13 trillion of the increase in domestic nongovernmental debt between 1991 and 2007, while household debt grew by \$10 trillion and nonfinancial business debt increased by \$6.4 trillion).

65. TURNER REVIEW, *supra* note 58, at 18 ex. 1.10; see also STOWELL, *supra* note 10, at 456 ex.3 (showing the rapid growth of total domestic nongovernmental debt as a percentage of GDP between the mid-1980s and the end of 2007); Wilmarth, *supra* note 1, at 974, 974 n.26 (referring to the credit boom of the 1920s that precipitated the Great Depression).

Financial sector debt as a percentage of GDP rose from 40 percent in 1988 to 70 percent in 1998 and 120 percent in 2008.⁶⁶ Meanwhile, household sector debt grew from two-thirds of GDP in the early 1990s to 100 percent of GDP in 2008.⁶⁷

The credit boom produced a surge in profits and employee compensation in the financial sector, and it greatly enhanced the financial sector's importance within the broader economy. "From 1996 through 2006, profits at financial companies rose an average of 13.8% per year, compared with 8.5% for nonfinancial companies."⁶⁸ Financial sector earnings doubled as a share of total corporate pretax profits between 1980 and 2007, rising from thirteen to twenty-seven percent of such profits.⁶⁹ During the same period, the compensation gap between financial sector employees and other workers grew from ten percent to fifty percent.⁷⁰ Stocks of financial firms included in the S&P 500 index held the highest aggregate market value of any sector of that index from 1995 to 1998, and again from 2002 to 2007.⁷¹

As the credit book inflated and the financial sector grew in size and importance to the overall economy, LCFIs also became more leveraged, more fragile, and more vulnerable to a systemic crisis. At the end of 2007, the ten largest U.S. financial institutions—all of which were leading participants in structured-finance securitization—had an average leverage ratio of 27:1 when their off-balance-sheet ("OBS") commitments

66. *The Gods Strike Back: A Special Report on Financial Risk*, ECONOMIST, Feb. 13, 2010, at 3, chart 1.

67. Peter Coy, *Why the Fed Isn't Igniting Inflation*, BUS. WEEK, June 29, 2009, at 20, 21; see also *supra* n.22 (reporting that the ratio of U.S. household debt to disposable personal income increased from 87% in 1990 to 139% in 2007).

68. Tom Lauricella, *Crumbling Profit Center: Financial Sector Showing Life, but Don't Bank on Long-Term Revival*, WALL ST. J., Mar. 24, 2008, at C1; see also HENRY KAUFMAN, *THE ROAD TO FINANCIAL REFORMATION: WARNINGS, CONSEQUENCES, REFORMS* 161 (2010) (stating that financial sector profits increased by 313% between 1995 and 2007, compared to a 197% profit rise for nonfinancial businesses).

69. Justin Lahart, *Has the Financial Industry's Heyday Come and Gone?*, WALL ST. J., Apr. 28, 2008, at A2; see also Buttonwood, *The Profits Puzzle*, ECONOMIST, Sept. 15, 2007, at 99 (reporting that the financial sector contributed "around 27% of the profits made by companies in the S&P 500 index [in 2007], up from 19% in 1996").

70. Lahart, *supra* note 69.

71. Elizabeth Stanton, *Bank Stocks Cede Biggest S&P Weighting to Technology* (Update 1), BLOOMBERG.COM, May 21, 2008; see also Lauricella, *supra* note 68 (reporting that financial stocks accounted for 22.3% of the value of all stocks included in the S&P index at the end of 2006, "up from just 13% at the end of 1995").

were taken into account.⁷² James Crotty has summarized the parallel development of financial growth, leverage and fragility as follows:

Over time, financial markets grew ever larger relative to the nonfinancial economy, important financial products became more complex, opaque and illiquid, and system-wide leverage exploded. As a result, financial crises became more threatening. This process culminated in the current crisis, which is so severe that it has pushed the global economy to the brink of depression.⁷³

As I noted in a previous article, “[b]y 2007, the health of the U.S. economy relied on a massive confidence game—indeed, some might say, a Ponzi scheme—operated by its leading financial institutions.”⁷⁴ This “confidence game,” which sustained the credit boom, could continue only as long as investors were willing “to keep buying new debt instruments that would enable overstretched borrowers to expand their consumption and service their debts.”⁷⁵ In the summer of 2007, when investors lost confidence in the ability of subprime borrowers to meet their obligations, “the game collapsed and a severe financial crisis began.”⁷⁶

B. LCFIs Retained Exposures to Many of the Hazards Embedded in Their High-Risk Lending

During the credit boom, LCFIs pursued a securitization strategy that produced highly leveraged risk-taking through the use of complex structured-finance products, CDS, and OBS vehicles.⁷⁷ This securitization strategy was highly attractive in the short term, because LCFIs (as well

72. See KAUFMAN, *supra* note 68, at 105 ex.8.4 (providing the total assets, OBS commitments and shareholders' equity for each of the 10 largest U.S. financial institutions—Citigroup, BofA, Chase, Morgan Stanley, Merrill, Wells Fargo, AIG, Goldman and Lehman—at the end of 2007). I calculated the leverage ratio for each of the 10 LCFIs by (i) combining the total assets and OBS commitments of each LCFI and (ii) dividing the combined number by the LCFI's shareholders' equity. See *infra* notes 90–99 and accompanying text (explaining how LCFIs used OBS vehicles to increase their leverage).

73. Crotty, *supra* note 41, at 564; see also TURNER REVIEW, *supra* note 58, at 19 (observing that “[t]he growing size of the financial sector was accompanied by an increase in total system leverage which . . . played an important role in driving the boom and in creating vulnerabilities that have increased the severity of the crisis”) (footnote omitted).

74. Wilmarth, *supra* note 1, at 1008 (footnote omitted).

75. *Id.*

76. *Id.*

77. Viral V. Acharya & Philipp Schnabl, *How Banks Played the Leverage Game, in* RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 83, 83–89 (Viral V. Acharya & Matthew Richardson eds., 2009); Blundell-Wignall et al., *supra* note 4, at 3–13; Saunders, Smith & Walter, *supra* note 45, at 140–45; Wilmarth, *supra* note 1, at 1027–41.

as the mortgage brokers, nonbank lenders and CRAs who worked with LCFIs) collected lucrative fees at each stage of originating, securitizing, rating and marketing the risky residential mortgages, commercial mortgages, credit card loans and LBO loans.⁷⁸ Based on the widespread belief that LCFIs were following an OTD strategy, both managers and regulators of LCFIs operated under the illusion that the credit risks inherent in the securitized loans were being transferred to the ultimate purchasers of structured-finance securities.⁷⁹ In significant ways, however, LCFIs actually pursued an originate to *not really* distribute program.⁸⁰

For example, LCFIs decided to keep large amounts of highly-rated, structured-finance securities on their balance sheets because regulators allowed LCFIs to do so with a minimum of capital. In the U.S., LCFIs took advantage of a regulation issued by the federal banking agencies in November 2001, which greatly reduced the risk-based capital charge for structured-finance securities rated “AAA” or “AA” by CRAs. The 2001 regulation assigned a risk weighting of only twenty percent to such securities in determining the amount of risk-based capital that banks were required to hold.⁸¹ As a practical matter, the 2001 rule cut the risk-based capital requirement for highly-rated tranches of RMBS and related CDOs from four percent to only 1.6 percent.⁸² The federal agencies adopted the 2001 rule even though commentators at the proposal stage warned that CRAs faced “an inherent conflict of interest” in rating structured-finance securities because the bank issuers would be “paying for the rating[s].”⁸³

In Europe, LCFIs similarly retained AAA-rated structured-finance securities on their balance sheets because the Basel I and Basel II capital accords assigned very low risk weights to such securities. In contrast to the U.S., European nations did not require banks to maintain a minimum leverage capital ratio and instead required banks only to meet the Basel

78. Crotty, *supra* note 41, at 565–66; Wilmarth, *supra* note 1, at 984–87, 995–96, 1017–20, 1034–42.

79. Wilmarth, *supra* note 1, at 995–96, 1030.

80. Acharya & Richardson, *supra* note 34, at 198–201; Wilmarth, *supra* note 1, at 970–71, 1032–35, 1039–43, 1046–48; TURNER REVIEW, *supra* note 58, at 15–21.

81. See Risk-Based Capital Guidelines, 66 Fed. Reg. 59614, 59625–27 (Nov. 29, 2001) [hereinafter 2001 Risk-Based Capital Rule]; Arnold Kling, Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008 at 25–26 (Sept. 15, 2009) (unpublished manuscript), available at <http://ssrn.com/abstract=1474430>.

82. Kling, *supra* note 81, at 25 fig.4.

83. 2001 Risk-Based Capital Rule, *supra* note 81, at 59265 (noting statements by “[s]everal commenters” who responded to the proposed rule by warning that the reliability of ratings would be undermined by conflicts of interest at CRAs); Kling, *supra* note 81, at 25–26; see also *supra* notes 49–53 and accompanying text (discussing conflicts of interest created by the “issuer pays” business model adopted by CRAs).

risk-weighted capital standards. As a result, European banks did not incur significant capital charges for holding on-balance-sheet, AAA-rated instruments due to their low risk weights under Basel rules.⁸⁴

LCFIs had other reasons to retain highly-rated structured finance securities on their balance sheets. As the credit boom reached its peak, LCFIs found it difficult to locate investors to purchase all of the AAA tranches they were producing. Managers at aggressive LCFIs decided to assume “warehouse risk” by keeping AAA-rated tranches on their balance sheets, because they wanted to complete more securitization deals, earn more fees, produce higher short-term profits and distribute larger compensation packages to executives and key employees.⁸⁵ In addition, several LCFIs engaged in “negative basis trades” (“NBTs”) by purchasing AAA-rated tranches and selling CDS on the same instruments to either AIG or monoline insurance companies. LCFIs used aggressive accounting techniques to book an immediate profit on each NBT in an amount equal to the estimated present value of the difference between (i) the expected revenues to be received from the AAA-rated tranches during the term of the NBT and (ii) the premiums to be paid on the CDS during that period (usually five to ten years).⁸⁶ The promise of near-term

84. For discussion of the liberal treatment of AAA-rated securities under the Basel accords, see Acharya & Schnabl, *supra* note 77, at 94–98; Andrew G. Haldane, *Banking on the State*, BANK INT'L SETTLEMENTS REVIEW 5–8 (Nov. 11, 2009), available at <http://www.bis.org/review/r091111e.pdf>. Because European banks did not have to comply with a minimum leverage capital ratio, the 13 largest European banks operated in 2008 with an average leverage ratio of 2.68%, compared to an average leverage ratio of 5.88% for the ten largest U.S. banks (which were required to maintain a leverage capital ratio of at least 4%). Similarly, the four largest U.S. securities firms had an average leverage ratio of only 3.33%, because the SEC did not require those firms to comply with a minimum leverage ratio. Adrian Blundell-Wignall & Paul Atkinson, *The Sub-prime Crisis: Causal Distortions and Regulatory Reform*, in LESSONS FROM THE FINANCIAL TURMOIL OF 2007 AND 2008: PROCEEDINGS OF A CONFERENCE ON 14-15 JULY 2008 55, 93–94, 95 tbl.6 (Paul Bloxham & Christopher Kent eds., 2008), available at <http://www.rba.gov.au/publications/conf/2008/conf-vol-2008.pdf>; McCoy et al., *supra* note 9, at 1358–60 (explaining that the SEC exempted the five largest U.S. investment banks from the SEC's net capital rule in 2004 and allowed them to determine their capital requirements based on internal risk models, with the result that leverage at the five firms increased to about 30:1 by 2008).

85. Wilmarth, *supra* note 1, at 1032–33; see also Gian Luca Clementi et al., *Rethinking Compensation in Financial Firms*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 197, 198–200 (Viral V. Acharya & Matthew Richardson eds., 2009); Crotty, *supra* note 41, at 568–69; Jaffee et al., *supra* note 45, at 71–73.

86. For discussion of negative basis trades, see Wilmarth, *supra* note 1, at 1033 n.355; David Henry & Matthew Goldstein, *Death of a Bond Insurer*, BUS. WEEK, Apr. 14, 2008, at 24, 25–26; Serena Ng & Susan Pulliam, *The Bond 'Transformers': Regula-*

profits from fees and NBTs blinded LCFIs to the risk that AIG and monoline insurers might default on their CDS obligations.⁸⁷

By 2007, Citigroup, Merrill, and UBS together held more than \$175 billion of AAA-rated CDOs on their books.⁸⁸ The huge losses suffered by those institutions on retained CDO exposures were a significant reason why all three needed extensive governmental assistance to avoid failure.⁸⁹

In addition, LCFIs retained risk exposures for many of the assets they ostensibly transferred to OBS entities through securitization. Regulators in the U.S. and Europe allowed LCFIs to sponsor structured investment vehicles (“SIVs”) and other OBS conduits, which were frequently used as dumping grounds for the RMBS and CDOs that LCFIs were unable to sell to arms-length investors. The sponsored conduits sold asset-backed commercial paper (“ABCP”) to investors (including MMMFs) and used the proceeds to buy structured-finance securities originated by the sponsoring LCFIs. The conduits faced a potentially dangerous funding mismatch between their longer-term, structured-finance assets and their shorter-term, ABCP liabilities. The sponsoring LCFIs covered that mismatch (in whole or in part) by providing explicit credit enhancements (including lines of credit) or implicit commitments to ensure the availability of liquidity if the sponsored conduits could not roll over their ABCP.⁹⁰

U.S. regulators adopted capital rules that encouraged the use of ABCP conduits. Those rules did not assess any capital charges against LCFIs for transferring securitized assets to sponsored conduits, but instead, required LCFIs to post capital only if they provided explicit credit en-

tors Revisit a Loophole Allowing Insurers to Do Swaps, WALL ST. J., Jan. 30, 2008, at C1.

87. GILLIAN TETT, *FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE* 127–28, 134, 138, 216–17 (2009); Wilmarth, *supra* note 1, at 1031–35 (noting that AIG and monoline insurers wrote about \$1 trillion of CDS with respect to structured-finance securities); Henry & Goldstein, *supra* note 86; Ng & Pulliam, *supra* note 86 (noting that “[f]or Wall Street firms, the bond insurers’ willingness to sell [CDS] was a potential bonanza” that “benefited the banks by freeing capital . . . [and] enabled the banks to book sizable profits upfront”).

88. Clementi et al., *supra* note 85, at 198–200.

89. TETT, *supra* note 87, at 133–39, 204–06; Blundell-Wignall et al., *supra* note 4, at 4, 7–11; Jaffee et al., *supra* note 45, at 68–69, 72–73; *infra* notes 118–119 and accompanying text.

90. For discussion of the risk exposures of LCFIs to SIVs and other sponsored conduits, see TETT, *supra* note 87, at 97–98, 127–28, 136, 196–98; Acharya & Schnabl, *supra* note 77, at 88–94; Wilmarth, *supra* note 1, at 1033.

hancements to their conduits.⁹¹ Moreover, a 2004 regulation approved a very low capital charge for sponsors' lines of credit, equal to only one-tenth of the usual capital charge of eight percent, as long as the lines of credit had maturities of one year or less.⁹²

ABCP conduits sponsored by LCFIs grew rapidly during the peak years of the credit boom. As a result, the ABCP market in the United States nearly doubled after 2003 and reached \$1.2 trillion in August 2007. Three-quarters of that amount was held in 300 conduits sponsored by U.S. and European LCFIs.⁹³ Citigroup was the largest conduit sponsor, and seven of the top ten sponsors were members of the "big eighteen" club of LCFIs.⁹⁴ As a result of their risk exposures to conduits and their other OBS commitments, many of the leading LCFIs were much more highly leveraged than their balance sheets indicated.⁹⁵

After the financial crisis broke out in August 2007, conduits suffered large losses on their holdings of structured-finance securities. Many conduits were unable to roll over their ABCP because investors refused to buy securities (like ABCP) that were exposed to potential losses from subprime mortgages.⁹⁶ To prevent conduit defaults and avoid damage to their reputations, most LCFI sponsors went beyond their legal obligations and either brought conduit assets back onto their balance sheets or provided stronger credit enhancements that enabled conduits to remain in business.⁹⁷

91. Acharya & Schnabl, *supra* note 77, at 89.

92. Risk-Based Capital Guidelines, 69 Fed. Reg. 44908, 44910-11 (July 28, 2004); *see also* Acharya & Schnabl, *supra* note 77, at 89 (noting that capital requirements for short-term "liquidity enhancements" were "only 0.8 percent of asset value").

93. For an analysis of ABCP conduits and the growth of the ABCP market, see Martin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009*, 24 J. ECON. PERSP. 29, 32-34, 38 fig.1 (2010).

94. Acharya & Schnabl, *supra* note 77, at 93 tbl.2.1 (listing Citigroup, BofA, Chase, HSBC, Société Générale, Deutsche and Barclays among the top 10 conduit sponsors).

95. *See* KAUFMAN, *supra* note 68, at 105 exh.8.4; TETT, *supra* note 87, at 97-98; Crotty, *supra* note 41, at 570.

96. For a discussion of losses suffered by ABCP conduits and the collapse of the ABCP market, *see* Acharya & Schnabl, *supra* note 77, at 89-92 (noting that the outstanding volume of ABCP fell from \$1.22 trillion to \$800 billion between August 2007 and January 2008).

97. *Id.* at 91-94; *see also* Wilmarth, *supra* note 1, at 1033 (observing that the conduit rescues "showed that LCFIs felt obliged, for reasons of 'reputation risk,' to support OBS entities that they had sponsored, even when they did not have explicit contractual commitments to do so"). Citigroup absorbed \$84 billion of assets onto its balance sheet from seven SIVs, while HSBC and Société Générale took back \$50 billion of assets from their SIVs. Wilmarth, *supra* note 1, at 1033 n.358.

Thus, notwithstanding the widely-shared assumption that LCFIs were following an OTD strategy, they did not transfer many of the credit risks created by their securitization programs. Instead, “they ‘warehoused’ nonprime mortgage-related assets . . . [and] transferred similar assets to sponsored OBS entities.”⁹⁸ In fact, LCFIs retained risk exposures to about half of the outstanding AAA-rated ABS in mid-2008 through their “warehoused” and OBS positions.⁹⁹ In many respects, LCFIs “pursued an ‘originate to *not really* distribute’ strategy, which prevented financial regulators and analysts from understanding the true risks created by the LCFIs’ involvement with nonprime mortgage-related assets.”¹⁰⁰

Commentators noted that the LCFIs’ use of complex derivatives and OBS structures resembled the abusive accounting maneuvers of Enron, which Congress thought it had prohibited by passing the Sarbanes-Oxley Act in 2002.¹⁰¹ Indeed, many of the same LCFIs that were embroiled in the financial crisis had previously played major roles in structuring Enron’s deceptive transactions.¹⁰² Belatedly, the Financial Accounting Standards Board (“FASB”) and federal banking agencies took action during the past year to force banks to provide on-balance-sheet accounting and capital treatment for OBS entities they control.¹⁰³

98. Wilmarth, *supra* note 1, at 1033–34.

99. Acharya & Schnabl, *supra* note 77, at 97 tbl.2.2, 97–98.

100. Wilmarth, *supra* note 1, at 1034.

101. See, e.g., Floyd Norris, *Why Surprises Still Lurk After Enron*, N.Y. TIMES, Feb. 29, 2008, at C1; David Reilly, *Look Under the Banks’ Hoods: FASB to Re-Examine Whether Financing Vehicles That Added to Woes Should Stay Off Books*, WALL ST. J., Feb. 29, 2008, at C1. For a description of Enron’s manipulative use of derivatives and OBS entities, see Arthur E. Wilmarth, Jr., *Conflicts of Interest and Corporate Governance Failures at Universal Banks During the Stock Market Boom of the 1990s: The Cases of Enron and WorldCom*, in CORPORATE GOVERNANCE IN BANKING: A GLOBAL PERSPECTIVE 97, 102–10 (Benton E. Gup ed., 2007).

102. Wilmarth, *supra* note 1, at 999–1001; Wilmarth, *supra* note 101, at 101–12 (explaining the important roles played by Citigroup, Chase, Barclays, Credit Suisse, Deutsche, RBS, Merrill Lynch, BNP Paribas and UBS in (i) structuring Enron’s abusive transactions and/or (ii) pressuring their in-house research analysts to provide favorable reports on Enron).

103. Risk-Based Capital Guidelines, 74 Fed. Reg. 47138, 47140–41 (Sept. 15, 2009) (explaining that FASB had adopted new standards that would require consolidated accounting treatment for all OBS “variable interest entities” (VIEs), including ABCP conduits, over which a bank exercises a “controlling financial interest” by reason of (i) “the power to direct matters that most significantly impact the activities of the VIE” or (ii) “either the obligation to absorb losses of the VIE that could potentially be significant to the VIE, or the right to receive benefits from the VIE that could potentially be significant to the VIE, or both”); Risk-Based Capital Guidelines, 75 Fed. Reg. 4636, 4637–39 (Jan. 28, 2010) (applying risk-based and leverage capital requirements to VIEs that are subject to consolidated accounting treatment under the FASB’s new standards).

C. LCFIs were Not Solely Responsible for the Financial Crisis, but They were the Most Important Private-Sector Catalysts for the Crisis

Excessive risk-taking by LCFIs was not the only cause of the current financial crisis. Several additional factors played an important role. First, many analysts have criticized the FRB for maintaining an excessively loose monetary policy during the second half of the 1990s and again between 2001 and 2005. Critics charge that the FRB's monetary policy mistakes produced speculative asset booms that led to the dotcom-telecom bust in the stock market between 2000 and 2002 and the bursting of the housing bubble after 2006.¹⁰⁴

Second, during the past decade several Asian nations that were large exporters of goods (including China, Japan, and South Korea) maintained artificially low exchange rates for their currencies against the dollar, the pound sterling, and the euro. To preserve the desired currency exchange rates, those nations boosted the value of Western currencies by purchasing Western government securities and investing in Western financial markets. In addition, many oil exporting nations invested large amounts in Western assets. Thus, nations with significant balance-of-trade surpluses provided large amounts of credit and investment capital that helped to promote asset booms in the U.S., the U.K., and other European countries.¹⁰⁵

Third, Robert Shiller and others have argued that "bubble thinking" caused home buyers, LCFIs, CRAs, investors in structured-finance securities, and regulators to believe that the housing boom would continue

104. For critiques of the FRB's monetary policy, see JOHN B. TAYLOR, GETTING OFF TRACK: HOW GOVERNMENT ACTIONS AND INTERVENTIONS CAUSED, PROLONGED AND WORSENERED THE FINANCIAL CRISIS 1-6, 11-13 (2009) (contending that the FRB's "extra-easy [monetary] policy accelerated the housing boom and thereby ultimately led to the housing bust"); Wilmarth, *supra* note 1, at 1005-06 (summarizing analysis by various critics of the FRB); Yener Altumbas et al., *Does Monetary Policy Affect Bank Risk-taking* 1, 4, 16 (Bank Int'l Settlements Working Paper No. 298, 2010), available at <http://www.bis.org/publ/work298.htm> (determining, based on a study of performance data for 1,100 banks operating in the U.S. and the EU from 1998 to 2008, that "unusually low interest rates over an extended period of time contributed to an increase in banks' risk-taking"); Kling, *supra* note 81, at 38-39. For an impassioned attack on the FRB's monetary policy between the mid-1990s and 2005, see generally WILLIAM A FLECKENSTEIN & FREDERICK SHEEHAN, GREENSPAN'S BUBBLES: THE AGE OF IGNORANCE AT THE FEDERAL RESERVE (2008).

105. For analysis of the impact of large purchases of Western government securities and other investments in Western financial markets by Asian nations and oil exporting countries, see MORRIS, *supra* note 46, at 88-104; Wilmarth, *supra* note 1, at 1006-07; Astley et al., *supra* note 58, at 180-82.

indefinitely and “could not end badly.”¹⁰⁶ According to these analysts, a “*social contagion* of boom thinking” helps to explain both why the housing bubble continued to inflate for several years, and why regulators failed to stop LCFIs from making high-risk loans to borrowers who had no capacity to repay or refinance their loans unless their properties continued to appreciate in value.¹⁰⁷ Failures by federal financial regulators to stop unsound lending and speculative risk-taking by LCFIs played a significant role in precipitating the financial crisis.¹⁰⁸

Finally, Fannie Mae (“Fannie”) and Freddie Mac (“Freddie”) contributed to the housing bubble by purchasing large quantities of nonprime mortgages and RMBS beginning in 2003. Those government-sponsored entities (“GSEs”) purchased nonprime mortgages and RMBS because (i) Congress pressured them to fulfill affordable housing goals, (ii) large nonprime mortgage lenders (including Countrywide) threatened to sell most of their mortgages to Wall Street firms if the GSEs failed to purchase more of their nonprime loans, and (iii) Fannie’s and Freddie’s senior executives feared the loss of additional market share to LCFIs that were aggressively securitizing nonprime mortgages into private-label RMBS. In 2007, the two GSEs held \$220 billion of RMBS backed by subprime and Alt-A mortgages, representing a tenth of the nonprime market. Heavy losses on Fannie’s and Freddie’s portfolios of nonprime RMBS contributed to their collapse in 2008.¹⁰⁹

106. ROBERT J. SHILLER, *THE SUBPRIME SOLUTION* 48–54 (2008); *see also* MORRIS, *supra* note 46, at 65–69; Wilmarth, *supra* note 1, at 1007–08; Astley et al., *supra* note 58, at 181 (observing: “Financial market participants were lulled into a false sense of security by extrapolating only from recent benign data, thereby attaching low probabilities to adverse outcomes. This ‘disaster myopia’ may have contributed to the price of risk being set too low”) (footnote omitted).

107. SHILLER, *supra* note 106, at 41–54; *see also* Wilmarth, *supra* note 1, at 1007–08, and sources cited therein.

108. For critiques of regulatory failures by the FRB, the Office of the Comptroller of the Currency (“OCC”), the Office of Thrift Supervision (“OTS”) and SEC, *see, e.g.*, Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 80–95 (2008); McCoy et al., *supra* note 9, at 1343–66; Wilmarth, *supra* note 10, at 19–31; Neglect and Inaction: An Analysis of Federal Banking Regulators’ Failure to Enforce Consumer Protections (Center for Responsible Lending, CRL Policy Brief, July 13, 2009), *available at* <http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/neglect-and-inaction-7-10-09-final.pdf>.

109. For discussions of Fannie’s and Freddie’s purchases of nonprime RMBS and the reasons for such purchases, *see, for example*, Dwight Jaffee et al., *What to Do about the Government-Sponsored Enterprises*, in *RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM* 121, 124–30 (Viral V. Acharya & Matthew Richardson eds., 2009); Christopher L. Peterson, *Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis*, 10 LOY. J. PUB. INT. L. 149, 163–168 (2009); Jo Becker et al., *White*

Notwithstanding the foregoing factors, LCFIs were clearly “the primary private-sector catalysts for the destructive credit boom that led to the subprime financial crisis, and they [became] the epicenter of the current global financial mess.”¹¹⁰ As indicated above, the big eighteen LCFIs were dominant players in global securities and derivatives markets during the credit boom.¹¹¹ The big eighteen LCFIs included most of the top underwriters for nonprime RMBS, ABS, CMBS and LBO loans as well as related CDOs, CLOs and CDS.¹¹² While Fannie and Freddie funded about one-tenth of the nonprime mortgage market between 2003 and 2007, they did so primarily by purchasing RMBS that were underwritten by LCFIs.¹¹³ LCFIs provided most of the rest of the funding for nonprime mortgages, as well as much of the financing for risky credit card loans, CRE loans, and LBO loans.¹¹⁴

The central role of the big eighteen LCFIs in the financial crisis is confirmed by the enormous losses they suffered and the huge bailouts they received. The big eighteen LCFIs accounted for almost three-fifths of the \$1.49 trillion of total worldwide losses recorded by banks, securities firms, and insurers between the outbreak of the financial crisis in mid-2007 and the beginning of 2010.¹¹⁵ The list of leading LCFIs is “a who’s who of the current financial crisis” that includes “[m]any of the firms that either went bust . . . or suffered huge write-downs that led to significant government intervention.”¹¹⁶ Lehman Brothers (“Lehman”) failed, while two other members of the big eighteen LCFIs (AIG and RBS) were nationalized and three others (Bear Stearns, Merrill Lynch, and Wachovia) were acquired by other LCFIs with substantial governmental assis-

House Philosophy Stoked Mortgage Bonfire, N.Y. TIMES, Dec. 21, 2008, at A1; Paul Davidson, *Lawmakers Blast Former Freddie, Fannie CEOs: Execs Say Competition Played Role in Decisions*, USA TODAY, Dec. 10, 2008, at 3B; Charles Duhigg, *Pressured to Take More Risk, Fannie Reached Tipping Point*, N.Y. TIMES, Oct. 5, 2008, at A1.

110. Wilmarth, *supra* note 1, at 1046.

111. See *supra* note 45 and accompanying text.

112. Wilmarth, *supra* note 1, at 982–84, 989–91, 1019–20, 1031–35, 1039–42; see also Jaffee, *supra* note 45, at 69 tbl.1.4 (showing that the big eighteen LCFIs included eleven of the twelve top global underwriters of CDOs during 2006 and 2007).

113. See Peterson, *supra* note 109, at 167–69; *supra* note 109 and accompanying text.

114. See Jaffee et al., *supra* note 45, at 68–73; Saunders, Smith & Walter, *supra* note 45, at 143–45; *supra* Part II.A.1.

115. Yap & Pierson, *supra* note 14 (showing that the big eighteen LCFIs accounted for \$860 billion, or 58%, of the \$1.49 trillion of losses suffered by banks, securities firms and insurers); see also Saunders, Smith & Walter, *supra* note 45, at 144–45 tbl.5.3 (showing writedowns by nine of the big eighteen LCFIs as of mid-2008).

116. Jaffee, *supra* note 45, at 69.

tance.¹¹⁷ Three additional members of the group—Citigroup, Bank of America (“BofA”), and UBS—survived only because they received costly government bailouts.¹¹⁸ JP Morgan Chase (“Chase”), Goldman Sacks (“Goldman”), and Morgan Stanley received substantial infusions of capital under the federal government’s Troubled Asset Relief Program (“TARP”), and Goldman and Morgan Stanley quickly converted to BHCs to secure permanent access to the FRB’s discount window as well as “the Fed’s public promise of protection.”¹¹⁹

Only Lehman failed of the big eighteen LCFIs, but the U.S., the U.K., and European nations provided extensive assistance to ensure the survival of at least twelve other members of the group.¹²⁰ In the U.S., the federal government guaranteed the viability of the nineteen largest BHCs as well as AIG.¹²¹ Those institutions received \$290 billion of capital infusions from the federal government, and they also issued \$235 billion of debt that was guaranteed (and thereby subsidized) by the FDIC. In contrast, smaller banks received only \$41 billion of capital assistance and

117. STOWELL, *supra* note 10, at 182–84, 398–405, 408–17; Wilmarth, *supra* note 1, at 1044–45; Wilmarth, *supra* note 10, at 28–30.

118. Wilmarth, *supra* note 1, at 1044–45 (stating that Citigroup and BofA received “huge bailout packages from the U.S. government that included \$90 billion of capital infusions and more than \$400 billion of asset guarantees,” while UBS “received a \$60 billion bailout package from the Swiss government”); *see also* WESSEL, *supra* note 9, at 239–41, 259–63 (discussing Citigroup and BofA bailouts).

119. WESSEL, *supra* note 9, at 217; *see also id.* at 217–18, 227, 236–40 (noting that Chase received \$25 billion of TARP capital while Goldman and Morgan Stanley each received \$10 billion).

120. Because Lehman’s collapse created a severe disruption in global financial markets, federal authorities decided to take all measures necessary to prevent other major LCFIs from suffering comparable failures. That decision led to the federal government’s bailouts of AIG, Citigroup and BofA, the infusions of TARP capital into other LCFIs and other extraordinary measures of support for the financial markets. *See generally* ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES* 373–537 (2009); WESSEL, *supra* note 9, at 189–241; Fabio Benedetti-Valentini, *SocGen Predicts ‘Challenging’ 2009, Posts Profit*, BLOOMBERG.COM (Feb. 18, 2009) (reporting that the French government had provided financial assistance to Société Générale by purchasing subordinated debt and preferred stock from the bank); *supra* notes 117–119 and accompanying text (explaining that Bear, Merrill and Wachovia avoided failure due to government-assisted acquisitions, while AIG, RBS, BofA, Citigroup, UBS, Chase, Goldman and Morgan Stanley received varying amounts of direct governmental assistance).

121. *See* Robert Schmidt, *Geithner Slams Bonuses, Says Banks Would Have Failed* (Update 2), BLOOMBERG.COM (Dec. 4, 2009) (quoting statement by Treasury Secretary Timothy Geithner that “none” of the biggest U.S. banks would have survived if the federal government had not intervened to support the financial system); *supra* notes 9–12 and accompanying text.

issued only \$11 billion of FDIC-guaranteed debt.¹²² A prominent FRB official recently observed that LCFIs “were central to this crisis as it expanded and became a global recession. However, while the crisis caused workers to lose their jobs and families to forfeit their homes, the stockholders and creditors of these firms enjoyed special protection funded by the American taxpayer.”¹²³ He further remarked, “It is no longer conjecture that the largest institutions in the United States have been determined to be too big to fail. They have been bailed out.”¹²⁴

122. November 2009 COP Report, *supra* note 7, at 75, 76 fig.10 (showing that the 19 largest BHCs received \$220 billion of TARP capital and issued \$235 billion of FDIC-guaranteed debt); *see also id.* at 117 fig.26 (showing that AIG received \$70 billion of TARP capital); *see also id.* at 6–7, 35–38, 58–63 (describing the FDIC’s Debt Guarantee Program (DGP) for banks and BHCs); *id.* at 68–72 (concluding that financial institutions received significant federal subsidies from issuing FDIC-guaranteed debt). Financial institutions other than the 19 largest BHCs issued \$66 trillion of FDIC-guaranteed debt by October 2009. However, \$55 billion of that amount was issued by GE Capital, a huge finance company that is a subsidiary of GE, a leading industrial conglomerate. GE Capital owns two FDIC-insured depository institutions (a thrift and an industrial bank) located in Utah. Federal regulators granted GE Capital special permission to issue FDIC-guaranteed debt even though it was not a BHC and therefore did not meet the general terms and conditions for participation in the DGP. After subtracting the amount issued by GE Capital, smaller banks issued only \$11 trillion of FDIC-guaranteed debt. *See id.* at 37–38, 69 fig.6 (showing amount of FDIC-guaranteed debt issued by GE Capital); 75–76 (showing amounts issued by the 19 largest BHCs and by other institutions); *see also* Jeff Gerth, *Paulson’s Book Details GE Chief’s Private Concerns in 2008 Over Company’s Debt*, WASH. POST, Feb. 6, 2010, at A8 (reporting on federal regulators’ approval of GE Capital’s participation in the DGP in November 2008, after GE Capital encountered significant problems in selling commercial paper to fund its operations); Jeff Girth & Brady Dennis, *How a Loophole Benefits GE in Bank Rescue: Industrial Giant Becomes Top Recipient in Debt-Guarantee Program*, WASH. POST, June 29, 2009, at A1.

123. Thomas M. Hoenig, President, Federal Reserve Bank of Kansas City, Regulatory Reform and the Economy: We Can Do Better 8, Speech at the 2009 Colorado Economic Forums, Denver, Colo. (Oct. 6, 2009), *available at* <http://www.kansascityfed.org/SpeechBio/HoenigPDF/Denver.Forums.10.06.09.pdf> [hereinafter *Hoenig October 6, 2009 Speech*].

124. Thomas M. Hoenig, President, Fed. Reserve Bank of Kansas City, Leverage and Debt: The Impact of Today’s Choices on Tomorrow 4, Speech at the 2009 Annual Meeting of the Kansas Bankers Association (Aug. 6, 2009), *available at* <http://www.kansascityfed.org/SpeechBio/HoenigPDF/hoenigKBA.08.06.09.pdf> [hereinafter *Hoenig August 6, 2009 Speech*]; *see also* Charles I. Plosser, President and CEO, Fed. Reserve Bank of Philadelphia, Some Observations About Policy Lessons from the Crisis 3, Speech at the Philadelphia Fed Policy Forum (Dec. 4, 2009), *available at* http://www.philadelphiafed.org/publications/speeches/plosser/2009/12-04-09_fed-policy-forum.pdf (stating that “[d]uring this crisis and through the implementation of the stress tests, we have effectively declared at least 19 institutions as too big to fail”).

D. Recent Bailouts of LCFIs Have Confirmed Their TBTF Status, Thereby Intensifying Systemic Risk and Moral Hazard in Financial Markets

As shown above, LCFIs became the “epicenter of the current global financial mess” because they pursued aggressive business strategies premised on (i) maximizing short-term fee income by originating and securitizing high-risk loans, (ii) seeking speculative gains by investing in structured-finance securities and trading in CDS, (iii) leveraging earnings by manipulating regulatory capital requirements, and (iv) funding operations by relying on the continuous availability of short-term funding from the capital markets.¹²⁵ Those high-risk business strategies exposed LCFIs to huge losses and potential failures when asset bubbles in U.S. and European housing markets, CRE markets and LBO markets burst in the second half of 2007.¹²⁶ Three prominent academics recently concluded that LCFIs

. . . committed themselves to unusual degrees of leverage and other business practices on and off the balance sheet to ramp up earnings but which . . . jeopardized their institution’s safety and soundness, ultimately imposing a high level of risk on the financial system as a whole. This generalization applied equally to LCFIs originating in commercial banking, insurance, and investment banking. . . . All types of LCFIs contributed to placing the financial system and consequently the real economy at severe risk.¹²⁷

By 2007 LCFIs had created very high levels of systemic risk in U.S. and European financial markets. The term “systemic risk” is typically used to describe the vulnerability of financial markets and the real economy to spillover effects from (i) the failure of a major financial institution or (ii) the failures of many financial institutions with highly correlated risk exposures.¹²⁸ For example, the failure of a leading financial

125. Wilmarth, *supra* note 1, at 970–71, 994–97, 1046–48.

126. *Id.* at 1032–43.

127. Saunders, Smith & Walter, *supra* note 45, at 144–45.

128. For helpful definitions of systemic risk, see, for example, E. PHILIP DAVIS, DEBT, FINANCIAL FRAGILITY AND SYSTEMIC RISK 117 (1992) (defining systemic risk as “a disturbance in financial markets which entails unanticipated changes in prices and quantities in credit or asset markets, which lead to a danger of failure of financial institutions, and which in turn threatens to spread so as to disrupt the payments mechanism and the capacity of the financial system to allocate capital”); Viral Acharya et al., *Regulating Systemic Risk*, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 283, 284–89 (Viral V. Acharya & Matthew Richardson eds., 2009) [hereinafter Acharya et al., *Regulating Systemic Risk*]; George G. Kaufman & Kenneth E. Scott, *What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?*, INDEP. REV., Winter 2003, at 371, 372–76 (2003) (describing “chain-reaction and common-shock concepts of systemic risk”); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198–204 (2008).

institution may create a “chain reaction” that imposes severe losses and the threat of failure on other important financial institutions that are counterparties in transactions with the failed institution. Alternatively, a “common economic shock” may cause the failures of many financial institutions with correlated exposures to that shock. In either case, widespread defaults among important financial institutions are likely to cause significant disruptions in financial markets and to inflict serious injury on the real economy through a sharp increase in the cost of capital and credit and/or a steep reduction in the availability of capital and credit.¹²⁹ The threat that AIG would default on its CDS and securities lending contracts with a number of major U.S. and foreign LCFIs is a good example of “chain reaction” systemic risk, while the highly correlated exposures of many LCFIs in 2007 to collapsing prices in housing, CRE, and LBO markets provide a striking illustration of “common economic shock” systemic risk.¹³⁰ As indicated by those examples, both types of systemic risk are likely to occur during severe and widespread financial crises.

The systemic risk created by LCFIs during the credit boom led inexorably to government-financed bailouts of major financial institutions during the present crisis. Several years ago, I argued that emergency measures taken by governments around the world in response to systemic crises manifested a strong trend in favor of protecting large banks and their depositors:

[G]overnment officials often proclaim their adherence to ‘market discipline’ before a banking crisis occurs, [but] the experiences of the Great Depression and more recent events have convinced most authorities that systemic banking crises cannot be left to run their course. The conventional response since the 1970s has been to take the same course that U.S. authorities adopted after 1933—namely to recapitalize large banks and protect depositors against loss.¹³¹

129. Kaufman & Scott, *supra* note 128, at 372–73, 375.

130. For discussions of the federal government’s decision to bail out AIG because of the risk that AIG’s failure would impose severe losses on major U.S. and foreign LCFIs that were counterparties of AIG, see, for example, SORKIN, *supra* note 120, at 380–407, 532–33; TETT, *supra* note 87, at 233, 237–39; WESSEL, *supra* note 9, at 25–26, 189–98; Blundell-Wignall, et al., *supra* note 4, at 11, 12 tbl.3. For discussions of systemic risk resulting from the risk exposures of many LCFIs in 2007 to falling prices in housing, CRE, and LBO markets, see, for example, MORRIS, *supra* note 46, at 65–85, 113–39; Blundell-Wignall & Atkinson, *supra* note 84, at 58–66; McCoy et al., *supra* note 9, at 1329–33, 1338–44, 1366–71; Wilmarth, *supra* note 1, at 970–71, 994–97, 1008–11, 1020–24, 1032–43.

131. Arthur E. Wilmarth, Jr., *Does Financial Liberalization Increase the Likelihood of a Systemic Banking Crisis? Evidence from the Past Three Decades and the Great Depression*, in TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 77, 96

At about the same time, I predicted that the Gramm-Leach-Bliley Act of 1999 (“GLBA”) would make the TBTF problem much worse by “extend[ing] the scope of the TBTF subsidy to reach nonbank affiliates of large financial holding companies.”¹³² I warned that GLBA’s authorization of financial conglomerates “increases the likelihood that major segments of the securities and life insurance industry will be brought within the scope of the TBTF doctrine.”¹³³

In fact, the current financial crisis has caused the U.S. and other nations to implement massive bailouts of LCFIs, including leading securities firms and insurance companies as well as banks.¹³⁴ At the height of the financial crisis in March 2009, FRB Chairman Bernanke declared that the federal government was committed to ensure the survival of “systemically important financial institutions” (“SIFIs”) in order to prevent a systemic collapse of the financial markets and an economic depression.¹³⁵ Chairman Bernanke defended the federal government’s decision to ensure “the continued viability” of SIFIs in the following terms:

In the midst of this crisis, given the highly fragile state of financial markets and the global economy, government assistance to avoid the failures of major financial institutions has been necessary to avoid a

(Benton E. Gup ed., 2004); *see also* GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* 40, 75–77 (2004) (observing that many foreign countries provided extensive assistance to banks and protected depositors during systemic financial crises in the 1980s and 1990s); Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 *CONN. L. REV.* 1539, 1589, 1598–1606 (2007) [hereinafter Wilmarth, *Separation of Banking and Commerce*] (same).

132. Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 *U. ILL. L. REV.* 215, 446; *see also id.* at 303–04.

133. *Id.* at 447.

134. *See* Office of the Special Inspector General for the Troubled Asset Relief Program, *Additional Insight on Use of Troubled Asset Relief Funds (SIGTARP-10-004)* 2–3, 7–9, 26–31 (Dec. 10, 2009) (discussing \$4.4 billion of capital assistance provided by the Treasury Department to two large life insurers, Hartford Life and Lincoln National), *available at* http://www.sig tarp.gov/reports/audit/2009/Additional_Insight_on_Use_of_Troubled_Ass et_Relief_Program_Funds.pdf; *supra* notes 9–13, 117–124 and accompanying text (describing rescues of LCFIs by the U.S. and foreign governments, including, inter alia, federally-assisted rescues of AIG, Bear and Merrill and federal assistance provided to Goldman and Morgan Stanley).

135. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve, *Financial Reform to Address Systemic Risk*, Speech at the Council on Foreign Relations (Mar. 10, 2009), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>.

further serious destabilization of the financial system, and our commitment to avoiding such a failure remains firm.¹³⁶

Chairman Bernanke admitted that “the too-big-to-fail issue has emerged as an enormous problem” because “it reduces market discipline and encourages excessive risk-taking” by TBTF firms.¹³⁷ Several months later, Governor Mervyn King of the Bank of England condemned the perverse incentives created by TBTF subsidies in even stronger terms. Governor King maintained that “[t]he massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created possibly the biggest moral hazard in history.”¹³⁸ He further argued that TBTF subsidies provided a likely explanation for decisions by LCFIs to engage in high-risk strategies during the credit boom:

Why were banks willing to take risks that proved so damaging to themselves and the rest of the economy? One of the key reasons – mentioned by market participants in conversations before the crisis hit – is that incentives to manage risk and to increase leverage were distorted by the implicit support or guarantee provided by government to creditors of banks that were seen as ‘too important to fail.’ . . . Banks and their creditors knew that if they were sufficiently important to the economy or the rest of the financial system, and things went wrong, the government would always stand behind them. And they were right.¹³⁹

Industry studies and anecdotal evidence confirm that TBTF subsidies create significant economic distortions and promote moral hazard. In recent years, and particularly during the present crisis, LCFIs have operated with much lower capital ratios, and have benefited from a much lower cost of funds, compared with smaller banks.¹⁴⁰ In addition, CRAs

136. *Id.*

137. *Id.*

138. Mervyn King, Governor of the Bank of England, Speech to Scottish Business Organizations in Edinburgh 4 (Oct. 20, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf> [hereinafter King 2009 Speech]; see also RICHARD S. CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 326 (4th ed. 2009) (explaining that “moral hazard” results from the fact that “[i]nsurance changes the incentives of the person insured [I]f you no longer fear a harm [due to insurance], you no longer have an incentive to take precautions against it”).

139. King 2009 Speech, *supra* note 138, at 3.

140. See Allen Berger et al., *How Do Large Banking Organizations Manage Their Capital Ratios?*, 34 J. FIN. SERV. RES. 123, 138–39, 145 (2008) (finding that, between 1992 and 2006, banks with more than \$50 billion of assets maintained significantly lower capital ratios, compared to smaller banks); Wilmarth, *supra* note 132, at 295, 301–02 (citing additional studies finding that large banks operated with capital ratios that were

and bond market investors have given preferential treatment to TBTF institutions because of the explicit and implicit government backing they receive.¹⁴¹ The preferential status of TBTF institutions is confirmed by the fact that they received by far the largest share of governmental assistance in the form of TARP capital assistance and FDIC debt guarantees.¹⁴² The federal government publicly announced in early 2009 that it would ensure the survival of the nineteen largest BHCs, thereby certifying their TBTF status.¹⁴³

much lower than those of smaller banks, and that large banks also paid significantly lower interest rates on their deposits in comparison with smaller banks); David Cho, *Banks 'Too Big to Fail' Have Grown Even Bigger; Behemoths Born of the Bailout Reduce Consumer Choice, Tempt Corporate Moral Hazard*, WASH. POST, Aug. 28, 2009 (reporting that “[l]arge banks with more than \$100 billion in assets are borrowing at interest rates 0.34 percentage points lower than the rest of the industry,” compared to a borrowing advantage of 0.08% in 2007); Gretchen Morgenson, *The Cost of Saving These Whales*, N.Y. TIMES, Oct. 4, 2009, § BU, at 1 (reporting on a study by Dean Baker and Travis McArthur, finding that (i) from 2000 through 2007, the average cost of funds for smaller banks was 0.29% higher than the average cost of funds for banks with \$100 billion or more in assets, and (ii) “this spread widened to an average of 0.78 percentage point” from 2008 through June 2009, “when bailouts for large institutions became expected”); Hoenig August 6, 2009 Speech, *supra* note 124 (observing that the ten largest U.S. banks operated with a Tier 1 common stock capital ratio of 3.2% during the first quarter of 2009, compared to a Tier 1 common stock capital ratio of 6.0% for banks smaller than the top-20 banks).

141. See, e.g., STERN & FELDMAN, *supra* note 131, at 30–37 (describing preferential treatment given to TBTF banks by financial markets); Wilmarth, *supra* note 132, at 301, 301 n.359 (citing study by Donald Morgan and Kevin Stiroh, which showed that “during 1993–98, (i) bond markets applied substantially *less* market discipline to banks larger than \$85 billion, and (ii) bond markets applied the *weakest* market discipline to the eleven banks that the OCC publicly identified as TBTF in 1984”); Peter Eavis, *Bank's Safety Net Fraying*, WALL ST. J., Nov. 16, 2009, at C6 (reporting that “S&P gives Citigroup a single-A rating, but adds that it would be rated triple-B-minus, four notches lower, with no [governmental] assistance . . . [while] Morgan Stanley and Bank of America get a three-notch lift . . . [and] Goldman Sachs Group enjoys a two-notch benefit”).

142. See *supra* notes 121–123 and accompanying text (stating that the 19 largest BHCs and AIG received \$290 billion of TARP capital assistance and issued \$235 billion of FDIC-guaranteed debt, while smaller banks received only \$41 billion of capital infusions and issued only \$11 billion of FDIC-guaranteed debt). In addition, “[d]uring the second half of 2007, the Federal Home Loan Bank System (“FHLBS”) provided more than \$200 billion of secured credit to Citigroup, Countrywide, Merrill, Wachovia and Wamu after those institutions suffered severe losses from subprime mortgages and related assets. . . . Advances from the FHLBS helped Countrywide to survive until it received an emergency takeover offer from [BoFA].” Arthur E. Wilmarth, Jr., *Subprime Crisis Confirms Wisdom of Separating Banking and Commerce*, BANKING & FIN'L SERV. POL'Y REP., May 2008, at 1, 6.

143. See *supra* notes 11–12, 121–123 and accompanying text.

FRB Chairman Bernanke also assured the public that federal regulators would *not* impose regulatory sanctions on the nineteen largest BHCs under the “prompt-corrective-action” (“PCA”) regime established by Congress in 1991.¹⁴⁴ Federal bank regulators entered into confidential memoranda of understanding with BofA and Citigroup, but regulators have not taken any formal enforcement actions against the nineteen largest BHCs. In contrast, regulators have initiated hundreds of formal enforcement proceedings against smaller banks.¹⁴⁵ Thus, as Edward Kane has pointed out, the financial crisis has confirmed that major LCFIs are “too big to discipline adequately” (“TBTDA”) as well as TBTF.¹⁴⁶

Given the enormous benefits of TBTF status, LCFIs have pursued aggressive growth strategies during the past two decades in order to reach a size at which they would be presumptively TBTF and largely immune

144. Steven Sloan, *Bernanke: 'Don't Need' to Nationalize Weak Banks*, AM. BANKER, Feb. 25, 2009, at 1 (reporting on congressional testimony by FRB Chairman Ben Bernanke, in which Mr. Bernanke confirmed that “regulators would not employ ‘prompt-corrective-action’ tools, . . . such as replacing management,” against the 19 largest BHCs); see also Richard S. Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvements Act of 1991*, 12 ANN. REV. BANKING L. 317 (1993) (describing PCA regime mandated by Congress in 1991).

145. Compare Dan Fitzpatrick, *U.S. Regulators to BofA: Obey or Else*, WALL ST. J., July 16, 2009, at C1 (reporting that (i) BofA was operating under a “secret” memorandum of understanding (“MOU”) with federal regulators since May 2009, while Citigroup had been operating under “a similar order” since 2008; and (ii) the informal MOU procedure “gives banks a chance to work out their problems without the glare of outside attention,” in contrast to a “publicly announced” formal enforcement order) with *Exploring the Balance between Increased Credit Availability and Prudent Lending Standards Before the H. Comm. on Financial Services*, 111th Cong. 7–8 (2009) (testimony of R. Michael S. Menzies, Sr., Pres. and CEO, Easton Bank and Trust Co., on behalf of the Independent Community Bankers of America) (stating that “I have yet to hear of an enforcement action against a too-big-to-fail bank, while such actions are commonplace in the community banking industry”), available at <http://www.icba.org/files/ICBASites/PDFs/test032509.pdf>. All of the formal enforcement orders cited in a recent survey of enforcement actions by federal bank regulators were issued against community banks. See Thomas P. Vartanian & Lawrence K. Nesbitt, *Enforcement Actions Against Banks Exceeded 1000 For First Time in 2009*, 94 BANKING REP. (BNA) 444 (Mar. 2, 2010) (providing results of a survey of 1,095 formal enforcement actions against banks in 2010).

146. Edward J. Kane, *Extracting Nontransparent Safety Net Subsidies by Strategically Expanding and Contracting a Financial Institution's Accounting Balance Sheet*, 36 J. FIN. SERV. RES. 161, 162 (2009) (explaining that “in times of financial-sector distress, authorities can and will circumvent [PCA] constraints to assist bank and nonbank institutions that they regard as either too big and too complex to fail and unwind or at least as . . . [TBTDA]”).

from takeover threats.¹⁴⁷ Chief executive officers (“CEOs”) of LCFIs have strong incentives to pursue TBTF status because they “draw their paychecks – and their identity – from the companies they run.”¹⁴⁸ The “quest for immortality” encourages CEOs to build “legacy” institutions, and growth also produces large increases in CEO compensation.¹⁴⁹

All of today’s four largest U.S. banks (BofA, Chase, Citigroup and Wells Fargo) are the products of serial acquisitions and explosive growth since 1990.¹⁵⁰ BofA’s and Citigroup’s rapid expansions led them to brink

147. See, e.g., Robert De Young et al., *Mergers and Acquisitions of Financial Institutions: A Review of the Post-2000 Literature*, 36 J. FIN. SERV. RES. 87, 96–97, 104 (2009) (reviewing studies and finding that “subsides associated with becoming ‘too big to fail’ are important incentives for large bank acquisitions”); Todd Davenport, *Understanding the Endgame: Scale Will Matter, But How Much?*, AM. BANKER, Aug. 30, 2006, at 1 (describing the widespread belief among banking industry executives that “size is the best guarantor of survival” and that “[t]he best way—and certainly the quickest way—to achieve scale is to buy it”); Wilmarth, *supra* note 132, at 300–08 (citing additional evidence for the conclusion that “TBTF status allows megabanks to operate with virtual ‘fail-safe’ insulation from both market and regulatory discipline”); Elijah Brewer & Julapa Jagtiani, *How Much Would Banks Be Willing to Pay to Become ‘Too-Big-to-Fail’ and to Capture Other Benefits?* 9–20, 25–26 (Fed. Res. Bank of Kansas City Econ. Research Dep’t Research Working Paper 07-05, 2007) (determining that large banks paid significantly higher premiums to acquire smaller banks when (i) the acquisition produced an institution that crossed a presumptive TBTF threshold, such as \$100 billion in assets or \$20 billion in market capitalization, or (ii) a bank that was already TBTF acquired another bank and thereby enhanced its TBTF status).

148. Davenport, *supra* note 147; see also Wilmarth, *supra* note 132, at 292–93 (stating that “a major growth incentive for bank managers is the widely shared assumption that the biggest banks will achieve *permanent* status at the top of the financial industry”).

149. Davenport, *supra* note 147 (noting that the CEO of the median bank with assets between \$1 billion and \$5 billion earned \$636,000 in 2005, while Jamie Dimon, CEO of Chase, earned \$22.3 million); see also Richard T. Bliss & Richard J. Rosen, *CEO Compensation and Bank Mergers*, 61 J. FIN. ECON. 107, 109–10, 116–19, 124–25, 135–36 (2001) (finding that CEOs at 32 large banks increased their compensation significantly by entering into megamergers, and those CEOs reaped significant compensation gains even when they made acquisitions that negatively affected their banks’ stock values); Wilmarth, *supra* note 132, at 288–89 (citing additional studies indicating that “managerial self-interest plays a major role in determining the frequency of mergers among both corporations and banks”).

150. See KAUFMAN, *supra* note 68, at 100–05; STOWELL, *supra* note 10, at 405–08; Wilmarth, *supra* note 1, at 975–77; Valerie Bauerlein, *Vault to the Top: Bank of America CEO In Spotlight After Deal—Countrywide Gives Lewis Status He Long Craved; Up From Walnut Grove*, WALL ST. J., Aug. 27, 2007, at A1 (describing the tremendous growth of BofA under the leadership of Hugh McColl and Kenneth Lewis, and quoting Mr. Lewis’ belief that “size and scale do matter”); David Mildenberg, *Bank of America’s Lewis Resigns After Bet on Rebound* (Update 3), BLOOMBERG.COM, (Oct. 1, 2009) (reporting that Mr. Lewis spent more than \$130 billion on acquisitions since becoming CEO in 2001, and that BofA more than tripled in size under his leadership); Annys Shin, *Citi’s*

of failure, from which they were saved by huge federal bailouts.¹⁵¹ Wachovia (the fourth-largest U.S. bank at the beginning of the crisis) pursued a similar path of frenetic growth until it collapsed in 2008 and was rescued by Wells Fargo in a federally-assisted merger.¹⁵² A comparable pattern of rapid expansion, collapse and bailout occurred among several European LCFIs, frequently due to CEOs who pursued similarly misguided aspirations for impregnable status.¹⁵³

Unfortunately, the emergency acquisitions of LCFIs arranged by U.S. regulators have produced domestic financial markets in which the largest

Relentless Quest for Growth: History of Innovation Has Led Banks to Milestones, Mistakes, WASH. POST, Nov. 25, 2008, at D1 (explaining how an “emphasis on size” and rapid growth “landed Citibank in the midst of every financial crisis over the past century, including the stock market crash of 1929, the Latin American debt crisis of the 1980s and the current financial meltdown”).

151. See *supra* notes 9, 118 and accompanying text.

152. For descriptions of Wachovia’s aggressive growth, see, for example, Dennis K. Berman et al., *Wachovia Strikes \$26 Billion Deal for Golden West: California S&L Will Give Acquisitive Giant Big Slice of Mortgage-Loan Business*, WALL ST. J., May 8, 2006, at A1 (reporting that “Wachovia has been the most voracious [acquirer] of all, forging about 140 takeovers and mergers – large and small – that have transformed it from a sleepy Southern bank into a coast-to-coast financial-services giant”); Barbara A. Rehm, *Wachovia Chief’s Vision: Handful of Dominant Firms*, AM. BANKER, May 19, 2006, at 2 (quoting Wachovia CEO G. Kennedy Thompson’s belief that the banking industry would have “a handful of dominant firms” and that “[c]onsolidation continues to make economic sense” because “size enhances competitive power”). For discussions of Wachovia’s collapse and the federally-assisted acquisition of Wachovia by Wells Fargo, see, for example, Paul Davis, *In Closing Act, Wachovia Lays Bare Extent of Woe*, AM. BANKER, Oct. 23, 2008, at 1; Art Levy, *Wells Fargo Chairman Prefers U.S. Plan to Buy Stakes* (Update 3), BLOOMBERG.COM (Oct. 22, 2008), <http://www.bloomberg.com/apps/news?pid=20670001&sid=atJpJcGxblqA>; Paul Davis, *Was It Really All Golden West?: Option ARM Hit was one of Many at Wachovia*, AM. BANKER, Oct. 1, 2008, at 1.

153. See, e.g., Wilmarth, *supra* note 1, at 976 (discussing rapid consolidation among banks in the U.K. and other European nations); Simon Clark et al., *Decline of West Where Mathewson Rues What RBS Wrought* (Update 1), BLOOMBERG.COM, June 19, 2009, [available at http://www.bloomberg.com/apps/news?pid=20601109&sid=anU5X5BaNe4M#](http://www.bloomberg.com/apps/news?pid=20601109&sid=anU5X5BaNe4M#) (describing how RBS “expanded on three continents” and became the biggest European bank under its “hard-driving” CEO, Fred Goodwin, before RBS “collapsed” and was nationalized by the U.K. government); Antonio Ligi & Ben Holland, *Why Bernie Madoff Is No Marcel Ospel as Man Swiss Love to Hate*, BLOOMBERG.COM (Feb. 24, 2009), <http://www.bloomberg.com/apps/news?pid=20670001&sid=aApnFtmhFswQ> (discussing how UBS CEO Marcel Ospel “vowed to turn [UBS] into the largest global investment bank” and pursued a high-risk expansion strategy that resulted in “writedowns in excess of \$50 billion” and a massive bailout of UBS by the Swiss government); *supra* notes 13, 120 and accompanying text (discussing government rescues of RBS, UBS, and several other major European banks).

institutions hold even greater dominance.¹⁵⁴ The four largest U.S. banks (BofA, Chase, Citigroup and Wells Fargo) now control 56% of domestic banking assets, up from 35% in 2000,¹⁵⁵ while the top ten U.S. banks control 75% of domestic banking assets, up from 54% in 2000.¹⁵⁶ The four largest banks also control a majority of the product markets for home mortgages, home equity loans, and credit card loans.¹⁵⁷ Together with Goldman, the same four banks account for 97% of the aggregate notional values of OTC derivatives contracts written by U.S. banks.¹⁵⁸ Thus, as Nomi Prins observed last September, “[n]othing has changed [as a result of the financial crisis] except that we have larger players who are more powerful, who are more dependent on government capital and who are harder to regulate than they were to begin with.”¹⁵⁹

III. REGULATORY REFORMS TO ADDRESS SYSTEMIC RISK CREATED BY LCFIS

In 2002, I warned that “the TBTF policy is the great unresolved problem of bank supervision” because it “undermines the effectiveness of

154. See *supra* notes 10, 152 and accompanying text (discussing acquisitions of Countrywide and Merrill by BofA, of Bear and Wamu by Chase, and of Wachovia by Wells Fargo).

155. Peter Eavis, *Finance Fixers Still Living in Denial*, WALL ST. J., Dec. 16, 2009, at C18. Compare Benton Ives, *Consolidation Fuels Megabank Boom*, CQ WEEKLY, Oct. 27, 2008, at 2858 (reporting that BofA, Chase, Citigroup and Wells Fargo collectively held \$8.5 trillion of assets, accounting for “more than half of all bank assets”) with Peter Boone & Simon Johnson, *Shooting Banks*, NEW REPUBLIC, Mar. 11, 2010, at 20 (stating that the six largest U.S. banks currently have combined assets exceeding 63% of GDP, while the combined assets of the six largest banks in 1995 were equal to only 17% of GDP).

156. Heather Landy, *What’s Lost, Gained if Giants Get Downsized*, AM. BANKER, Nov. 5, 2009, at 1.

157. Kate Berry, *Mortgages’ Big Two Are Too Big to Avoid*, AM. BANKER, Sept. 28, 2009, at 1 (reporting that the four largest banks “control 57.8% of the overall [mortgage] lending market”); David Cho, *Banks ‘Too Big to Fail’ Have Grown Even Bigger*, WASH. POST, Aug. 28, 2009 (reporting on the top four banks’ majority share of the mortgage and credit card markets); Renae Merle, *Second Loans Complicate Homeowner Assistance*, WASH. POST, Mar. 27, 2010, at A1 (reporting that the same four banks held 53% of the \$840 billion of outstanding home equity loans and lines of credit); Daniel Wolfe, *Top Issuers, with Less Appetite for Risk, Slashing Credit Lines*, AM. BANKER, Dec. 2, 2008, at 7 (reporting that BofA, Citigroup and Chase “account for more than half of the U.S. credit card market”).

158. OFF. OF THE COMPTROLLER OF THE CURRENCY, OCC’S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, FOURTH QUARTER 2009, app. graph 4 & tbl.5 (2009), available at <http://www.occ.treas.gov/ftp/release/2010-33a.pdf>.

159. Alison Fitzgerald & Christine Harper, *Lehman Monday Morning Lesson Lost With Obama Regulator-in-Chief*, BLOOMBERG.COM (Sept. 11, 2009) (quoting Ms. Prins).

both supervisory and market discipline, and it creates moral hazard incentives for managers, depositors, and other uninsured creditors of [LCFIs].”¹⁶⁰ The current financial crisis has confirmed that the U.S. and European nations adhere to a TBTF policy that embraces the entire financial sector. Recent studies have shown that the TARP capital infusions and FDIC debt guarantees announced in October 2008 represented very large transfers of wealth from taxpayers to the shareholders and creditors of the largest U.S. LCFIs.¹⁶¹ The enormous competitive advantages enjoyed by TBTF institutions must be eliminated (or at least significantly reduced) in order to restore a more level playing field for smaller financial institutions and to encourage the voluntary breakup of inefficient and risky financial conglomerates.

Despite their access to extensive government subsidies, large financial conglomerates have never proven their ability to achieve superior performance.¹⁶² Even before the financial crisis began, economic studies showed that (i) large financial conglomerates were producing “higher levels of systemic risk on both sides of the Atlantic,”¹⁶³ (ii) LCFIs were subject to greater risks as they increased their “involvement in nontraditional activities, produced higher percentages of fee income, and relied more heavily on wholesale (non-deposit) funding,”¹⁶⁴ and (iii) financial markets applied a significant “conglomerate discount” to banks that engaged in multiple lines of financial activity, thereby indicating that “functional breadth impairs both competitive performance and share-

160. Wilmarth, *supra* note 132, at 475.

161. Elijah Brewer III & Anne Marie Klingenhagen, *Be Careful What You Wish for: The Stock Market Reactions to Bailing Out Large Financial Institutions—Evidence from the USA*, 18 J. FIN. REG. & COMPLIANCE 56, 57–59, 64–66 (2010) (finding significant increases in stock market valuations for the 25 largest U.S. banks as a result of Treasury Secretary Paulson’s announcement, on Oct. 14, 2008, of \$250 billion of TARP capital infusions into the banking system, including \$125 billion for the nine largest banks); Pietro Veronesi & Luigi Zingales, *Paulson’s Gift* 2–3, 11–31 (Chicago Booth Research Paper No. 09-42, 2009), available at <http://ssrn.com/abstract=1498548> (concluding that the TARP capital infusions and FDIC debt guarantees produced \$130 billion of gains for holders of equity and debt securities of the nine largest U.S. banks, at an estimated cost to taxpayers of \$21 to \$44 billion).

162. See Kane, *supra* note 146, at 162 (observing that “[b]ecause safety net subsidies increase with size and complexity, offsetting diseconomies [of scale and scope] must exist in the operation of large institutions”).

163. See Wilmarth, *supra* note 1, at 996, 996 nn.139–40 (discussing pre-crisis studies finding that “growing convergence among the activities of banks, securities firms and insurance companies . . . intensified the risk that losses in one sector of the financial services industry would spill over into other sectors and produce a systemic financial crisis”).

164. *Id.* at 997 (citing study by Asli Demirguc-Kunt and Harry Huizinga).

holder value.”¹⁶⁵ In addition, while each of the four largest U.S. banks has assets exceeding \$1 trillion, studies have not found favorable economies of scale or scope in banks larger than \$100 billion.¹⁶⁶ The financial crisis has proven, beyond any reasonable doubt, that large universal banks operate based on a dangerous business model that is riddled with conflicts of interest and prone to speculative risk-taking.¹⁶⁷

Accordingly, U.S. and European governments must rapidly adopt reforms that will (i) greatly reduce the scope of governmental safety nets and thereby significantly diminish the subsidies currently provided to LCFIs, and (ii) facilitate the orderly failure and liquidation of LCFIs under governmental supervision, with consequential losses to managers, shareholders and creditors of LCFIs. I believe that the following five key reforms are needed to accomplish these objectives: (1) strengthen current statutory restrictions on the growth of LCFIs, (2) create a special resolution process to manage the orderly liquidation or restructuring of SIFIs, (3) establish a consolidated supervisory regime and enhanced capital requirements for SIFIs, (4) create a special insurance fund for SIFIs, to cover the costs of resolving failed SIFIs, and (5) rigorously insulate FDIC-insured banks that are owned by LCFIs from the activities and risks of their nonbank affiliates. Due to space limitations, this symposium article provides only a summary overview of the proposed re-

165. Markus M. Schmid & Ingo Walter, *Do Financial Conglomerates Create or Destroy Economic Value?*, 18 J. FIN. INTERMEDIATION 193, 214 (2009) (analyzing more than 600 U.S. financial firms operating between 1985 and 2004); *see also* Luc Laeven & Ross Levine, *Is There a Diversification Discount in Financial Conglomerates?*, 85 J. FIN. ECON. 331, 333–335 (similarly finding, based on an analysis of more than 800 banks operating in 43 countries between 1998 and 2002, that “the market values of banks that engage in multiple activities are much lower than if those banks were broken up into financial intermediaries that specialized in the individual activities”).

166. Wilmarth, *supra* note 132, at 279–81 (citing studies finding an absence of economies of scale or scope in LCFIs larger than \$25 billion); Boone & Johnson, *supra* note 155 (stating that there are “no economies of scale for banks above \$100 billion in total assets”); *see also* June 2009 COP Report, *supra* note 7, at 51–52 fig.4 (reporting that, as of Mar. 31, 2009, BofA had assets of \$2.3 trillion, Chase had assets of approximately \$2.1 trillion, Citigroup had assets of approximately \$1.8 trillion, and Wells Fargo had assets of approximately \$1.3 trillion).

167. Saunders, Smith & Walter, *supra* note 45, at 143–47; Wilmarth, *supra* note 1, at 970–72, 994–1002, 1024–50; Boone & Johnson, *supra* note 155; John Kay, *Narrow Banking: The Reform of Financial Regulation* 12–16, 41–44, 86–88 (Sept. 15, 2009) (unpublished manuscript), available at <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf>.

forms.¹⁶⁸ I intend to develop more detailed expositions of such reforms in future works.

A. Existing Statutory Limits on the Growth of LCFIs Should Be Strengthened

In 1994, Congress authorized interstate bank acquisitions and interstate bank branching by adopting the Riegle-Neal Interstate Banking and Branching Act of 1994 (“Riegle-Neal Act”).¹⁶⁹ To prevent the emergence of dominant megabanks, the Riegle-Neal Act imposes nationwide and statewide deposit concentration limits on interstate expansion by large banking organizations.¹⁷⁰ A BHC may not acquire a bank in another state, and a bank may not merge with another bank across state lines, if the resulting banking organization (together with all affiliated FDIC-insured depository institutions) would hold (i) hold ten percent or more of the total deposits of all depository institutions in the U.S., or (ii) thirty percent or more of the total deposits of all depository institutions in any state.¹⁷¹

Unfortunately, the effectiveness of Riegle-Neal’s nationwide and statewide deposit concentration limits is undermined by three major loopholes. First, the concentration limits do not apply to intrastate bank ac-

168. For the same reason of space limitations, this article will not analyze a regulatory reform bill that was passed by the U.S. House of Representatives in December 2009. See H.R. 4173, 111th Cong. (2009), available at http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf. For helpful summaries of H.R. 4173, see Gail C. Bernstein, Matthew A. Chambers, Sara A. Kelsey & Martin E. Lybecker, *Are We Half-way There Yet? House Passes Major Financial Services Bill with Senate Expected to Act Early This Year*, 127 BANKING L. J. 12 (2010); Mike Ferullo, Malini Manickavasagam, Richard Hill & R. Christian Bruce, *Regulatory Reform: House Clears Regulatory Reform Package Calling for New Controls on Financial Sector*, 93 BANKING REP. (BNA) 1167 (Dec. 15, 2009). As this article went to press, it was not clear whether the Senate would pass similar legislation. See Alison Vekshin, *Dodd Says Panel Has ‘No Agreement’ on Financial Rules Overhaul*, BLOOMBERG.COM, Mar. 5, 2010, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSPIHb52zYGw>.

169. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, Sept. 29, 1994.

170. See H.R. REP. NO. 103-448, at 65–66 (1994) (additional views of Rep. Neal and Rep. McCollum) (explaining that the Riegle-Neal Act “adds two new concentration limits to address concerns about potential concentration of financial power at the state and national levels”), as reprinted in 1994 U.S.C.C.A.N. 2039, 2065–66.

171. Riegle-Neal Act, §§ 101, 102, 108 Stat. 2340, 2345 (codified as amended in 12 U.S.C. §§ 1831u(b)(2), 1842(d)(2)). The Riegle-Neal Act permits a state to waive or relax, by statute, regulation or order, the thirty percent statewide concentration limit with respect to interstate mergers or acquisitions involving banks located in that state. See 12 U.S.C. §§ 1831u(b)(2)(D), 1842(d)(2)(D).

quisitions or intrastate bank mergers. Second, the concentration limits do not apply to acquisitions of, or mergers with, thrift institutions and industrial banks, because those institutions are not treated as “banks” for purposes of the Riegle-Neal Act.¹⁷² Third, the concentration limits do not apply to acquisitions of, or mergers with, banks that are “in default or in danger of default.”¹⁷³

The acquisitions of Countrywide, Merrill, Washington Mutual (“WaMu”), and Wachovia demonstrate the significance of Riegle-Neal’s loopholes and the need to close them. In reliance on the “non-bank” loophole, the FRB allowed BofA to acquire Countrywide and Merrill even though (i) both firms controlled FDIC-insured depository institutions (a thrift, in the case of Countrywide, and a thrift and industrial bank, in the case of Merrill), and (ii) both transactions allowed BofA to exceed the ten percent nationwide deposit cap.¹⁷⁴ Similarly, after the FDIC seized control of WaMu as a failed depository institution, the FDIC sold the giant thrift to Chase even though the transaction enabled Chase to exceed the ten percent nationwide deposit cap.¹⁷⁵ Finally, although the FRB determined that Wells Fargo’s acquisition of Wachovia would give Wells Fargo control of just under ten percent of nationwide deposits, the FRB could probably have approved the acquisition in any case by designating Wachovia as a bank “in danger of default.”¹⁷⁶

172. See *Order Approving the Acquisition of a Savings Association and an Industrial Loan Company (Bank of America Corporation)*, FED. RES. BULL., B13, B14 (Mar. 2009) [hereinafter FRB BofA-Merrill Order] (noting that thrifts and industrial banks “are not ‘banks’ for purposes of the [Riegle-Neal] Act and its nationwide deposit cap”).

173. 12 U.S.C. §§ 1831u(e), 1842(d)(5).

174. See *Order Approving the Acquisition of a Savings Association and Other Non-banking Activities (Bank of America Corporation)*, FED. RES. BULL., C81–C82, C83 n.13 (Aug. 2008) (approving BofA’s acquisition of Countrywide and Countrywide’s thrift subsidiary, even though the transaction resulted in BofA’s ownership of 10.9% of nationwide deposits); FRB BofA-Merrill Order, *supra* note 172, at B13–B14, B14 n.6 (approving BofA’s acquisition of Merrill and Merrill’s thrift and industrial bank subsidiaries, even though the transaction resulted in BofA’s ownership of 11.9% of nationwide deposits).

175. Joe Adler, *Thrift M&A Could Suffer As Frank Slams ‘Loophole’*, AM. BANKER, Dec. 10, 2009, at 1.

176. See *Statement by the Board of Governors of the Federal Reserve System Regarding the Application and Notices by Wells Fargo & Company to Acquire Wachovia Corporation and Wachovia’s Subsidiary Banks and Nonbanking Companies (Wells Fargo & Company)*, FED. RES. BULL., B40, B41–42 (Mar. 2009) (determining that “the combined organization would not control an amount of deposits that would exceed the nationwide deposit cap on consummation of the proposal”); *id.* at B48 (concluding that “expeditious approval of the proposal was warranted in light of the weakened condition of Wachovia”).

The foregoing acquisitions have enabled BofA, Chase, and Wells Fargo to surpass the ten percent nationwide deposit cap.¹⁷⁷ Thus, the loopholes in Riegle-Neal's concentration limits have allowed giant TBTF and TBTDA institutions to reach a size that Congress clearly did not anticipate. To prevent further breaches of the Riegle-Neal limits, Congress should extend the nationwide and statewide deposit caps to cover all intrastate and interstate transactions involving acquisitions of, or mergers with, any type of FDIC-insured depository institution (including thrifts and industrial banks).

In addition, Congress should significantly narrow the failing bank exception by requiring federal regulators to make a "systemic risk determination" ("SRD") in order to invoke that exception. Thus, an SRD would be a precondition to any acquisition or merger involving a failing FDIC-insured depository institution that would exceed one of the Riegle-Neal concentration limits.

Congress should establish the following requirements for an SRD. First, the FRB and FDIC should be required to determine jointly, with the concurrence of the Treasury Secretary, that the proposed transaction is necessary to avoid a substantial threat of severe systemic injury to the banking system, the financial markets, or the national economy. Second, each SRD should be published and reported in writing to the Systemic Risk Oversight Council described below ("SROC") and to Congress. Third, the Government Accountability Office ("GAO") should undertake an audit to determine whether regulators satisfied the criteria for an SRD, and the SRD and the GAO audit report should be reviewed in a joint hearing held by the House and Senate committees with oversight of the financial markets.¹⁷⁸ Mandating the SRD Procedure would ensure much greater public transparency of, and scrutiny for, any federal agency order that invokes the "failing bank" exception to the Riegle-Neal concentration limits. The SRD Procedure would also ensure similar public transparency and scrutiny for regulatory decisions of comparable importance, as discussed below.

The Obama Administration has recently announced its support for a proposal by former FRB Chairman Paul Volcker to prohibit mergers and acquisitions that would give a single bank control of more than ten percent of total bank liabilities other than insured deposits (the "Volcker liabilities cap"). The Volcker liabilities cap would supplement the exist-

177. See Matt Ackerman, *Big 3 Deposit Share Approaches 33%*, AM. BANKER, Oct. 28, 2008, at 16 (reporting the nationwide deposit shares for BofA, Chase, and Wells Fargo as 11.3%, 10.2%, and 11.2%, respectively).

178. The foregoing process for approving and reviewing an SRD is hereinafter referred to as the "SRD Procedure."

ing Riegle-Neal deposit concentration limits and would be subject to the same exemption for acquisitions of banks “in default or in danger of default.”¹⁷⁹ If enacted, the Volcker liabilities cap would present a significant barrier to further acquisitions of banks by BofA, Chase, and Citigroup.¹⁸⁰ As a practical matter, the Volcker liabilities cap would have the greatest impact on Citigroup, because Citigroup currently is not close to exceeding the Riegle-Neal nationwide deposit cap. In contrast, the Riegle-Neal nationwide deposit concentration limit already blocks the three major rivals of Citigroup (BofA, Chase, and Wells Fargo) from making further interstate acquisitions of banks.¹⁸¹

The Volcker liabilities cap has been criticized as vague and unworkable.¹⁸² It remains to be seen whether the proposal can be clarified in a manner that would give it a utility and ease of application comparable to the Riegle-Neal deposit concentration limits. If it is appropriately clarified, the Volcker liabilities cap should be adopted as a supplemental method of restricting the growth of very large banks (e.g., Citigroup, Goldman, and Morgan Stanley) that rely mainly on the capital markets, rather than deposits, for their funding.¹⁸³ For the reasons stated above with regard to the Riegle-Neal limits, the Volcker liabilities cap should apply to acquisitions of all FDIC-insured depository institutions (including thrifts and industrial banks), and regulators should not be able to invoke the “failing bank” exception unless they comply with the SRD Procedure.

179. Rebecca Christie & Phil Mattingly, *‘Volcker Rule’ Draft Signals Obama Wants to Ease Market Impact*, BLOOMBERG.COM, Mar. 4, 2010.

180. *Id.* (reporting that U.S. banks held \$10.4 trillion of liabilities, while Chase, BofA, and Citigroup held liabilities of \$1.5 trillion, \$1.3 trillion, and \$1 trillion, respectively).

181. See Kevin Dobbs, *Even After Infusion, Citi Seen Needing Fix*, AM. BANKER, Nov. 25, 2008, at 1 (reporting that Citigroup had only \$200 billion of domestic deposits, compared to the more than \$600 billion of domestic deposits held by each of its three major rivals); *supra* note 177 and accompanying text (citing news article reporting that BofA, Chase, and Wells slightly exceeded the Riegle-Neal 10% nationwide deposit cap).

182. Cheyenne Hopkins, *Obama to Banks: Big Is Bad*, AM. BANKER, Jan. 25, 2010, at 22 (quoting criticisms of the proposed Volcker liabilities cap by Jamie Cox of Harris Financial Group and Sean Ryan of Wisco Research).

183. See Heather Landy, *Review/Preview: Goldman and Morgan Stanley Ditch Banking Script, So Far*, AM. BANKER, Dec. 30, 2009, at 1 (reporting that Goldman and Morgan Stanley relied primarily on the capital markets for funding, as each firm had less than \$70 billion of deposits in 2009); *supra* notes 180–181 and accompanying text (stating that Citigroup had \$1 trillion of assets but only \$200 billion of domestic deposits).

B. A Special Resolution Regime Should Be Authorized for Systemically Important Financial Institutions

Regulators and analysts support the creation of a special resolution regime to handle the failures of SIFIs.¹⁸⁴ As shown by the FRB-assisted rescue of Bear Stearns, the federal government's massive bailout of AIG, and the traumatic collapse of Lehman, federal regulators currently confront a "Hobson's choice of bailout or disorderly bankruptcy" when they decide how to respond to a SIFI's potential failure.¹⁸⁵ A statutory resolution regime for SIFIs, similar to the existing resolution regime for FDIC-insured depository institutions,¹⁸⁶ would be a highly beneficial "third way, between bankruptcy and bailout, that would either euthanize [SIFIs] peacefully or resuscitate them under new management."¹⁸⁷ This special resolution regime for SIFIs should include three essential elements.

First, Congress should establish an SROC, consisting of federal officials representing the Treasury Department, the FRB, the FDIC, the OCC, the SEC, the Commodity Futures Trading Commission ("CFTC"), and the Federal Housing Finance Agency, as well as state officials representing the National Association of Insurance Commissioners, and the Conference of State Bank Supervisors.¹⁸⁸ The FRB and the FDIC

184. See, e.g., Sheila C. Bair, Chairman, Fed. Deposit Insurance Corp., Statement on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission (Jan. 14, 2010), available at <http://fdic.gov/news/news/speeches/chairman/spjan1410.html> [hereinafter Bair FCIC Testimony]; Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve System, Financial Regulatory Reform, Speech at the U.S. Monetary Policy Forum (Feb. 26, 2010) [hereinafter Tarullo Regulatory Reform Speech], available at <http://www.federalreserve.gov/newsevents/speech/tarullo20100226a.htm>; Alan S. Blinder, *Time for Financial Reform, Plan C*, THE ECONOMISTS' VOICE (Feb. 2010), at 2, available at <http://www.bepress.com/ev/vol7/iss1/art5/>; Stephen Joyce, *Regulatory Reform: Cohen Says Not Enacting Financial Reform 'Unthinkable' But Opposes 'Volcker Rule'*, 94 BANKING REP. (BNA) 464 (Mar. 9, 2010) (citing view of H. Rodgin Cohen that "creating [a] resolution authority that would allow even the largest U.S. financial institutions to fail should be the 'lynchpin' of any meaningful financial regulatory overhaul").

185. Regulatory Reform Speech, *supra* note 184.

186. See CARNELL, MACEY & MILLER, *supra* note 138, ch. 13 (describing the FDIC's resolution regime for failed banks).

187. Blinder, *supra* note 184, at 2; see also Bair FCIC Testimony, *supra* note 184 (stating, while discussing potential financial reforms, that "[f]oremost among needed reforms is a new legal and regulatory framework for large interconnected firms [i.e., SIFIs] to ensure their orderly wind-down while avoiding financial disruptions that could devastate our financial markets and economy," and suggesting that the "FDIC's authority to resolve failing banks and thrifts is a good model").

188. The proposed SROC would include all seven of the primary federal regulators of financial institutions and financial markets, as well as the organizations that represent state regulators of insurance companies and state-chartered banks. I would not include the

should have joint responsibility for designating financial firms as SIFIs on a quarterly basis, based on criteria established by the SROC and after consultation with the SROC. The SROC should have authority (by the affirmative vote of at least five of its seven members who are not representatives of the FRB or FDIC) either (i) to designate a financial firm as a SIFI, in the event of a disagreement between the FRB and the FDIC, or (ii) to overrule the FRB's and FDIC's joint decision to designate a financial firm as a SIFI. The criteria for identifying a financial firm as a SIFI should be based on factors relevant to systemic risk, including the firm's size and the risk of contagion from the firm's failure due to (i) the firm's interconnectedness or correlations of risk exposures with other important financial institutions or financial markets or (ii) the firm's role as a key participant within one or more important sectors of the financial markets.¹⁸⁹

Some commentators have opposed any identification of SIFIs, due to concerns that firms designated as SIFIs would be treated as TBTF by the financial markets and would create additional moral hazard.¹⁹⁰ However, moral hazard already exists in abundance because the financial markets are currently treating major LCFIs as TBTF. As noted above, during the current crisis federal regulators publicly identified and supported the nineteen largest BHCs, as well as Bear and AIG, as TBTF institutions.¹⁹¹ As a result of this massive and explicit governmental support, CRAs,

OTS on the SROC. As I have explained elsewhere, I believe that (i) the federal thrift charter should be abolished, and existing federal thrifts should be required to convert into national or state banks, and (ii) the OTS should be abolished and its existing supervisory functions and staff should be transferred to the OCC. The current financial crisis has demonstrated (as the savings and loan crisis of the 1980s previously showed) that it is not desirable to charter federally-insured depository institutions that engage primarily in housing finance. Such institutions expose the federal deposit insurance fund and taxpayers to an excessive risk of loss due to the boom-and-bust cycles that have characterized housing markets over the past century. See Arthur E. Wilmarth, Jr., *Comment Letter to the U.S. Treasury Department Concerning the Regulatory Structure for Financial Institutions* 1–2 (Geo. Wash. U. Law Sch. Legal Studies Research Paper No. 388, 2007), available at <http://ssrn.com/abstract=1067065>.

189. See, e.g., Acharya et al., *Regulating Systemic Risk*, *supra* note 128, at 283–92; Saunders, Smith & Walter, *supra* note 45, at 151–55; James B. Thomson, *On Systemically Important Financial Institutions and Progressive Systemic Mitigation* 1–6 (Fed. Reserve Bank of Clev. Pol'y Discussion Paper No. 27, 2009).

190. See Malini Manickavasagam & Mike Ferullo, *Regulatory Reform: Witnesses Warn Against Identifying Institutions as Systemically Significant*, 41 SEC. REG. L. REP. (BNA) 502 (2009).

191. See *supra* notes 9–12, 117–124, 130–137, 143–144 and accompanying text.

depositors, and bondholders are giving highly preferential treatment to LCFIs that are viewed as TBTF.¹⁹²

Accordingly, it is no longer credible for federal regulators to pretend that they can retreat to their former policy of “constructive ambiguity” by asserting their willingness to allow major LCFIs to collapse into disorderly bankruptcies similar to the Lehman debacle.¹⁹³ Any such assertion would not be believed by the public or the financial markets.¹⁹⁴ As shown below, the best way to impose effective discipline on SIFIs, and to reduce the federal subsidies they receive, would be to designate them publicly as SIFIs and to impose stringent regulatory requirements that would force them to internalize the potential costs of their TBTF status.

Second, the FRB and FDIC should have shared authority to initiate the new special resolution regime for a failing SIFI, based on a joint finding that the SIFI either (i) has fallen below a specified minimum capital threshold or (ii) is facing a near-term risk of insolvency or bankruptcy due to a lack of adequate liquidity or a threatened acceleration of outstanding creditor claims. The resolution process for a failed SIFI should be administered by the FDIC, given its experience in resolving large bank failures.¹⁹⁵

192. See *supra* notes 141–142 and accompanying text.

193. Thomson, *supra* note 189, at 8–9.

194. For example, Herbert Allison recently claimed before the Congressional Oversight Panel (“COP”) that “[t]here is no ‘too big to fail’ guarantee on the part of the U.S. government.” Members of the COP responded to Mr. Allison’s claim with derision and disbelief. COP member Damon Silvers declared, “I do not understand why it is that the United States government cannot admit what everyone in the world knows.” Cheyenne Hopkins, *Pandit Sees a New Citigroup, But Others aren’t Convinced*, AM. BANKER, Mar. 5, 2010, at 1 (noting that Mr. Allison’s claim “angered and baffled the panelists”).

195. Due to current limitations on its statutory authority, the FDIC does not have experience in resolving the failures of large holding companies that control banks. However, the FDIC’s failure resolution process for banks appears to provide a better model for designing a new process to ensure an orderly resolution of SIFIs, compared to Chapter 11 bankruptcy procedures. See, e.g., Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Remarks to the Council of Institutional Investors (Apr. 12, 2010), available at <http://www.fdic.gov/news/news/speeches/chairman/spapr1210.html>; Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?* 10–16 (Columbia L. & Econ. Working Paper No. 362, 2009), available at <http://ssrn.com/abstract=1529802> (concluding that creation of a new regulatory process for regulating SIFIs and resolving their failures would be preferable to an approach that would rely on Chapter 11 bankruptcy proceedings to resolve such failures). For a more favorable view of the Chapter 11 bankruptcy alternative, see Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?* (U. Pa. L. Sch. Instit. L. & Econ. Res. Paper No. 09-11, 2009), available at <http://ssrn.com/abstract=1362639>. A detailed analysis of this issue is beyond the scope of this article.

The resolution process for SIFIs should include the following principles: (A) stockholders must lose their entire investment if the SIFI is unable to pay all valid creditor claims, (B) senior managers must be dismissed, together with other employees who were responsible for the SIFI's failure, and (C) unsecured creditors must be required to accept meaningful "haircuts," either in the form of a significant reduction in the amount of their debt claims or an exchange of a substantial amount of their debt for stock of a successor institution. In other words, the resolution process for a SIFI should resemble, to the maximum extent possible, the outcome of a Chapter 11 bankruptcy proceeding.¹⁹⁶ The FDIC should be required to prepare an SRD, and to comply with the SRD Procedure, if it decides either that (A) it must depart from any of the foregoing principles, or (B) it must advance funds to support the SIFI's resolution without a reasonable assurance of repayment from the proceeds of the resolution. Any net proceeds realized by the FDIC from a SIFI's resolution (over and above the FDIC's expenses in carrying out the resolution) should be added to the Systemic Risk Insurance Fund ("SRIF"), described below.¹⁹⁷

Third, Congress should limit the FRB's ability to make loans to SIFIs under its emergency lending authority contained in § 13(3) of the Federal Reserve Act.¹⁹⁸ The FRB should be prohibited from extending credit to SIFIs under § 13(3) for more than ninety days unless (i) the SIFI has been placed in a resolution process or (ii) the FRB makes an SRD and complies with the SRD Procedure. In addition, the FRB should not be allowed to make additional § 13(3) loans to a SIFI after initiation of the resolution process.

C. SIFIs Should Be Subject to Consolidated Supervision by the FRB and Should Comply with Systemic Risk Capital Requirements

Congress should designate the FRB as the consolidated supervisor for SIFIs, subject to the oversight of the SROC. Given the FRB's experience as the regulator of BHCs and as the "umbrella supervisor" for financial holding companies ("FHCs"), it is the logical choice as the consolidated supervisor for SIFIs.¹⁹⁹ However, the FRB has a longstanding concern

196. See Bair FCIC Testimony, *supra* note 184.

197. See *infra* Part III.D.

198. 12 U.S.C. § 343 (2006); see also Christian A. Johnson, *Exigent and Unusual Circumstances: The Federal Reserve and the U.S. Financial Crisis*, EUR. BUS. ORG. L. REV. (forthcoming 2010) (manuscript at Part II.E) (describing the FRB's emergency lending authority under § 13(3)), available at <http://ssrn.com/abstract-1584731>.

199. See CARNELL, MACEY & MILLER, *supra* note 138, at 437–40, 455–60, 465–74 (discussing the FRB's supervision of BHCs and FHCs); Heidi Mandanis Schooner, *Regu-*

with maintaining the stability of financial markets, and it has frequently intervened in the markets to avoid the failure of significant firms that might threaten financial stability.²⁰⁰ The FRB thus has a tendency to grant forbearance to LCFIs in order to maintain financial stability, and the SROC should therefore be given oversight powers to prevent the FRB from granting excessive leniency to SIFIs.

As consolidated supervisor, the FRB should have power to examine, and require reports from, SIFIs and their subsidiaries and affiliates. The FRB should also have authority to take enforcement actions (including cease-and-desist orders, civil money penalty orders, and orders removing directors and officers) against SIFIs and their subsidiaries and affiliates. The FRB's authority in these matters should be direct. The FRB should not be required (as it is under current law) to rely primarily on actions taken by regulators of functionally regulated subsidiaries (e.g., banks, securities broker-dealers, and insurance companies).²⁰¹

If a functional regulator (e.g., the OCC or the SEC) believes that actions by the FRB as systemic risk regulator are creating an unwarranted conflict with the functional regulator's supervision of a functionally regulated subsidiary, the functional regulator should have the right to appeal to the SROC. By a two-thirds vote, the SROC could require the FRB to rescind or modify any regulatory action with regard to a functionally regulated subsidiary of a SIFI that the SROC determined was not necessary or appropriate to prevent a serious threat to the stability of the SIFI or any of the SIFI's FDIC-insured subsidiaries.

The FRB should also have authority, with the concurrence of the FDIC, to establish systemic risk capital requirements ("SRCRs") for SIFIs. The FDIC should be given a concurrent role in establishing SRCRs in view of its role as administrator of the SRIF.²⁰² The FDIC's responsibilities for administering the SRIF would encourage the FDIC to apply

lating Risk Not Function, 66 UNIV. CIN. L. REV. 441, 478-86 (1998) (contending that the FRB is best situated to act as "systemic risk regulator" for financial conglomerates).

200. The FRB's extraordinary efforts to prevent widespread failures among LCFIs during the current financial crisis are broadly consistent with the FRB's past responses to financial crises. From 1970 to 2001, the FRB repeatedly intervened in the financial markets to prevent the failure of large financial institutions and to preserve financial stability. *See Wilmarth, supra* note 132, at 470-73.

201. Under current law, the FRB is required to rely "to the fullest extent possible" on reports provided and examinations conducted by primary regulators of functionally regulated subsidiaries of BHCs and FHCs. The FRB has only limited authority to require reports from, to conduct examinations of, or to take enforcement actions against, functionally regulated subsidiaries of BHCs and FHCs. *See* 12 U.S.C. §§ 1844(c), 1844(e), 1844(g), 1848a; CARNELL, MACEY & MILLER, *supra* note 138, at 457-60.

202. *See infra* Part III.D.

strict discipline against SIFIs in order to protect the SRIF's solvency. Accordingly, the FDIC's tendency toward supervisory stringency would serve as a desirable counterweight against the FRB's tendency toward supervisory forbearance.²⁰³ If the FRB and the FDIC disagreed over the appropriate level of SRCRs, the SROC could resolve the disagreement and specify SRCRs by a vote of at least five members other than the representatives of the FRB and FDIC.

SRCRs should include a leverage capital requirement, which would be calculated based on the total (unweighted) assets of each SIFI. A leverage requirement is a useful tool for limiting excessive risk-taking by financial institutions, and it is an essential supplement to risk-based capital requirements. In 2007, European banks and U.S. investment banks operated with very high asset-to-equity ratios (usually above 30:1) because they were subject only to risk-based capital rules and did not have to satisfy a leverage capital requirement. By contrast, asset-to-equity ratios for U.S. commercial banks were typically below 25:1 because those banks had to comply with a leverage requirement as well as risk-based capital rules. To provide an additional margin for safety, the minimum leverage capital requirement for SIFIs should be increased to a level well above the current requirement of five percent for well-capitalized institutions.²⁰⁴

203. For example, the conduct of the FRB and the FDIC during the negotiations that led to the Basel II international capital accord indicated that the FRB was more inclined than the FDIC to accommodate the interests and concerns of large banks. During those negotiations, the FRB actively supported an "advanced internal risk-based" ("A-IRB") method for establishing capital requirements for the largest banks. The A-IRB method was favored by major banks because it allowed each bank to calculate its capital needs based on internal quantitative risk models, as long as those models satisfied supervisory criteria. Major banks supported the A-IRB method because that approach held out the possibility of significantly reducing their capital requirements. In contrast to the FRB, the FDIC expressed great skepticism about the A-IRB approach. The FDIC therefore insisted that federal regulations implementing Basel II must include transitional, phased-in capital floors to prevent any rapid drop in risk-based capital requirements under the A-IRB method. In addition, the FDIC fought hard to preserve the U.S. leverage capital requirement as an essential safeguard that would help maintain adequate capital levels at all U.S. banks, even though the Basel II accord did not include any leverage requirement. See DANIEL K. TARULLO, *BANKING ON BASEL: THE FUTURE OF INTERNATIONAL FINANCIAL REGULATION* 99–130 (2008).

204. For sources supporting the imposition of a leverage capital requirement, and noting the disparity between the asset-to-equity ratios at U.S. commercial banks and the significantly higher (and more risky) ratios at U.S. investment banks and European banks in 2007, see Blundell-Wignall & Atkinson, *supra* note 84, at 93–96; Blundell-Wignall et al., *supra* note 4, at 18–22; Haldane, *supra* note 84, at 7 (stating that "[o]ne simple means of altering the rules of the asymmetric [risk] game between banks and the state is to place heavier restrictions on leverage").

In addition to a leverage requirement, SRCRs should incorporate risk-based components, including rules that emphasize “the importance of common equity” as well as the need to “reduce pro-cyclical tendencies by establishing special capital buffers that would be built up in boom times and drawn down as conditions deteriorate.”²⁰⁵ The marginal rates for risk-based SRCRs should become progressively higher as a SIFI poses greater systemic risk due to (a) increases in its size, complexity, or interconnectedness with other LCFIs, (b) hazards created by an aggressive compensation structure for managers or for key employees who work in high-risk areas (e.g., proprietary trading), and/or (c) weaknesses in the SIFI’s liquidity.²⁰⁶ In addition, SRCRs should take full account of all risk exposures of a SIFI, whether those exposures are held on the SIFI’s balance sheet or are linked to OBS entities.²⁰⁷

One intriguing proposal would require each SIFI to issue “contingent capital” as one component of its SRCR. This contingent capital would be issued in the form of convertible subordinated debt. That debt would convert automatically into common stock upon the occurrence of a designated event of financial stress, such as (i) a decline in the SIFI’s capital below a specified level that would “trigger” an automatic conversion, or (ii) the initiation by the FRB and the FDIC of the special resolution process for a SIFI. One advantage of contingent capital is that the SIFI’s common equity would be increased (due to the mandatory conversion of subordinated debt) at a time when the SIFI would face significant financial stress and probably could not sell stock in the market. Additionally, mandatory conversion would encourage holders of convertible subordinated debt to exercise greater discipline over the SIFI’s management, since those holders would risk losing their entire investment if mandatory conversion occurred.²⁰⁸

The biggest problem with the contingent capital proposal is that outside investors would be reluctant to purchase convertible subordinated debt unless the terms of the debt included a relatively high interest rate or other investor-friendly features (e.g., a voluntary conversion option on

205. Tarullo Regulatory Reform Speech, *supra* note 184.

206. For one approach to calculating SRCRs, see Acharya et al., *Regulating Systemic Risk*, *supra* note 128, at 289–93.

207. See *supra* notes 90–95 and accompanying text (describing how LCFIs retained large risk exposures to OBS conduits during the credit boom that led to the current financial crisis).

208. For discussion of proposals for a contingent capital requirement, see, for example, Christopher L. Culp, *Contingent Capital vs. Contingent Reverse Convertibles for Banks and Insurance Companies*, J. APPLIED CORP. FIN., Fall 2009, at 17, 23–27; Emily Flitter, *Push for ‘Contingent Capital’ Has Momentum*, AM. BANKER, Oct. 2, 2009, at 1; David Henry, *The Second Coming of ‘Safer’ Securities*, BUSINESS WK., Dec. 7, 2009, at 56.

favorable terms) that would offset the risk of forfeiture due to a mandatory conversion event. SIFIs and outside investors therefore might not be able to agree on an interest rate and other terms for contingent capital that would be acceptable to both sides.²⁰⁹

Contingent capital might be a much more feasible option if it is used to compensate senior managers and other key employees. Managers and key employees would become “captive investors” for contingent capital if they were required to accept convertible subordinated debentures in payment of a significant portion (e.g., one-third) of their annual compensation. Managers and key employees should not be allowed to make voluntary conversions of their subordinated debentures into common stock until the expiration of a minimum holding period (e.g., three years) after the termination date of their employment. Such a minimum post-employment holding period would discourage managers and key employees from taking excessive risks to boost the value of the conversion option during the term of their employment. At the same time, their debentures would be subject to mandatory conversion into common stock upon the occurrence of a designated event of financial stress. Requiring managers and key employees to hold a significant portion of contingent capital could give them positive incentives to manage their SIFI prudently in accordance with the interests of creditors as well as shareholders. Such a requirement would also force managers and key employees to share a significant portion of the loss if their SIFI is threatened with failure.²¹⁰

D. SIFIs Should Be Required to Pay Risk-Based Premiums to Establish a Systemic Risk Insurance Fund Administered by the FDIC

To accomplish a further reduction in TBTF subsidies, Congress should require SIFIs to pay risk-based insurance premiums to establish the SRIF. SRIF insurance premiums should be established by the FDIC with the FRB’s concurrence. If the FDIC and FRB disagree about the appropriate schedule for SRIF premiums, the SROC should possess authority to resolve the disagreement and to specify SRIF premiums by a vote of at least five members other than the FDIC’s and FRB’s representatives.

209. See Culp, *supra* note 208, at 27; Flitter, *supra* note 208; Henry, *supra* note 208.

210. For two other recent proposals that call for managers and key employees to receive part of their compensation in debt securities in order to encourage them to avoid excessive risk-taking, see Lucian Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L. J. 247, 283–86 (2010); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation and Risk Regulation* 31–51 (Emory L. & Econ. Res. Paper No. 10-60, 2010), available at <http://ssrn.com/abstract=1546229>.

The FDIC should be required to assess SRIF premiums in order to establish, within a period not to exceed five years, a SRIF that would provide reasonable protection to taxpayers against the cost of a future systemic financial crisis. As explained above, federal regulators provided \$290 billion of capital assistance to the nineteen largest BHCs (each with assets of more than \$100 billion) and to AIG during the current crisis.²¹¹ It therefore appears that (i) \$300 billion (appropriately adjusted for inflation) would be the minimum acceptable size for the SRIF, and (ii) SRIF premiums should be paid by all BHCs with assets of more than \$100 billion (also adjusted for inflation) and by all other designated SIFIs. As with SRCRs, the marginal rates for SRIF premiums should become progressively higher as SIFIs pose greater systemic risk, adopt riskier compensation structures, and/or maintain inadequate liquidity.²¹² In addition, the FDIC should impose additional assessments on SIFIs in order to replenish the SRIF within three years after the SRIF incurs any loss due to the failure of a SIFI.

For four reasons, it is essential to establish a pre-funded SRIF. First, it is unlikely that most SIFIs would have adequate financial resources to pay large SRIF premiums after one or more of their peers failed during a financial crisis. LCFIs are frequently exposed to highly correlated risk exposures during a serious financial disruption, because they followed similar high-risk business strategies (“herding”) during the credit boom that led to the crisis.²¹³ Many LCFIs are therefore likely to suffer severe

211. See *supra* notes 9–12, 121–123 and accompanying text.

212. Acharya et al., *Regulating Systemic Risk*, *supra* note 128, at 293–94; see also Xin Huang et al., *A Framework for Assessing the Systemic Risk of Major Financial Institutions*, 33 J. BANKING & FIN. 2036 (2009) (proposing a stress testing methodology for calculating an insurance premium sufficient to protect against losses of more than 15% of the total liabilities of twelve major U.S. banks during the period 2001–2008, and concluding that the hypothetical aggregate insurance premium would have had an “upper bound” of \$250 billion in July 2008).

213. A recent study concluded that market returns of the 100 largest banks, securities firms, insurers, and hedge funds became “highly interconnected,” and their risk exposures became “highly interrelated,” during the current financial crisis as well as during (i) the dotcom-telecom bust of 2000–2002 and (ii) the crisis surrounding Russia’s debt default and the threatened failure of Long-Term Capital Management, a major hedge fund, in 1998. Monica Billio et al., *Measuring Systemic Risk in the Finance and Insurance Sectors* 16–17, 40–47 (MIT Sloan Sch. Mgmt. Working Paper 4774-10, 2010), available at <http://ssrn.com/abstract=1571277>. For additional evidence indicating that banks and other financial institutions engage in herding behavior that can trigger systemic financial crises, see Viral V. Acharya & Tanju Yorulmazer, *Information Contagion and Bank Herding*, 40 J. MONEY, CREDIT & BANKING 215, 215–17, 227–29 (2008); Viral V. Acharya & Tanju Yorulmazer, *Too Many To Fail – An Analysis of Time-Inconsistency in Bank Closure Policies*, 16 J. FIN. INTERMEDIATION 1, 2–4, 18–19, 24–27 (2007); Raghuram G. Rajan,

losses and to face a substantial risk of failure during a major disturbance in the financial markets.²¹⁴ Consequently, a post-funded SRIF (i) would probably not be able in the short term to collect enough premiums from surviving SIFIs to cover the costs of resolving one or more failed SIFIs, and (ii) would therefore have to borrow large sums from the federal government to cover short-term resolution costs. Even if the SRIF ultimately repaid the borrowed funds by imposing ex post assessments on surviving SIFIs, the public and the financial markets would understandably conclude that the federal government provided bridge loans to bail out creditors of the failed SIFIs.²¹⁵ Accordingly, a post-funded SRIF would not be successful in eliminating many of the implicit subsidies (and associated moral hazard) that our current TBTF policy has created.

Second, in a post-funded system, the most reckless SIFIs (which would be the most likely to fail) would effectively shift the potential costs of their risk-taking to the most prudent SIFIs, because the latter would be more likely to survive and bear the ex post costs of resolving failed SIFIs. Thus, a post-funded SRIF is undesirable because “firms that fail never pay and the costs are borne by surviving firms.”²¹⁶

Third, a pre-funded SRIF would create beneficial incentives that would encourage each SIFI to monitor other SIFIs and to alert regulators to excessive risk-taking by those institutions. Every SIFI would know that the failure of another SIFI would deplete the SRIF and would also trigger future assessments that it and other surviving SIFIs would have to pay. Thus, each SIFI would have good reason to complain to regulators if it became aware of unsound practices or conditions at another SIFI.

Fourth, a pre-funded SRIF would reduce the TBTF subsidy for SIFIs by forcing them to internalize more of the “negative externality” (i.e., the potential public bailout cost) of their activities.²¹⁷ A pre-funded SRIF would provide a reserve fund, paid for by SIFIs, that would protect governments and taxpayers from having to incur the expense of underwriting future bailouts of failed SIFIs.

Has Finance Made the World Riskier?, 12 EUR. FIN. MGMT. 499, 499–503, 513–22 (2006). As described above in Part III, major LCFIs engaged in parallel behavior that resembled herding during the credit boom that precipitated the present crisis, particularly with regard to high-risk securitized lending in the residential and commercial mortgage markets and the corporate LBO market.

214. See *supra* notes 115–122 and accompanying text (showing that the big eighteen LCFIs accounted for nearly three-fifths of the \$1.5 trillion of losses incurred by global banks, securities firms and insurers during the current crisis, and twelve of those institutions were bailed out or received substantial governmental assistance).

215. Bair FCIC Testimony, *supra* note 184.

216. *Id.*

217. Acharya et al., *Regulating Systemic Risk*, *supra* note 128, at 293–95.

To further reduce the potential TBTF subsidy for SIFIs, the SRIF should be strictly separated from the existing Deposit Insurance Fund (“DIF”). To ensure this separation, Congress should repeal the “systemic-risk exception” that is currently included in the Federal Deposit Insurance Act (“FDI Act”).²¹⁸ The FDIC relied on that exception when it joined with the Treasury Department and the FRB in providing more than \$400 billion of asset guarantees to Citigroup and BofA.²¹⁹ The DIF should no longer be available as a potential source of protection for creditors of SIFIs. Instead, the SRIF should be designated as the exclusive source of future funding for resolutions of failed SIFIs. Thus, the systemic-risk exception for the DIF should be repealed, and the FDIC should be required to apply the least-cost test in resolving all future bank failures.²²⁰ Repeal of the systemic-risk exception would ensure that the DIF is no longer viewed as a potential bailout fund for TBTF banking organizations.

E. Banks Controlled by Financial Holding Companies Should Operate as “Narrow Banks” to Ensure that They Cannot Transfer Their Federal Safety Net Subsidies to Their Nonbank Affiliates

In January 2010, President Obama announced his support for the “Volcker rule” proposed by former FRB Chairman Paul Volcker. The Volcker rule would prohibit FDIC-insured banks and companies controlling such banks from owning or controlling hedge funds or private equity funds or from engaging in proprietary trading (i.e., buying and selling securities, derivatives, and other tradable assets for their own account). Trading in the capital markets by banks and their holding companies would be limited to “market making” activities conducted on behalf of

218. 12 U.S.C. § 1823(c)(4)(G) (2006) (allowing the FDIC, with the concurrence of the Treasury Secretary and the FRB, to disregard the least-cost requirement for bank resolutions if the failure of a bank “would have serious adverse effects on economic conditions or financial stability”); *see also* CARNELL, MACEY & MILLER, *supra* note 138, at 731–32 (discussing “systemic-risk exception”).

219. *See* Press Release, Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup (Nov. 23, 2008), *available at* <http://www.fdic.gov/news/news/pres/2008/pr08125.html>; Sheila C. Bair, Chairman, Fed. Deposit Insurance Corp., Statement on Bank of America Acquisition of Merrill Lynch before the House Committee on Oversight and Government Reform and the Subcommittee on Domestic Policy (Dec. 11, 2009), *available at* <http://www.fdic.gov/news/news/speeches/archives/2009/spdec1109.html>.

220. The least-cost test requires the FDIC to “meet the obligation of the [FDIC] to provide insurance coverage for the insured deposits” in a failed bank by using the approach that is “least costly to the [DIF].” 12 U.S.C. § 1823(c)(4)(A)(i), (ii) (2006).

clients.²²¹ The primary purpose of the Volcker rule is to prevent government safety nets from “protecting and supporting essentially proprietary and speculative activities.”²²² As this article went to press, it was uncertain whether Congress would adopt the Volcker rule. One of the most widely-shared critiques of the rule was the difficulty in distinguishing between permissible market-making for clients and prohibited proprietary trading for a bank’s own account.²²³

In my view, the most feasible way to accomplish the basic purpose of the Volcker rule—namely, to prevent SIFIs from using the federal safety net to subsidize their speculative activities in the capital markets—would be to create a two-tiered structure of bank regulation and deposit insurance. As described below, the first tier of “traditional” banking organizations would provide a relatively broad range of banking-related services, but those organizations would not be allowed to engage in, or affiliate with firms engaged in, securities underwriting or dealing, insurance underwriting or derivatives dealing. In contrast, the second tier of “narrow banks” could affiliate with “nontraditional” firms engaged in capital markets activities, except for private equity investments. However, “narrow banks” would be prohibited from making any extensions of credit or other transfers of funds to their nonbank affiliates, except for lawful dividends paid to their parent holding companies. The “narrow bank” approach provides the most practicable method for ensuring that banks cannot transfer their safety net subsidies to affiliated companies engaged in speculative activities in the capital markets, and it is therefore consistent with the spirit of the Volcker rule.²²⁴

221. See Cheryl Bolen et al., *Regulatory Reform: White House Seeks Tough Limits on Size, Trading Activities of Large Financial Firms*, 94 BANKING REP. (BNA) 127 (2010).

222. Brady Dennis, *Volcker Urges Senators to Adopt Obama’s Rules on Banking*, WASH. POST, Feb. 3, 2010, at A11 (quoting testimony by Mr. Volcker).

223. See, e.g., Sewell Chan, *Dodd Calls Obama Plan Too Grand*, N.Y. TIMES, Feb. 3, 2010, at B1; Rebecca Christie & Phil Mattingly, *‘Volcker Rule’ Draft Signals Obama Wants to Ease Market Impact*, BLOOMBERG.COM, Mar. 4, 2010, available at http://www.bloomberg.com/apps/news?pid=20601103&sid=aHT_LKrSCQ1c; Stacy Kaper, *Absence of Details Hurts Obama Plans*, AM. BANKER, Feb. 4, 2010, at 1; Alison Vekshin, *Obama’s ‘Volcker Rule’ May Not Survive Congressional Skepticism*, BLOOMBERG.COM, Feb. 5, 2010, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=apVODE601KQ4>; CARNELL, MACEY & MILLER, *supra* note 138, at 130, 528–29 (describing the roles of “dealers” (i.e., proprietary traders) and “market makers” and indicating that the two roles can frequently overlap).

224. I have previously presented my proposal for a two-tiered structure of bank regulation and deposit insurance in two articles. See Arthur E. Wilmarth, Jr., *How Should We Respond to the Growing Risks of Financial Conglomerates?*, in FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 65, 121–32 (Patricia A. McCoy ed.,

1. The First Tier of Traditional Banking Organizations

Under my proposal, the first tier of regulated banking firms would be “traditional” banking organizations that limit their activities (including the activities of all holding company affiliates) to lines of business that meet the “closely related to banking” test under Section 4(c)(8) of the Bank Holding Company Act (“BHC Act”).²²⁵ For example, this first tier of traditional banks could take deposits, make loans, and offer fiduciary services, as well as act as agents in selling securities, mutual funds, and insurance products underwritten by non-affiliated firms. Additionally, they could underwrite and deal solely in “bank-eligible” securities that national banks are permitted to underwrite and deal in directly.²²⁶ First-tier banking organizations could also purchase, as end-users, derivatives solely for bona fide hedging transactions that qualify for hedging treatment under FASB’s Financial Accounting Standard (“FAS”) Statement No. 133.²²⁷

Most first-tier banking firms would probably be smaller, community-based banks, because those banks do not have any comparative advantage—and therefore have not shown any substantial interest—in engaging as principal in insurance underwriting, securities underwriting, or

2002) [hereinafter Wilmarth, *Financial Conglomerates*]; Arthur E. Wilmarth, Jr., *Too Good to Be True? The Unfulfilled Promises Behind Big Bank Mergers*, 2 STAN. J.L. BUS. & FIN. 1, 77–87 (1995) [hereinafter Wilmarth, *Big Bank Mergers*]. The discussion in this article is adapted in part from those prior articles. As indicated in those articles, I am indebted to Robert Litan for many of the concepts incorporated in my two-tiered proposal. See generally ROBERT E. LITAN, WHAT SHOULD BANKS DO? 164–89 (1987). For additional works that favor the use of “narrow banks” to achieve a strict separation between banking institutions and affiliates engaged in capital markets operations, see, for example, Emiliios Avgouleas, *The Reform of ‘Too Big-To-Fail’ Bank: A New Regulatory Model for the Institutional Separation of ‘Casino’ from ‘Utility’ Banking*, Feb. 14, 2010, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1552970; Kay, *supra* note 167, at 39–92; Ronnie J. Phillips & Alessandro Roselli, *How to Avoid the Next Taxpayer Bailout of the Financial System: The Narrow Banking Proposal* (Networks Fin. Instit. Pol’y Brief 2009-PB-05, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1459065.

225. 12 U.S.C. § 1843(c)(8) (2006); CARNELL, MACEY & MILLER, *supra* note 138, at 442–44 (describing “closely related to banking activities” that are permissible for non-bank subsidiaries of BHCs under § 4(c)(8)).

226. See CARNELL, MACEY & MILLER, *supra* note 138, at 132–34 (discussing “bank-eligible” securities that national banks are authorized to underwrite or purchase or sell for their own account); Wilmarth, *supra* note 132, at 225, 225–26 n.30 (same).

227. See Wilmarth, *Financial Conglomerates*, *supra* note 224, at 117 n.132 (discussing FASB’s adoption of FAS 133); see also Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998), available at <http://www.fasb.org/pdf/fas133.pdf>.

dealing, derivatives dealing, or other capital markets activities. Those community banks are well positioned to continue their traditional business of attracting core deposits, providing relationship loans to consumers and small and medium-sized business firms, and offering wealth management services to local customers through their fiduciary operations.²²⁸

In order to provide reasonable flexibility for this first tier of traditional banks, Congress should amend Section 4(c)(8) of the BHC Act by allowing the FRB to expand the list of “closely related” activities that are permissible for holding company affiliates of traditional banks.²²⁹ However, Congress should prohibit first-tier BHCs from engaging as principal in underwriting or dealing in securities, underwriting any type of insurance (except for credit insurance), dealing in OTC derivatives, or making private equity investments. Traditional banks and their holding companies would continue to operate under their current supervisory arrangements, and all of the banks’ deposits (up to the current statutory limit of \$250,000) would be covered by deposit insurance.

2. The Second Tier of Nontraditional Banking Organizations

In contrast to first-tier banking firms, the second tier of “nontraditional” banking organizations would be allowed to engage in (i) underwriting and dealing (i.e., proprietary trading) in “bank-ineligible” securities, (ii) underwriting insurance, and (iii) dealing or trading in derivatives. Second-tier organizations would include: (A) FHCs registered under Sections 4(k) and 4(l) of the BHC Act,²³⁰ (B) holding companies owning grandfathered “nonbank banks,” and (C) grandfathered “unitary thrift” holding companies.²³¹ In addition, firms controlling industrial banks

228. For a discussion of the business strategies typically followed by community banks, see, for example, Wilmarth, *supra* note 132, at 268–72.

229. Unfortunately, GLBA prohibits the FRB from approving any new “closely related” activities for bank holding companies under Section 4(c)(8) of the BHC Act. See CARNELL, MACEY & MILLER, *supra* note 138, at 444 (explaining that GLBA does not permit the FRB to expand the list of permissible activities under Section 4(c)(8) beyond the activities that were approved as of Nov. 11, 1999). Congress should revise Section 4(c)(8) by authorizing the FRB to approve a limited range of new activities that are “closely related” to the traditional banking functions of accepting deposits, extending credit, discounting negotiable instruments, and providing fiduciary services. See Wilmarth, *Big Bank Mergers*, *supra* note 224, at 80 n.365, 84 & n.378.

230. 12 U.S.C. § 1843(k), (l) (2006); see also CARNELL, MACEY & MILLER, *supra* note 138, at 467–48 (describing registration of FHCs under the BHC Act).

231. See CARNELL, MACEY & MILLER, *supra* note 138, at 468–70 (discussing activities authorized for FHCs under the GLB Act); Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1569–71, 1584–86 (explaining that (i) during the 1980’s and

should be required either to register as FHCs or to divest their ownership of such banks if they cannot comply with the BHC Act's prohibitions against commercial activities.²³² Second-tier holding companies would thus encompass all of the largest banking organizations, most of which are heavily engaged in capital markets activities, together with other financial conglomerates that control FDIC-insured depository institutions.

a. The "Narrow Bank" Structure for Second-Tier Banks

Under this proposal, FDIC-insured depository institutions that are subsidiaries of second-tier holding companies would be required to operate as "narrow banks." Narrow banks could offer all permissible types of FDIC-insured deposit accounts, including checking and savings accounts. These banks would hold all of their assets in the form of cash and marketable, short-term debt obligations, including qualifying government securities, highly-rated commercial paper, and other liquid, short-term debt instruments that are eligible for investment by MMMFs under the SEC's rules. Narrow banks could not hold any other types of loans or investments, nor could they accept any uninsured deposits. Narrow banks would present a very small risk to the DIF, because (i) each narrow bank's non-cash assets would consist solely of short-term securities that could be "marked to market" on a daily basis, and the FDIC could therefore readily determine whether a narrow bank was threatened with insolvency, and (ii) the FDIC could promptly convert a narrow bank's assets into cash if the FDIC decided to liquidate the bank and pay off the claims of its insured depositors.²³³

Thus, narrow banks would effectively operate as FDIC-insured MMMFs. In order to prevent unfair competition with narrow banks, and to avoid future government bailouts of uninsured MMMFs, firms that

1990's, many securities firms, life insurers, and industrial firms used the "nonbank bank" loophole or the "unitary thrift" loophole to acquire FDIC-insured institutions, and (ii) those loopholes were closed to new acquisitions by a 1987 statute and GLBA, respectively).

232. For a discussion of reasons for this requirement, see generally Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1554-1620 (arguing that commercial firms should not be permitted to acquire industrial banks because such acquisitions (i) undermine the long-established U.S. policy of separating banking and commerce, (ii) threaten to spread federal safety net subsidies to the commercial sector of the U.S. economy, (iii) threaten the solvency of the DIF, (iv) create competitive inequities between owners of industrial banks and other commercial firms, and (v) increase the likelihood of federal bailouts of commercial companies); Wilmarth, *supra* note 142.

233. See Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907, 921-22, 928-29 (1989); Wilmarth, *Big Bank Mergers*, *supra* note 224, at 79-82.

manage uninsured MMMFs should be prohibited from representing, either explicitly or implicitly, that they will redeem their shares based on a “constant net asset value” (“NAV”) of \$1 per share.²³⁴ Currently, the MMMF industry (which manages \$3.3 trillion of assets) leads investors to believe that their funds will be available for withdrawal (redemption) based on “a stable price of \$1 per share.”²³⁵ Not surprisingly, “the \$1 share price gives investors the false impression that money-market funds are like [FDIC-insured] bank accounts and can’t lose money.”²³⁶ However, “[t]hat myth was shattered in 2008” when Lehman’s default on its commercial paper caused Reserve Primary Fund (a large MMMF that invested heavily in Lehman’s paper) to suffer large losses and to “break the buck.”²³⁷ Reserve Primary Fund’s inability to redeem its shares based on a NAV of \$1 per share caused an investor panic that precipitated runs on several MMMFs. The Treasury Department responded by establishing the Money Market Fund Guarantee Program (“MMFGP”) which protected investors in participating MMMFs between October 2008 and September 2009.²³⁸

Critics of MMMFs maintain that the Treasury’s MMFGP has created an expectation of similar government bailouts if MMMFs “break the

234. See Daisy Maxey, *Money Funds Exhale After New SEC Rules, But Should They?*, WALL ST. J., Feb. 2, 2010, at C9 (describing the SEC’s adoption of new rules governing MMMFs, and reporting on concerns expressed by representatives of the MMMF industry that the SEC might someday force the industry to adopt a “floating NAV” in place of the industry’s current practice of quoting a constant NAV of \$1 per share).

235. David Reilly, *Goldman Sachs Wimps Out in Buck-Breaking Brawl*, BLOOMBERG.COM, Feb. 3, 2010, available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=aZq9IO8WsG0Q>; see also November 2009 COP Report, *supra* note 7, at 28 (stating that MMMFs are “structured to be highly liquid and [to] protect principal by maintaining a stable net asset value (NAV) of \$1.00 per share”).

236. Reilly, *supra* note 235; see also Kay, *supra* note 167, at 65 (arguing that an MMMF with a constant NAV of \$1 per share “either confuses consumers or creates an expectation of government guarantee”).

237. Reilly, *supra* note 235; see also Christopher Condon, *Volcker Says Money-Market Funds Weaken U.S. Financial System*, BLOOMBERG.COM, Aug. 25, 2009, available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=a5O9Upz5e0Qc>.

238. November 2009 COP Report, *supra* note 7, at 28–35 (describing creation and terms of the Treasury Department’s MMFGP); Reilly, *supra* note 235 (describing “panic” that occurred among investors in MMMFs after Lehman’s collapse forced the Reserve Primary Fund to “break the buck”); Malini Manickavasagam, *Mutual Funds: Citing Stability, Treasury Allows Expiration of Money Market Fund Guarantee Program*, 93 BANKING REP. (BNA) 508 (2009) (reporting that “[t]o prevent other money market funds from meeting the Reserve fund’s fate, Treasury launched its [MMFGP] in October 2008” and continued that program until Sept. 18, 2009).

buck” in the future.²³⁹ In addition, former FRB chairman Paul Volcker has argued that MMMFs weaken banks because of their ability to offer bank-like products without equivalent regulation. MMMFs typically offer accounts with check-writing features, and they provide returns to investors that are higher than bank checking accounts because MMMFs do not have to pay FDIC insurance premiums or to comply with other bank regulations.²⁴⁰ A Group of Thirty report, which Mr. Volcker spearheaded, proposed that MMMFs “that want to offer bank-like services, such as checking accounts and withdrawals at \$1 a share, should reorganize as a type of bank, with appropriate supervision and government insurance.”²⁴¹ In contrast, MMMFs that do not wish to operate as banks “should not maintain the implicit promise that investors’ money is always safe” and should be required to base their redemption price on a floating NAV.²⁴²

239. Jane Bryant Quinn, *Money Funds Are Ripe for ‘Radical Surgery’*, BLOOMBERG.COM, July 29, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601212&sid=a6iLSIGSSoFo>; see also Reilly, *supra* note 235 (arguing that the failure of federal authorities to reform the regulation of MMMFs “creates the possibility of future market runs and the need for more government bailouts”).

240. Condon, *supra* note 237; Quinn, *supra* note 239 (observing that “[b]anks have to hold reserves against demand deposits and pay for [FDIC] insurance” while “[m]oney funds offer similar transaction accounts without being burdened by these costs. That’s why they usually offer higher interest rates than banks”).

241. Quinn, *supra* note 239 (summarizing recommendation presented in a January 2009 report by the Group of Thirty); see GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY 29 (2009), available at <http://www.group30.org/pubs/reformreport.pdf> (recommending that “[m]oney market mutual funds wishing to continue to offer bank-like services, such as transaction account services, withdrawals on demand at par, and assurances of maintaining a stable net asset value (NAV) at par, should be required to reorganize as special-purpose banks, with appropriate prudential regulation and supervision, government insurance, and access to central bank lender-of-last resort facilities”). “The Group of Thirty . . . is a private, non-profit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers.” About the Group of 30, <http://www.group30.org/about.htm> (last visited May 21, 2010).

242. Quinn, *supra* note 239 (summarizing recommendations of Group of Thirty); see GROUP OF THIRTY, *supra* note 247, at 29 (stating that MMMFs “should be clearly differentiated from federally insured instruments offered by banks” and should base their pricing on “a fluctuating NAV”); see also Reilly, *supra* note 235 (supporting the Group of Thirty’s recommendation that MMMFs “either use floating values—and so prepare investors for the idea that these instruments can lose money—or be regulated as if they are bank products”); Kay, *supra* note 167, at 65 (similarly arguing that “[i]t is important to

For the above reasons, uninsured MMMFs should be prohibited from representing, explicitly or implicitly, that they will redeem shares based on a stable NAV. If Congress imposed this prohibition on MMMFs and adopted my proposal for a two-tiered structure of bank regulation, many MMMFs would probably reorganize as FDIC-insured narrow banks and would become subsidiaries of second-tier FHCs.²⁴³ As noted above, rules restricting the assets of narrow banks to commercial paper, government securities, and other types of marketable, highly-liquid investments would protect the DIF from any significant loss if a narrow bank failed.

b. Four Additional Rules Would Prevent Narrow Banks from Transferring Safety Net Subsidies to Their Affiliates

Four supplemental rules are needed to prevent second-tier holding companies from exploiting their narrow banks' safety net subsidies. First, narrow banks should be prohibited from making any extensions of credit or other transfers of funds to their affiliates, except for the payment of lawful dividends out of profits to their parent holding companies.²⁴⁴ During times of financial crisis, the FRB has repeatedly waived the current restrictions on affiliate transactions mandated by Sections 23A and 23B of the Federal Reserve Act.²⁴⁵ Those waivers have allowed bank subsidiaries of FHCs to provide extensive support to affiliated securities broker-dealers and MMMFs. By granting those waivers, the FRB has enabled banks controlled by FHCs to transfer the safety net subsidy provided by low-cost, FDIC-insured deposits to their nonbank affiliates.²⁴⁶ With respect to second-tier banking organizations, my proposal

create very clear blue water between deposits, subject to government guarantee, and [uninsured MMMFs], which may be subject to market fluctuation”).

243. See Quinn, *supra* note 239 (describing strong opposition by Paul Schott Stevens, chairman of the Investment Company Institute (the trade association representing the mutual fund industry), against any rule requiring uninsured MMMFs to quote floating NAVs, because “[i]nvestors seeking guaranteed safety and soundness would migrate back to banks” and “[t]he remaining funds would become less attractive because of their fluctuating price”).

244. Scott, *supra* note 233, at 929; Wilmarth, *Big Bank Mergers*, *supra* note 224, at 79–82, 86.

245. 12 U.S.C. §§ 371c, 371c-1 (2006); see also *infra* note 246 (describing the FRB's waivers of sections 23A and 23B).

246. Wilmarth, *supra* note 132, at 456–57, 472–73 (discussing the FRB's waiver of § 23A restrictions so that major banks could make large loans to their securities affiliates after the terrorist attacks on September 11, 2001); Wilmarth, *supra* note 142, at 9 (describing the FRB's waiver of § 23A restrictions in August 2007, so that major banks could provide credit to support their securities affiliates following the outbreak of the subprime lending crisis); see also Transactions Between Member Banks and Their Affiliates: Exemption for Certain Purchases of Asset-Backed Commercial Paper by a Member

would replace Sections 23A and 23B with an absolute prohibition on any extensions of credit or other transfers of funds by second-tier banks to their nonbank affiliates. That reform would effectively prevent the FRB from approving any similar transfers of safety net subsidies by narrow banks to their affiliates.

Second, as discussed above, the “systemic risk” provision currently included in the FDI Act should be repealed. By repealing the “systemic risk” exception, Congress would require the FDIC to follow the least costly resolution procedure for every failed bank, and the FDIC could no longer rely on the TBTF policy as a justification for protecting uninsured creditors of a failed bank’s parent holding company or other nonbank affiliates of a failed bank.²⁴⁷

Insulating the DIF from any possibility of TBTF bailouts would have important benefits. It would make clear to the financial markets that the DIF could only be used to protect depositors of failed banks. Uninsured creditors of FHCs—regardless of their size—would no longer have any reasonable expectation of being protected by the DIF. Shareholders and creditors of FHCs and their nonbank subsidiaries would therefore have stronger incentives to monitor the financial condition of such entities.

Additionally, smaller banks would no longer bear any part of the cost of rescuing uninsured creditors of TBTF banks. Under current law, all FDIC-insured banks must pay a special assessment (allocated in proportion to their total assets) to reimburse the FDIC for the cost of protecting uninsured claimants of a TBTF bank under the “systemic risk” provision.²⁴⁸ A 2000 FDIC report noted the unfairness of expecting smaller banks to help pay for “systemic risk” bailouts when “it is virtually inconceivable that they would receive similar treatment if distressed.”²⁴⁹ The FDIC report suggested that the way to correct this inequity is “to remove the systemic risk exception from the [FDI Act],”²⁵⁰ as I have proposed here.

Third, second-tier narrow banks should be prohibited from dealing in derivatives or from purchasing derivatives except as end-users for bona

Bank From an Affiliate, 74 Fed. Reg. 6226 (Feb. 6, 2009) (to be codified at 12 C.F.R. pt. 223) (approving waivers of §§ 23A and 23B in order to “increase the capacity” of banks to purchase ABCP from affiliated MMMFs, and explaining that such waivers—which had originally been granted in September 2008—were justified “[i]n light of ongoing dislocations in the financial markets, and the impact of such dislocations on the functioning of the ABCP markets and on the operations of [MMMFs]”).

247. See *supra* notes 218–220 and accompanying text.

248. 12 U.S.C. § 1823(c)(4)(G)(ii) (2006).

249. Federal Deposit Ins. Corp., Options Paper, Aug. 2000, at 33, available at http://www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf.

250. *Id.*

vide hedging purposes pursuant to FAS 133.²⁵¹ All other derivatives activities of second-tier banking organizations must be conducted through separate nonbank affiliates. This rule would prevent FHCs from continuing to exploit federal safety net subsidies by conducting risky derivatives activities within their FDIC-insured bank subsidiaries.

I have previously pointed out that bank dealers in OTC derivatives enjoy significant competitive advantages over nonbank dealers because of the banks' explicit and implicit safety net subsidies.²⁵² Banks typically borrow funds at significantly lower interest rates than their holding company affiliates because (i) banks can obtain direct, low-cost funding through FDIC-insured deposits, and (ii) banks present lower risks to their creditors because of their direct access to other federal safety net resources, including (A) the FRB's discount window lending facility, (B) the FRB's guarantee of interbank payments made on Fedwire, and (C) the greater potential availability of TBTF bailouts for uninsured creditors of banks (as compared to creditors of BHCs).²⁵³ The OCC has confirmed that FHCs generate higher profits when they conduct derivatives activities directly within their banks, in part because the "favorable [funding] rate enjoyed by the banks" is lower than "the borrowing rate of their holding companies."²⁵⁴ Such an outcome may be favorable to FHCs, but it is certainly not beneficial to the DIF and taxpayers, because they are exposed to a higher risk of losses when derivatives activities are conducted directly within banks instead of within nonbank holding company affiliates.²⁵⁵

251. See Wilmarth, *Big Bank Mergers*, *supra* note 224, at 84–85 (explaining why narrow banks should be allowed to purchase derivatives solely for hedging purposes); *supra* note 227 and accompanying text (discussing FAS 133).

252. Wilmarth, *supra* note 132, at 336–37, 372–73.

253. See CARNELL, MACEY & MILLER, *supra* note 138, at 492; Wilmarth, *supra* note 142, at 5–7, 16 n.39.

254. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC INTERPRETIVE LETTER NO. 892, at 3 (from Comptroller of the Currency John D. Hawke, Jr., to Rep. James A. Leach, Chairman of H. Committee on Banking & Financial Services), *available at* <http://www.occ.treas.gov/interp/sep00/int892.pdf>.

255. Wilmarth, *supra* note 132, at 372–73. For general discussions of the risks posed by OTC derivatives to banks and other financial institutions, see, for example, *id.* at 337–78; RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* 7–142 (2007); TETT, *supra* note 87, *passim*. CFTC Chairman Gary Gensler has proposed legislation that would require "standard" (as opposed to "customized") derivatives to be traded on exchanges or clearinghouses instead of being arranged through privately-negotiated contracts with OTC dealers. Chairman Gensler contends that "standard" derivatives should be traded on exchanges or clearinghouses in order to (i) increase the public transparency of trading positions and prices, and (ii) force derivatives counterparties to post collateral, as required by the relevant

Fourth, second-tier banks and their affiliates should be prohibited from making private equity investments. To accomplish this reform, Congress must repeal Sections 4(k)(4)(H) and (I) of the BHC Act,²⁵⁶ which allow FHCs to make merchant banking investments and insurance company portfolio investments.²⁵⁷ Private equity investments by second-tier banking organizations should be banned because they involve a high degree of risk and have inflicted significant losses on FHCs in the past.²⁵⁸ In addition, private equity investments “could potentially weaken the separation of banking and commerce” by allowing FHCs “to maintain long-term control over entities that conduct commercial (i.e., nonfinancial) businesses.”²⁵⁹ Such affiliations between banks and commercial firms are undesirable because they are likely to create serious competitive and economic distortions, including the spread of federal safety net benefits to the commercial sector of our economy.²⁶⁰

In combination, the four supplemental rules described above would help to ensure that narrow banks cannot transfer their federal safety net subsidies to their nonbank affiliates. Restricting the scope of safety net subsidies is of utmost importance in order to restore a more level playing

exchange or clearinghouse, to protect against the risk of counterparty default. *See, e.g.*, Graham Bowley, *A Convert to Reform: Goldman Deal-Maker Now Advocates Regulation*, N.Y. TIMES, Mar. 10, 2010, at B1; Ian Katz & Robert Schmidt, *Gensler Turns Back on Wall Street to Push Derivatives Overhaul*, BLOOMBERG.COM, Feb. 12, 2010, available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=a3OkrdITAZtA>. I strongly support Chairman Gensler’s proposal, but a detailed discussion of that proposal is beyond the scope of this article.

256. 12 U.S.C. § 1843(k)(4)(H), (I) (2006).

257. *See* CARNELL, MACEY & MILLER, *supra* note 138, at 483–85 (explaining that “through the merchant banking and insurance company investment provisions, [GLBA] allows significant nonfinancial affiliations” with banks).

258. *See* Wilmarth, *supra* note 132, at 330–32, 375–78.

259. Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1581–82 (noting, however, that the FRB and the Treasury Dept. have so far “impose[d] strict limitations” on such investments in order to help preserve the separation of banking and commerce).

260. For further discussion on this argument, see *id.* at 1588–1613. Federal regulators recently provided a large federal safety net subsidy to GE, a major industrial conglomerate, when they allowed GE’s finance company subsidiary, GE Capital, to issue \$55 billion of FDIC-guaranteed debt during 2008 and 2009. Federal regulators permitted GE Capital, which owns a thrift and industrial bank, to issue debt through the FDIC’s DGP after GE Capital experienced difficulties in selling commercial paper to fund its operations. GE Capital received this subsidy even though it is not a BHC and did not satisfy the general terms and conditions of the FDIC’s DGP. *See supra* note 122. This incident illustrates the potential risk that affiliations between banks and commercial firms will result in an extension of the federal safety net from the banking sector to the commercial sector of the economy.

field between small and large banks, and between banking and nonbanking firms. Safety net subsidies have increasingly distorted our regulatory and economic policies over the past three decades. During that period, nonbanking firms have pursued every available avenue to acquire FDIC-insured depository institutions so that they can secure the funding advantages provided by low-cost, FDIC-insured deposits. At the same time, nonbank affiliates of banks have made every effort to exploit the funding advantages and other safety net benefits conferred by their affiliation with FDIC-insured institutions.²⁶¹ The enormous benefits conferred by federal safety net subsidies are conclusively shown by the following facts: (i) no major bank organization has ever voluntarily surrendered its banking charter, and (ii) large nonbanking firms have aggressively pursued strategies to secure control of FDIC-insured depository institutions.²⁶²

The most practicable way to prevent the spread of federal safety net subsidies, and their distorting effects on regulation and economic activity, is to establish strong barriers that prohibit narrow banks from transferring their subsidies to their nonbanking affiliates, including those engaged in speculative capital markets activities.²⁶³ The narrow bank structure and the supplemental rules described above would force financial conglomerates to prove that they can produce superior risk-related returns to investors without relying on governmental subsidies. As noted above, economic studies have not confirmed the existence of favorable economies of scale or scope in financial conglomerates, and those conglomerates have not been able to generate consistently positive returns, even under the current regulatory system that allows them to capture extensive federal subsidies.²⁶⁴

A prominent bank analyst recently suggested that if Congress enacted new rules that imposed severe restrictions on affiliate transactions, and thereby prevented nonbank subsidiaries of FHCs from relying on low-cost deposit funding provided by their affiliated banks, large FHCs would not be economically viable and would be forced to break up vo-

261. Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1569–70, 1584–93; Wilmarth, *supra* note 142, at 5–8; *see also* Kay, *supra* note 167, at 43 (“The opportunity to gain access to the retail deposit base has been and remains irresistible to ambitious deal makers. That deposit base carries an explicit or implicit government guarantee and can be used to leverage a range of other, more exciting, financial activities. The archetype of these deal-makers was Sandy Weill, the architect of Citigroup.”).

262. Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1590–93.

263. *See* Kay, *supra* note 167, at 57–59.

264. *See supra* notes 165–167 and accompanying text.

luntarily.²⁶⁵ It is noteworthy that many of the largest commercial and industrial conglomerates in the U.S. and Europe have been broken up through hostile takeovers and voluntary divestitures during the past three decades because they proved to be “less efficient and less profitable than companies pursuing more focused business strategies.”²⁶⁶ It is long past time for financial conglomerates to be stripped of their safety net subsidies so that they will be subject to the same type of scrutiny and discipline that the capital markets have applied to commercial and industrial conglomerates during the past thirty years. The narrow bank concept provides a workable plan to impose such scrutiny and discipline on FHCs.

c. Responses to Critiques of the Narrow Bank Proposal

Critics have raised three major objections to the narrow bank concept. First, critics point out that the asset restrictions imposed on narrow banks would prevent them from acting as intermediaries of funds between depositors and most borrowers. As noted above, most narrow bank proposals would require such banks to invest their deposits in safe, highly marketable assets such as those permitted for MMMFs. Narrow banks would therefore be largely or entirely barred from making commercial loans. As a result, a banking system composed exclusively of narrow banks could not provide credit to small and mid-sized business firms that lack access to the capital markets and depend on banks as their primary source of outside credit.²⁶⁷

265. Karen Shaw Petrou, the managing partner of Federal Financial Analytics, recently explained that “[i]nteraffiliate restrictions would limit the use of bank deposits on non-banking activities,” and “[y]ou don’t own a bank because you like branches, you own a bank because you want cheap core funding.” Ms. Petrou therefore concluded that proposed federal legislation, which would impose tough restrictions on affiliate transactions, “really strikes at the heart of a diversified banking organization” and “I think you would see most of the very large banking organizations pull themselves apart” if Congress passed such legislation. Stacy Kaper, *Big Banks Face Most Pain Under House Bill*, AM. BANKER, Dec. 2, 2009, at 1 (quoting Ms. Petrou).

266. Wilmarth, *supra* note 132, at 284; *see also* Philip G. Berger & Eli Ofek, *Bustup Takeovers of Value-Destroying Diversified Firms*, 51 J. FIN. 1175, 1175–78, 1198 (1996); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 2–8, 52–60 (1986); Chris Veld & Yulia V. Veld-Merkoulova, *Value Creation Through Spin-Offs: A Review of the Empirical Evidence*, 11 INT’L J. MGMT. REVS. 407 (2009).

267. *See, e.g.*, Neil Wallace, *Narrow Banking Meets the Diamond-Dybvig Model*, 20 FRB of Minn. Q. Rev. (Winter 1996), at 3; Wilmarth, *Big Bank Mergers*, *supra* note 224, at 79–81 (explaining that narrow banks would be prohibited from making commercial loans, except perhaps for a limited basket of loans based on a fraction of their equity capital).

However, my two-tiered proposal would greatly reduce any disruption of the traditional role of banks in acting as intermediaries between depositors and bank-dependent firms by permitting first-tier “traditional” banks (primarily community banks) to continue making commercial loans that are funded by deposits. Community banks make most of their commercial loans in the form of longer-term “relationship” loans to small and mid-sized firms. Community banks have significant advantages in making such loans, because (i) their main offices are located in the communities where they make most of their commercial loans and their employees are therefore well informed about the character, reputation, and skills of local business owners, (ii) they maintain greater continuity in their branch managers and loan officers, thereby creating stronger relationships with local business owners, and (iii) they typically provide greater flexibility to their loan officers and business customers.²⁶⁸ Under my proposal, community banks could carry on their deposit-taking and lending activities as first-tier banking organizations without any change from current law, and their primary commercial lending customers would continue to be smaller, bank-dependent firms.

In contrast to community banks, most big banks do not make a substantial number of relationship loans to small firms. Instead, big banks primarily make loans to large and well-established firms. In addition, when big banks do provide credit to smaller firms they primarily do so through automated “transaction-based” programs that (A) disburse loans in relatively small amounts (usually under \$100,000), (B) use centralized, impersonal approval methods based on credit scoring, and (C) enable loans to be securitized into asset-backed securities sold to investors in the capital markets.²⁶⁹ Under my proposal, as indicated above, most large banks would operate as subsidiaries of second-tier “nontraditional” banking organizations. Second-tier holding companies would conduct their business lending programs through nonbank finance subsidiaries that are funded by commercial paper and other debt instruments that are sold to investors in the capital markets. This operational structure should not create a substantial disincentive for the small business lending programs currently offered by big banks, because major segments of those programs (e.g., business credit card loans) are already financed by the capital markets through securitization. Accordingly, my two-tier proposal should not cause a significant reduction in bank loans to bank-dependent

268. Wilmarth, *supra* note 132, at 261–66; see also Allen N. Berger et al., *Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks*, 76 J. FIN. ECON. 237, 239–46, 254–62, 266 (2005).

269. Wilmarth, *supra* note 132, at 264–66; see also Berger et al., *supra* note 268, at 240–41, 266.

firms, as big banks have already moved away from traditional relationship-based lending funded by deposits.²⁷⁰

The second major criticism of the narrow bank proposal is that it would lack credibility because federal regulators would retain the inherent authority (whether explicit or implicit) to organize bailouts of major financial firms during periods of severe economic distress. Accordingly, some critics maintain that the narrow bank concept would simply shift the TBTF problem from the insured bank to its nonbank affiliate.²⁷¹ However, the force of this objection would be greatly diminished if Congress established a new comprehensive regime for regulating SIFIs as described above, including a special resolution process, SRCRs, consolidated supervision, and mandatory payment of SRIF insurance premiums.²⁷² This proposed systemic risk supervision regime would ensure that all nonbanking firms that might be considered for TBTF bailouts are designated and regulated as SIFIs. In addition, all SIFIs would be required to pay premiums to fund the SRIF, and a fund separate from the DIF would therefore exist to resolve the failure of major nonbanking firms.

Accordingly, the narrow bank structure would prevent FDIC-insured banks that are controlled by SIFIs from transferring their safety net subsidies to their nonbank affiliates, and the systemic risk supervisory regime would force nonbank SIFIs to internalize the potential risks to financial and economic stability that result from their operations. In combination, both regulatory reforms should greatly reduce any TBTF subsidies that might otherwise be available to large nonbank firms.

The third principal objection to the narrow bank proposal is that it would place U.S. FHCs at a significant disadvantage in competing with foreign universal banks that are not required to comply with similar constraints.²⁷³ Again, there are persuasive rebuttals to this objection. For one thing, government officials in the U.K. have given serious consideration to the possible adoption of a narrow banking proposal developed by John Kay.²⁷⁴ If the U.S. and the U.K. both decided to implement a narrow

270. Wilmarth, *Financial Conglomerates*, *supra* note 224, at 126–27.

271. See Scott, *supra* note 233, at 929–30 (noting the claim of some critics that there would be “irresistible political pressure” for bailouts of uninsured “substitute-banks” that are created to provide the credit previously extended by FDIC-insured banks).

272. See *supra* Parts III.B–III.D.

273. See Scott, *supra* note 233, at 931; Kay, *supra* note 167, at 71–74

274. See TREASURY COMMITTEE, TOO IMPORTANT TO FAIL—TOO IMPORTANT TO IGNORE, 2009–10, H.C. 9–Vol. 1, at 52, 59, available at <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/261i.pdf> [hereinafter 2009 U.K. Treasury Committee Report] (expressing qualified support for Kay’s narrow banking proposal); King 2009 Speech, *supra* note 138, at 6–7 (expressing

banking structure (together with other needed systemic risk regulations), their joint dominance in global financial markets would place considerable pressure on other developed countries to adopt similar financial reforms.²⁷⁵

Moreover, the financial sector accounts for a large share of the domestic economies of the U.S. and U.K., and both economies have suffered severe injuries from two financial crises during the past decade (the dot-com-telecom bust and the subprime lending crisis). Both crises were produced by the same set of LCFIs that continue to dominate the financial systems in both nations. Accordingly, regardless of what other nations may do, the U.S. and the U.K. have compelling national interests in making sweeping changes to their financial systems in order to protect their domestic economies from the threat of a similar crisis in the future.²⁷⁶

Finally, the view that the U.S. and the U.K. must refrain from implementing fundamental financial reforms until all other major developed nations have agreed to do so rests upon two deeply flawed assumptions: (i) the U.S. and the U.K. must allow foreign nations with the weakest systems of financial regulation to dictate the level of supervisory constraints on LCFIs, and (ii) until a comprehensive international agreement on reform is achieved, the U.S. and the U.K. must continue to provide TBTF bailouts and other safety net subsidies that create moral hazard and distort economic incentives simply because other nations provide similar benefits to their LCFIs.²⁷⁷ Both assumptions are unacceptable and must be rejected.

support for Kay's narrow bank proposal and for the Volcker rule as two alternative possibilities for separating the "utility aspects of banking" from "some of the riskier financial activities, such as proprietary trading"); Kay, *supra* note 167, at 51–69 (describing the narrow bank proposal as a means for accomplishing "the separation of utility from casino banking").

275. 2009 U.K. Treasury Committee Report, *supra* note 274, at 70–71 (quoting views of former FRB Chairman Paul Volcker); *see also* TARULLO, *supra* note 203, at 45–54 (describing how the U.S. and U.K. reached agreement on bank capital rules and then pressured other developed nations to agree to the Basel I international capital accord); Kay, *supra* note 167, at 74.

276. *See e.g.*, Hoenig October 6, 2009 Speech, *supra* note 123, at 4–10; King 2009 Speech, *supra* note 138; 2009 U.K. Treasury Committee Report, *supra* note 274, at 71–74; Kay, *supra* note 167, at 14–17, 20–24, 28–31, 39–47, 57–58, 66–75, 86–87; *supra* Parts I–II.

277. *See e.g.*, Hoenig October 6, 2009 Speech, *supra* note 123, at 4–10; Kay, *supra* note 167, at 42–46, 57–59, 66–75.

d. The Relevance of the Schumer "Core Banking" Proposal of 1991

In 1991, Congress considered, but did not pass, legislation proposed by the Treasury Department to allow banks to affiliate with securities firms and insurance companies by organizing financial holding companies.²⁷⁸ During the House debates on the 1991 legislation, which was essentially a forerunner of GLBA,²⁷⁹ then-Representative Charles Schumer offered an amendment that incorporated a narrow banking proposal similar to the one outlined in this article.²⁸⁰ Representative Schumer argued that Congress should not authorize financial holding companies unless it adopted his amendment, which he described as a "core bank proposal."²⁸¹ His proposal sought to guarantee that "insured deposits [are] used for low-risk, traditional banking activities, and then if our large financial institutions wish to invest in high-risk activities, they do not use the depositors' money, they do not use insured dollars, but they go to the markets for money."²⁸²

Representative Schumer maintained that the FDIC and taxpayers should not be insuring such risky activities as "huge bridge loans to LBO's, . . . equity investments in real estate[,] . . . foreign currency trading and trading in . . . derivatives, which is betting on futures."²⁸³ He noted that "[m]ost of the large banks are opposed because they do not want to take the necessary medicine to make them better," but he argued that "[t]hey need strong medicine, and only core banking provides it."²⁸⁴ Representative Marge Roukema supported the proposal because "the core bank concept is the only proposal before us to insulate the deposit insurance fund and protect the taxpayer from future bailouts."²⁸⁵ She agreed that "insured deposits should only be used to finance [the] traditional business of banking" and should not be used to "finance highly

278. See Arthur E. Wilmarth, *Too Big to Fail, Too Few to Serve: The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957, 966, 978–80 (1992) (discussing congressional consideration of the Treasury Department's proposal to allow banks to affiliate with securities firms and insurance companies); Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1579–80.

279. Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1580–81 (explaining that Congress effectively adopted the Treasury Department's 1991 proposal when it enacted GLBA in 1999).

280. See 137 CONG. REC. 29359–29367 (1991).

281. *Id.* at 29361 (remarks of Rep. Schumer).

282. *Id.* at 29360.

283. *Id.*

284. *Id.* at 29361 (remarks of Rep. Schumer).

285. *Id.* at 29366 (remarks of Rep. Roukema).

speculative lending, equity investments or other activities which should be done outside the Federal safety net.”²⁸⁶

Representative Schumer’s core banking proposal was defeated.²⁸⁷ However, he was undoubtedly correct in saying that his proposal was the “only amendment on the floor today that says we will not do what we did during the S&L crisis, and that is [to] use insured dollars for risky activities.”²⁸⁸ He argued that Congress had grievously erred in 1982, when it allowed federal thrifts to “expand into new businesses with the taxpayers’ dollars.”²⁸⁹ He further warned that Congress would be confronted with a future bailout of the banking system that could cost “\$300 billion” unless we reform the system today. Do not put it off. Do not delay. The taxpayers cannot afford it. Only [the] core bank [proposal] will protect the insured deposit system once and for all.²⁹⁰

Unfortunately, Representative Schumer’s warning not only proved to be prescient but also underestimated the potential cost of allowing banks to expand into capital markets activities while relying on federal safety net subsidies. As the current financial crisis has made clear, Congress must mandate narrow banking in order to prevent FDIC-insured banks

286. *Id.* at 19363 (remarks of Rep. Roukema); *see also id.* at 29365 (remarks of Rep. Slattery) (arguing that the “core-bank proposal offers real reform” because “it will say to the big banks in this country that . . . you can speculate in the monetary markets, you can speculate in real estate, you can speculate in high-yield junk bonds, but you cannot do it with the taxpayers’ insured deposits”); *id.* at 29366–29367 (remarks of Rep. Weiss) (explaining that “the core bank proposal” would ensure that financial institutions interested in “underwriting, trading, and investment banking activities . . . would have to raise funds in the marketplace,” and contending that “it would be unconscionable to expand bank powers without enacting major safeguards to the American taxpayer”).

287. *Id.* at 29367 (reporting that Rep. Schumer’s amendment was defeated by a vote of 106-312).

288. *Id.* at 29360 (remarks of Rep. Schumer); *see also id.* at 29366 (remarks of Rep. Schumer) (contending that his proposal was the “only . . . amendment on the floor today that learns from history”).

289. *Id.* at 29366; *see also id.* at 29360 (remarks of Rep. Schumer) (contending that congressional “deregulation” of thrift powers meant that “we . . . were insuring crazy, and risky and wild investments in the S&L industry to an enormous extent”); Wilmarth, *Separation of Banking and Commerce*, *supra* note 131, at 1574–79 (explaining that (i) Congress’ expansion of the powers of federal thrifts in 1982 caused many states to “liberalize their own laws in order to keep state thrift charters attractive,” and (ii) federal and state deregulation allowed many thrifts to expand aggressively into “nontraditional activities,” including real estate development and investments in equity securities and junk bonds, which helped to cause “[s]ome of the largest and most costly thrift failures”).

290. 137 CONG. REC. 29366 (1991) (remarks of Rep. Schumer); *see also id.* at 29363 (remarks of Rep. Bacchus) (advocating the core banking proposal as the best way to “limit the risk [to] the taxpayers of a bank bailout that could cost hundreds of billions of dollars”).

from being used to subsidize similar high-risk underwriting, trading, and investment activities in the future.

CONCLUSION

The TBTF policy remains “the great unresolved problem of bank supervision,” more than a quarter century after the policy was invoked to justify the federal government’s rescue of Continental Illinois in 1984.²⁹¹ The current financial crisis has proven, once again, that TBTF institutions “present formidable risks to the federal safety net and are largely insulated from both market discipline and supervisory intervention.”²⁹² The crisis has also confirmed that TBTF institutions “pursue riskier and opaque activities and . . . increase their leverage, through capital arbitrage, if necessary, as they grow in size and complexity.”²⁹³ Accordingly, as I observed in 2002, “fundamentally different approaches for regulating financial conglomerates and containing safety net subsidies are urgently needed.”²⁹⁴

To respond to that need, this article has outlined a reform program to shrink safety net subsidies, force SIFIs to internalize the risks and costs of their activities, and create a more level playing field between smaller, traditional banks and LCFIs. My five-part program would (i) strengthen existing statutory limits on the growth of LCFIs, (ii) create a special resolution process to manage the orderly liquidation or restructuring of failed SIFIs, (iii) establish a consolidated supervisory regime and special capital requirements for SIFIs, (iv) create a special insurance fund (the SRIF), financed by assessments on SIFIs, in order to protect taxpayers against the costs of resolving failed SIFIs, and (v) mandate a “narrow bank” structure for FDIC-insured banks owned by LCFIs for the purpose of insulating those banks and the DIF from the risks of nonbank affiliates.

In combination, my proposed reforms would strip away many of the safety net subsidies that are currently exploited by LCFIs and would subject them to the same type of market discipline that the capital markets have applied to commercial and industrial conglomerates over the past thirty years. Financial conglomerates have never demonstrated that they can provide beneficial services to their customers and attractive returns to their investors without relying on safety net subsidies and massive taxpayer-funded bailouts. It is long past time for LCFIs to prove—based

291. Wilmarth, *supra* note 132, at 475; *see also id.* at 300–01, 314–15.

292. Wilmarth, *supra* note 132, at 476.

293. *Id.*

294. *Id.*

on a true market test—that their claimed superiority is a reality and not a myth.

ON FRENCH INTERVENTIONS IN THE FINANCIAL CRISIS

*Georges A. Cavalier**

INTRODUCTION

One of the main challenges in drafting this paper was compiling materials on “a moving target.” Nobody knows yet if the crisis is over, nor whether the actions implemented to cope with the crisis will be sufficient. France is still considering more interventions; for example, issuing an exceptional government bond.

There is no “single” European answer to the crisis, although all E.U. governments have agreed on a consensus.¹ Despite the coordination of the plan by the Eurozone governments, each Member State has implemented differing individual plans. Of course, there has been some intervention from the E.U. Commission in respect to competition law, and, in particular, rules for State aid. It appears more and more clear that a discussion on structural reform will happen on the E.U. level.²

This paper first analyzes where France stands today in the global picture, and then underlines how French interventions are trying to hold this crisis in check. Finally, it makes a few predictions for reform.

I. WHERE DOES FRANCE STAND IN THE GLOBAL PICTURE?

Where does France stand in the global picture? The causes of the crisis are mentioned first, followed by a discussion of the impact of the crisis on the French economy as compared to other economies.

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1. See Press Release, Summit of the Euro Area Countries: Declaration of a Concerted Action Plan of the Euro Area Countries (Oct. 12, 2008); see also C. Chatignoux, *Les Leaders du G20 Sous Pression pour Apporter une Réponse Commune à la Crise*, LES ECHOS, Apr. 2, 2009, at 6.

2. Alain Banluet, *Sarkozy et Merkel Font Front Commun Avant le G20*, LE FIGARO, Sept. 1, 2009.

A. Causes of the Crisis

It is unnecessary to repeat in great detail the causes of the crisis, but it can be linked to three factors.³ First, global imbalance due to worldwide excess liquidity. This results from a major trade surplus and large public savings in emerging countries like China.⁴ A second cause is microeconomic failure. Usually, when stocks are high, yield-to-maturity rates for bonds are low. In order to maintain profitability, banks have had to increase the volume of their activity by easing lending conditions and by using securitization vehicles.⁵ The use of securitization is a third cause. It consists of transforming traditionally illiquid bank loans into securities traded on the market through an *ad hoc* legal entity.⁶ What is the impact of this crisis on the French economy?

B. Impacts in France

Last May, the cover page of “The Economist,” the liberal English magazine, led readers to think that it was going to say *mea culpa*.⁷ French President Nicolas Sarkozy was on the top podium smiling down on a somewhat depressed German Chancellor Angela Merkel, and, the poor English Prime Minister Gordon Brown stood buried in gloom and doom.

3. See John Cassidy, *Anatomy of a Meltdown*, THE NEW YORKER, Dec. 1, 2008, at 49; PATRICK ARTUS, ET AL., COUNSEIL D'ANALYSE ÉCONOMIQUE, LA CRISE DES SUBPRIMES 11–60 (2008), available at <http://www.cae.gouv.fr/IMG/pdf/078.pdf>; see also BANQUE DE FRANCE, LA CRISE FINANCIERE 9–10 (Feb. 2009), available at http://www.banque-france.fr/fr/publications/telechar/doc_debat/numero_2/integral.pdf.

4. Indeed, the productivity stock impacted growth, which in turn boosted earnings forecasts and led to an increase in investment and, therefore, lending. Under normal circumstances, an increase in inflation limits increase in lending, which in turn prompts a rise in interest rates. In the case of the subprime crisis, there was excess liquidity worldwide, which prevented inflation; global inflation continued to fall, and any volatility vanished. The drop in inflation led to a drop in long-term rates, fueling an abundant and bargain credit supply.

5. When markets were down, investors turned to bonds. Because of the macroeconomic imbalances, yield-to-maturity rates were very low. To keep up with profitability, banks increased the volume of their activity by easing lending conditions. That should have led to an increase in banks' equity to preserve the debt/equity ratio, but banks preferred to avoid this constraint by using securitization vehicles.

6. For example, the bank that issued the loans sold them to a special purpose vehicle that financed the acquisitions by issuing shares on the markets. The investors then purchased the shares that paid the revenue linked to the loans (interest and repayment of the principal). Securitization allows banks to transfer their credit risk to the market. In theory it is good to spread the risk. The problem is that a bank that no longer bears risks often becomes less strict in screening and monitoring.

7. *A New Pecking Order*, THE ECONOMIST, May 9, 2009, at 13.

The highly regulated French economic model appears to be weathering the crisis better than the old liberal English model. President Sarkozy recently outlined his vision of a “Brave New World,” in which France would lead the way with the most rigorous regulations on record.⁸

Based on this observation, is *laissez-faire* an obsolete system? Just because France has resisted the crisis better than other countries does not mean that it will resist forever. Nothing is free in this world; there will certainly be a price to pay for greater social security and job protection. France may be slow to adjust and less innovative, leading, in the long run, to sluggish growth.

Looking at the litigation side, although people filed complaints in France because of the crisis, they are not equivalent in either number or subject matter to those filed in U.S. courts. The explanation for this is the attractiveness of U.S. securities class actions and the possibility of jurisdiction in U.S. courts over class actions initiated by French investors against French corporations.⁹

Nevertheless, France was severely impacted by the crisis, and the French government has reacted. Let us examine these interventions.

II. STATED INTERVENTIONS IN FRANCE

The French State first intervened directly through the French Bank Relief Act.¹⁰ The second set of interventions was more structural and indirect, such as reforming executive compensation rules. These types of interventions will be discussed. A number of *ad hoc* measures such as

8. *French Regulatory Vision*, FIN. TIMES, Aug. 27, 2009, at 1.

9. See *In re Vivendi Universal, S.A. Securities Litigation*, 2009 WL 855799, at *1 (S.D.N.Y. 2009); see also Pierre Servan-Schreiber & Olivier Boulon, *Le Contentieux Boursier né de la Crise Financière en France et aux Etats-Unis*, REVUE TRIMESTRIELLE DE DROIT FINANCIER 7 (2009). But see *Morrison v. Nat'l Austl. Bank*, 2010 U.S. LEXIS 5257 (June 24, 2010).

10. See Didier Martin, Olivier Saba, & Forrest Alogna, *European Responses to the Financial Crisis*, JCP/LA SEMAINE JURIDIQUE (2009); see also MAYER BROWN LLP, SUMMARY OF GOVERNMENT INTERVENTIONS IN FINANCIAL MARKETS – FRANCE (2009), available at <http://www.mayerbrown.com/publications/article.asp?id=7847&nid=6>; see also PASCAL BINES & SIDNE KOENIGSBERG, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP, 2009 INSIGHTS: NAVIGATING TUMULTUOUS TIMES 26 (2009), available at http://www.skadden.com/content/sitefiles/Skadden_0D39513A6E12353AA89BFD6B84527ADF.pdf; ROBERT PAROLAI ET AL., CLIFFORD CHANCE LLP, FRENCH ACTION PLAN TO RESTORE CONFIDENCE IN THE BANKING SYSTEM (2008); LATHAM & WATKINS LLP, EUROPEAN GOVERNMENTS ACT TO STABILIZE MARKETS (2008); Symposium, Aspects Juridiques de la Crise Financière, JCP E (2009); Symposium, L'actualité du Droit Financier sur Fond de Crise, REVUE TRIMESTRIELLE DE DROIT FINANCIER (2009).

parts of the French rescue plan, for instance *Dexia*,¹¹ or the French automobile manufacturers *Renault* and *Peugeot-Citroën*, will not be discussed.¹²

A. French Bank Relief Act

The most direct intervention to rein in the crisis is the French Bank Relief Act (“the Act”) adopted October 15, 2008.¹³ The main features of the Act are the creation of two special purpose vehicles (“SPVs”): a Refinancing Company¹⁴ and a Recapitalization Company.¹⁵ The Act establishes a State guarantee for any debt securities issued by these two companies. In other words, State aid to banks consists of guarantees granted to these two companies, and is not granted directly to the banks for their own underwriting.

This is a major difference between France and the U.S. In France, the Act provides financing through the Refinancing Company, which can raise money partly due to the confidence inspired by a State guarantee. On the contrary, the U.S. plan provides credit to the bank itself to obtain financing. One advantage of the French SPV is that it allows banks to raise funds at rates lower than those available to private institutions that qualify for a State guarantee.¹⁶ The French plan is easy because a single vehicle issues bonds.

Therefore, the French Bank Relief Act enables the State to become a major player in rescue efforts.¹⁷ Thus, the State has become both a “lender of last resort” and a “buyer of last resort.”

11. This refers to the action plan to save *Dexia* Group so it could continue to finance local French authority. Other French initiatives include the battle against tax havens and the prohibition of short selling. See PAROLAI ET AL., *supra* note 10.

12. Matthew Saltmarsh, *France Announces \$8.5 Billion Plan to Help Struggling Auto Industry*, N.Y. TIMES, Feb. 9, 2009, at B3.

13. Law No. 2008-1061 of Oct. 16, 2008, French Bank Relief Act, Journal Officiel de la République Française [J.O.] [Official Gazette of France], Oct. 17, 2008, p. 1; see also *Opinion of the European Central Bank* CON/2008/56 (Oct. 21, 2008). This paper limits itself to discussion of the financial industry. It does not discuss other direct interventions, such as aid to households to limit the increase in payment defaults, or the Strategic Investment Fund to support the development of small and medium-size businesses and increase protection for the capital of strategic companies.

14. Société française de refinancement de l'économie or SFRE.

15. Société de prise de participation de l'Etat or SPPE.

16. VIOLAINE LE GALL, L'AGEFI, LA SFEF BOUCLE UNE DEUXIÈME EMISSION DE SIX MILLIARDS D'EUROS À DEUX ANS (Dec. 2, 2008).

17. See MAYER BROWN LLP, *supra* note 10, at 2–3; see also BINES & KOENIGSBERG, *supra* note 10, at 26; PAROLAI *supra* note 10; LATHAM & WATKINS LLP, *supra* note 10.

1. State as a Lender of Last Resort

The French State has agreed to play the role of a lender of last resort in order to maintain liquidity and to support inter-bank financing. The state accomplishes this via State/governmental guarantees, and through the Refinancing Company. The State guarantees the Refinancing Company's obligations. The Refinancing Company then loans out funds it raises to institutions. The consideration provided for the loan is the posting of collateral interest at a mark-up rate, in addition to the rates required by the international credit market.

France allows a broad category of financial institutions to take advantage of the State guarantee, whereas the U.S. restricts eligibility to banks and related institutions.¹⁸ An "opt out" is possible in the U.S., whereas in France the scheme allows the financial institution to decide whether loans or bonds are preferred. By providing an opt-in/opt-out scheme, both the American and French plans preserve a quasi-contractual characteristic.

On October 24, 2008, seven French banks requested loans from the Refinancing Company for a total of 5 billion euros. The Refinancing Company borrowed funds from the financial institution of the French Government, the *Caisse des Dépôts et Consignation*. Thereafter, the Refinancing Company issued several public bonds, the proceeds of which were used to advance loans to credit institutions. It is estimated that the Refinancing Company will issue bonds totaling 80 billion euros in 2009, out of the total budget of 265 billion euros.

2. State as a Buyer of Last Resort

The second component of the French Bank Relief Act is recapitalization. For a total of 40 billion euros, recapitalization provides financial institutions with a sufficient cushion to continue to finance the "real" economy. The level of banks' regulatory capital directly affects the number of loans allowed. Through this recapitalization scheme, banks' debt/equity ratio should increase by an average of 1%.

It is the second SPV, the Recapitalization Company, which houses two types of instruments issued by the banks: deeply subordinated notes¹⁹

18. See WILLIAM D. TORCHIANA, *UNE REPOSE A LA CRISE FINANCIERE : L'ACCES DES SOCIETES ETRANGERES AUX PLANS DE SOUTIEN ETATIQUES*, JCP (2009).

19. In French: *titres super subordonnés*. A deeply subordinated note, which is also known as a "Perpetual" or "Perp," is a bond with no maturity date. Therefore, it may be treated as equity rather than debt.

and preferred shares.²⁰ In the U.S., investments made under the new Capital Assistance Program²¹ are placed in a trust.²² Although France has recently adopted a trust-like structure—the *fiducie*—it is, in fact, the Recapitalization Company that receives investments. In December 2008, the Recapitalization Company had already distributed the first tranche of 10.5 billion euros to six French banks. Technically, all these banks issued deeply subordinated instruments – not preferred shares. The Recapitalization Company subscribed to these deeply subordinated instruments.

During the summer of 2009, the Recapitalization Company distributed a second recapitalization tranche to *BNP Paribas* and *Société Générale* in the form of preferred shares, rather than deeply subordinated notes.²³ No voting rights attached to these preferred shares because the aim was to inject capital, not to gain control. *BNP Paribas* issued 5.1 billion euros of preferred shares, enabling it to repay the 2.55 billion euros of deeply subordinated notes subscribed by the Recapitalization Company.

There are at least two mechanisms that drive credit institutions back to private investors. The first is the very high interest rate of about 8.2 % charged by the Recapitalization Company for deeply subordinated notes.²⁴ The dividend for the preferred shares is even higher. The second mechanism that encourages prompt repayment is that the principal must be paid back at a premium that increases over time. For instance, the principal amount which has to be paid back would be over 10 % if one is waiting more than six years to repay his or her loan.²⁵ All of these are direct interventions by the French State, but there are other less direct and more structural interventions that aim to better regulate the financial industry.

20. Both the deeply subordinated notes and the preferred shares are qualified as Tier 1 capital (France's regulatory cap on the proportion of Tier 1 capital that may be represented by hybrid instruments has been raised from 25% to 35%). However, their regulatory treatment is not identical: whereas only 35% of the Tier 1 capital may include deeply subordinated notes, preferred shares are eligible for up to 50%. See *The Next Wave Should be Shares*, INT'L FIN. L. REV. (2009).

21. See *Minimization of Long-Term Costs and Maximization of Benefits for Taxpayers*, 12 U.S.C.A. §5223 (2008). To greatly simplify, money is given in exchange for preferred stock that pays a 9% dividend.

22. For this component of the plan, other European States also created an SPV (e.g., Germany and the U.K.).

23. This was due to the different regulatory treatment of preferred shares and deeply subordinated notes. See *supra* note 20 and accompanying text.

24. This was to ensure that the initial capital injection of 10.5 billion euro would generate 850 million euro by the end of 2009.

25. A call may be exercised by banks at par during the first year, at 101% during the second year, and the premium reaches 111% after the sixth year.

B. Structural Interventions

Structural interventions are at the national level, though more and more often they are adopted at the E.U. level.²⁶ Three pieces of French legislation will be mentioned: first, the law modernizing the securitization legal framework; second, the law enhancing hedge funds competitiveness; and third, a stricter regulation of executive compensation. They are presented below in chronological order.

1. Securitization

Securitization is one cause of the crisis. However, “*it is not because the water is not clean that you have to throw out the bathtub too . . .*” This is why it is not surprising that France has decided to modernize the legal framework of mutual debt funds, to make securitization more attractive.²⁷ In the past, mutual debt funds were not attractive because their lack of legal and tax personality was an issue when transferring foreign receivables. One of the major features of the June 2008 ordinance is a new category of securitization vehicles with legal personality that allow securitization of insurance risk and extend the asset class of receivables that can be securitized.²⁸

2. Hedge Funds

Some authors describe hedge funds as an accelerator of the crisis.²⁹ Here, the general view in France is not to eliminate hedge funds, but to regulate them better.³⁰ French law has therefore introduced *gate* possibilities as well as *side pocketing* for hedge funds in an ordinance dated October 23, 2008. The idea is to cope with the liquidity crisis on a micro-economic level.

26. See *infra* Part IV.

27. Philip Boys, *New Legal Framework for Securitization*, INT’L LAW OFFICES, (Sept. 9, 2008), available at <http://www.internationallawoffice.com/Newsletters/detail.aspx?g=a9415593-42c6-4286-bea3-eb2d592c6a0c>.

28. It now includes the assignment of future receivables arising under lease agreements and lease purchase agreements.

29. Claire Gatinois, *Pétrole: Les Fonds Spéculatifs Attisent la Flambée des Cours*, LE MONDE (Nov. 23, 2007); see also J. Attali, *Le Vortex du Monde*, L’EXPRESS (Dec. 29, 2007), <http://blogs.lexpress.fr/attali/2007/12/le-vortex-du-monde.php>; M. Rocard, *La Crise Mondiale est Pour Demain*, LE NOUVEL OBSERVATEUR (Dec. 13, 2007), <http://hebdo.nouvelobs.com/sommaire/les-debats/075556/la-crise-mondiale-est-pour-demain.html>.

30. See generally Georges Cavalier, *La Réglementation des Fonds Spéculatifs (The Regulation of Hedge Funds, and State Funds)*, REVUE DE DROIT INTERNATIONAL ET DE DROIT COMPARÉ (2010).

As a reminder, mutual fund shares (including hedge funds) are redeemable from investors at any time; whenever an investor wants to exit the fund, it is possible. A *gate* provision restricts the amount of withdrawals an investor can make from the fund. It aims to insure the liquidity of hedge funds. *Gates* allow management companies to cap the amount of capital withdrawn from a fund at each scheduled redemption date. In other words, *gates* control the liquidity of the fund by spreading redemptions over time. It keeps the fund from having to sell off assets at fire-sale prices, which is disadvantageous to investors.

One can find a similar concept in *side pocketing*. This type of account separates illiquid assets from other liquid investments. The October 2008 ordinance also made this possible.

3. Executive Compensation

Executive compensation is probably the hottest topic in France today. Corporate governance is increasingly capturing attention. An Act passed in 2007 increased scrutiny of “*golden parachutes*” by prohibiting the award of deferred compensation to resigning corporate officers in listed companies, unless the compensation was conditional on the achievement of performance objectives.³¹ It is a way to ensure that “*golden parachutes*” are not a “*reward for failure*.”

In the same vein, on October 6, 2008, the French Business Confederation³² presented a new Code of Corporate Governance (the “Code”) which proposed stricter regulations.³³ It focuses on several objectives, including: (i) putting an end to “*golden parachutes*” and “*golden hellos*,” and (ii) creating new rules for granting stock options and preferential shares.

In the context of the crisis, it is now required that the beneficiaries of the French Bank Relief Act comply with the new Code, but the Code is “soft law” and hardly sufficient. Therefore, responding to public outcry, the French government issued a Decree in March 2009 banning stock options and limiting bonuses for bankers who lay off workers after ac-

31. See AMF REPORT ON CORPORATE GOVERNANCE AND CONTROL, AUTORITE DES MARCHES FINANCIERS (Jan 28, 2008); see also Lukasz Stankiewicz, *Tax Reform in France: Sarkozy's Tax Package of August 2007*, BULLETIN FOR INTERNATIONAL TAXATION (2008).

32. The *Mouvement des Entreprises de France* (MEDEF) is the leading network of business people in France.

33. See Catherine Malecki, *Régulation Financière: Les Codes D'entreprise Feront-ils Grise Mine?*, RECUEIL DALLOZ (2009).

cepting government aid.³⁴ A number of French executives, including senior management at *Société Générale*, have recently abandoned bonuses.

III. FUTURE IMPLICATIONS

Even for the French, it is hard to make predictions in our “Brave New World.” Prophecy has always been harder than history; however, hereafter is a guess about what will happen next.

One may predict that a strong international voice will be part of any lasting solution. This is already true for credit rating agencies, with efforts at the E.U. level to regulate them.³⁵ For instance, the ratings methodology now has to be public. This might also become true for executive compensation, where the European Commission has made recommendations on remuneration policy in the financial services sector. Even more recently, President Sarkozy and Chancellor Merkel, pledged their willingness to fight unjustified remuneration for traders.³⁶ Prime Minister Brown joined that pledge a few days later, followed by confirmation from the G20 Finance Ministers. Solutions cannot be made unilaterally because the market for traders is international, and institutions are competing for a limited pool of profitable talent.

Additionally, one may predict that pragmatism and efficiency will guide solutions in the current competitive environment. After all, is it so difficult to accept that there is not just one model of economic development, and that models evolve over time? The liberal model is probably best for the United States. However, if one tries this system in France, the result may be a new French Revolution. The French population is not likely to accept large income disparities with low social output. Moreover, even after the crisis is over, applying the French system in the United States will likely provoke another Boston Tea Party.³⁷

Every nation and economy has to find a niche that best fits its talents and culture. It is not always easy to compare apples to oranges. Pragmatism and efficiency do not always align to one single ideology. Howev-

34. Decree No. 2009-348 of March 30, 2009, Journal Officiel de la République Française [J.O.] [Official Gazette of France] (as modified by decree dated Apr. 23, 2009).

35. The E.U. approved a regulation of credit rating agencies; the same movement can be observed in Japan and Australia.

36. Norma Cohen, Jean Eaglesham & Brooke Masters, *Europe’s Leaders Call for “Binding Rules” to Rein in Bankers’ Bonuses*, FIN. TIMES, Sept. 4, 2009, at 1.

37. See generally Zachary Roth, *Tea Party Group: Obama is Both Goebbels and Mengele*, TPMMUCKRAKER, (Sept. 4, 2009), available at http://tpmmuckraker.talkingpointsmemo.com/2009/09/tea_party_group_obama_is_both_goebbels_and_mengele.php.

er, pragmatism and efficiency will always be a cornerstone of an effective market.

Lastly, a new role should be assigned to lawyers in the financial and commercial arena.³⁸ Law is not economy. Historically, lawyers were priests. Legal systems are moral systems, they are like religions and can be all-powerful – as well as have their own heretics! Some institutions gave money away for free. Everybody thought the *château* on the hill was worth 100, but it was a fairy tale; it was worth only 50. With laws, lawyers may be able to ground human optimism and dispel the belief that you can get rich quick doing nothing!

38. See Philip R. Wood, *Predictions for the Future of Financial Law and Lawyers*, 9 BUS. L. INT'L 234 (2008); see also Yann Paclot, *Crise Financière, Crise du Droit*, LA TRIBUNE, Jan. 14, 2009, at 8.

FIRST PRINCIPLES FOR AN EFFECTIVE FEDERAL HOUSING POLICY

*David J. Reiss**

The federal government has a bewildering array of housing programs funded with tens of billions of dollars every year.¹ Just this year, the Department of Housing and Urban Development is creating “a new Energy Innovation Fund to catalyze private sector investment in the energy efficiency of the Nation’s housing stock” as well as a “a new Choice Neighborhoods Initiative to make a range of transformative investments in high-poverty neighborhoods where public and assisted housing is concentrated.”² And the federal government will continue, of course, to fund and operate a dizzying array of existing programs, including in the broadest strokes:

- The Federal Housing Administration (“FHA”);³
- The Government National Mortgage Association (“Ginnie Mae”);
- The Federal National Mortgage Association (“Fannie Mae”), Federal Home Loan Mortgage Corporation (“Freddie Mac”), and the Federal Home Loan Bank System (“FHLBS”);⁴
- Project-Based Rental Assistance;
- Section 8 Housing Vouchers;
- Housing Counseling Assistance;
- Supportive Housing for the Elderly;
- Disabled Housing; and

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1. See OFFICE OF MANAGEMENT AND BUDGET, A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA’S PROMISE at 74 (2009), available at <http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf> (providing Fiscal Year 2010 budget overview).

2. *Id.*

3. The Federal Housing Administration was created during the Depression to incentivize lenders to originate mortgages with longer terms.

4. In addition to the FHA, the federal government created a variety of other specialized housing finance entities. Ginnie Mae is an instrumentality of the federal government. Fannie, Freddie and FHLBS are government-sponsored enterprises (“GSEs”). Fannie Mae and Freddie Mac, the two largest GSEs, are owned by private shareholders but have a public mission to create a liquid secondary market for residential mortgages.

- HOPE (Housing Opportunities for People Everywhere) VI Grants.⁵

On top of these direct expenditures on housing, the federal government makes hundreds of billions of dollars more in tax expenditures.⁶ The main ones are:

- deductibility of mortgage interest on owner-occupied homes;
- deductibility of state and local property tax on owner-occupied homes;
- capital gains exclusion on home sales;
- exclusion of net imputed rental income;
- exception from passive loss rules for certain rental loss;
- credit for low-income housing investments; and
- accelerated depreciation on rental housing.⁷

The Tax Policy Center estimates that tax benefits to homeowners in 2005 amounted to \$147 billion, while direct aid to renters amounted to \$41 billion in the same year.⁸ The greatest benefits for homeowners accrue to the wealthy, with 72 percent of all the income tax benefits accruing to those making more than \$75,000 per year, while only a tiny amount goes to those making less than \$40,000 per year.⁹

5. See DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, FISCAL YEAR 2009 JUSTIFICATION FOR ESTIMATES, *available at* <http://www.hud.gov/offices/cfo/reports/2009/cjs/introduction.pdf>; see RICHARD K. GREEN & STEPHEN MALPEZZI, A PRIMER ON U.S. HOUSING MARKETS AND HOUSING POLICY 89–95 (2003).

6. A “tax expenditure” refers to a tax payment that would have been made in the absence of a special tax provision combined with a simultaneous and equal payment to the person benefiting from that special provision. See STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 6–7 (1973). For instance, the deduction for mortgage interest is a tax expenditure because the federal government is making an exception from its general tax on income that benefits homeowners in order to encourage homeownership. Tax expenditures are typically made “to achieve various social and economic objectives.” Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 HARV. L. REV. 705, 706 (1970).

7. UNITED STATES CENSUS BUREAU, THE 2009 STATISTICAL ABSTRACT: THE NATIONAL DATA BOOK 307 tbl. 459 (2009), *available at* <http://www.census.gov/prod/2008pubs/09statab/fedgov.pdf>. In Fiscal Year 2006, the deduction for mortgage interest was the fourth largest tax expenditure for individuals, trailing only exclusions pertaining to pensions; dividends and capital gains; and employer contributions for health care. THOMAS L. HUNGERFORD, TAX EXPENDITURES: TRENDS AND CRITIQUES, CRS REPORT RL33641, 4 Tab. 1 (2006).

8. Adam Carasso et al., *The Trend in Federal Housing Tax Expenditures*, TAX NOTES, Feb. 28, 2005, at 1081.

9. Adam Carasso, *Who Receives Homeownership Tax Deductions and How Much?* TAX NOTES, Aug. 01, 2005 (using FY2004 data).

Given its size, it is unsurprising that housing's regulatory web is also immense and intricate, including as it does:

- the newly-created Federal Housing Finance Agency;¹⁰
- the Department of Housing and Urban Development;
- the Federal Reserve Board;
- the Federal Trade Commission;
- the Office of the Comptroller of the Currency;
- the Office of Thrift Supervision; and
- the National Credit Union Administration.

Trying to derive a principled understanding of federal housing policy in the face of such enormous expenditures and extraordinary complexity is no easy task. Indeed, my quest to identify one or a few "first principles" of American housing policy might even be described as quixotic. Nonetheless, I have undertaken this endeavor because our muddled housing agenda has left debates surrounding housing policy confused and unproductive. The vast housing policy literature—spread as it is through the economics, policy, legal, sociology, and other bodies of scholarship—reflects that confusion.¹¹

Indeed, it is difficult to even define "housing policy." At its broadest, it can refer to government efforts to shape "the dynamic relationships between housing markets and economic, demographic, and social trends."¹² More typically, however, housing policy refers to government efforts to increase housing affordability.¹³

This article aims to clarify the housing field by providing a taxonomy of principles that are relied upon explicitly and implicitly in debates regarding the proper goals of housing policy. I proceed as follows. First, I distinguish between first principles of federal housing policy, on the one

10. The FHFA replaced the Office of Federal Housing Enterprise Oversight (Fannie and Freddie's regulator) and the Federal Home Loan Board (the FHLB System's regulator).

11. See generally Tim Iglesias, *Our Pluralist Housing Ethics and the Struggle for Affordability*, 42 WAKE FOREST L. REV. 511 (2007) (reviewing housing literature in various disciplines).

12. The Joint Center for Housing Studies of Harvard University, <http://www.jchs.harvard.edu/aboutus/index.html>.

13. See, e.g., Center for Housing Policy, *Center Mission and Goals*, <http://www.nhc.org/about/Center-Mission-Goals.html> ("the Center helps to develop effective policy solutions at the national, state and local levels that increase the availability of affordable homes."); ALEX F. SCHWARTZ, *HOUSING POLICY IN THE UNITED STATES I* (2006) (looking at "primary policies and programs designed to make decent and affordable housing available to Americans of modest means."). The role of tax expenditures like the mortgage interest deduction is often underemphasized in discussions of housing policy, notwithstanding their budgetary impact.

hand, and parallel and subordinate policies, on the other. Second, I survey current opinion about housing policy in order to begin my inquiry into first principles of federal housing policy in particular. Finally, I identify the particular principles that inform federal housing policy. To be clear, this article does not take a position on which principles of housing policy are preferable; it merely seeks to set forth the options. I leave the development of a particular position on housing policy to a later day.

I. FIRST, AND OTHER, PRINCIPLES

Identifying possible first principles for a field as complex and conflicted as housing policy is difficult. This article, however, will take a catholic approach to the categorizing of possible first principles, setting forth all principles put forth in good faith by those who write about housing. Aristotle took a similar approach in the *NICOMACHEAN ETHICS*, his study of politics.¹⁴ I find that the structure that Aristotle employed to study politics is useful in organizing my own thinking about contemporary housing policy

For Aristotle, the term “politics” has a broader meaning than it does for us: it means the things concerning the community and/or the state. This meaning is more in line with our definition of “government.”¹⁵ Aristotle writes that politics is a “master-art or master-science” that “prescribes which of the sciences a state needs . . . to [politics] we see subordinated even the highest arts, such as economy, rhetoric, and the art of war.”¹⁶ Housing policy, entailing, as it does, the spending of government monies on capital projects and operations, falls well within Aristotle’s definition of politics.

As Aristotle notes, when several arts or sciences are

subordinated to some one art of science—as the making of bridles and other trappings to the art of horsemanship, and this in turn, along with

14. ARISTOTLE, *NICOMACHEAN ETHICS* (Sarah Broadie and Christopher Rowe Trans., Oxford Univ. Press 2002). To be clear, my reliance on Aristotle in this article has a much more modest goal than one finds in the recent movement to adapt Aristotelian virtue ethics to discussions of real property policy questions. See, e.g., Eduardo Penalver, *Land Virtues*, 94 CORNELL L. REV. 821, 822 (2008–2009) (setting forth an approach to property “rooted in the Aristotelian traditional of virtue ethics”). My more modest goal is to adapt Aristotle’s approach to practical philosophy found in the *NICOMACHEAN ETHICS* to a modern policy question. This approach may be contrasted against that of Tim Iglesias. Iglesias’ work, discussed below, argues that housing ethics cannot be prioritized but must be seen as coexisting on an ever-shifting policy landscape.

15. M. T. Owens, Jr., *Aristotle’s Polis: Nature, Happiness, and Freedom*, Spring 1980 REASON PAPERS 69; ARISTOTLE, *supra* note 14, at 2–3.

16. ARISTOTLE, *supra* note 14, at 2–3.

all else that the soldier does, to the art of war, and so on,—then the end of the master-art is always more desired than the ends of the subordinate arts, since these are pursued for its sake.¹⁷

Housing policy, likewise, may be described as having within it several subordinate policies. Thus, we should take care to ensure that our inquiry does not confuse subordinate objectives with the primary objectives. As we review potential first principles, we should sort them into two categories: “one good in themselves, and the other good as means to the former.”¹⁸

At the same time, we must acknowledge that housing policy is not in and of itself a “supreme” art or science as Aristotle described politics—it is clearly an aspect of politics as Aristotle understood the term.¹⁹ So we must roughly indicate (i) what goal of politics housing policy is meant to follow from; (ii) what the goals of housing policy are; and (iii) what subordinate policies it is meant to include. And as with Aristotle’s study of politics, “[w]e must be content if we can indicate the truth roughly and in outline, and if, in dealing with matters that are not amenable to immutable laws, and reasoning from premises that are but probable, we can arrive at probable conclusions.”²⁰

Where to begin? Aristotle notes that, “[u]ndemonstrated facts always form the first step or starting-point of a science; and these starting-points or principles are arrived at some in one way, some in another—some by induction, others by perception, others again by some kind of training.”²¹ Thus, I begin my inquiry like that of Aristotle, by surveying “current opinions on the subject.”²²

One current opinion-maker in the field, Tim Iglesias, does a thorough job of setting forth five broad “housing ethics” that have informed housing policy in the United States.²³ His use of the term “ethics” is substantively similar to my use of the term “principles.” But his “ethics” are intended to be more descriptive, while my “principles” are intended to be used as tools of evaluation. As such, Iglesias accepts that even contradictory ethics can coexist as political priorities shift, while I argue that those seeking to shape housing policy should attempt to identify and resolve such conflicts so that housing policy does not work at cross purposes with itself.

17. *Id.* at 95.

18. *Id.* at 99.

19. *Id.* at 2.

20. *Id.* at 96.

21. *Id.* at 102.

22. *Id.*

23. Iglesias, *supra* note 11, at 511.

II. "CURRENT OPINION" OF HOUSING POLICY

With this caveat in mind, Iglesias' five ethics are useful because they do reflect many of the broadly held intuitions that we have about housing policy. The five ethics he identifies are:

1. Housing as an Economic Good;
2. Housing as Home;
3. Housing as a Human Right;
4. Housing as Providing Social Order; and
5. Housing as One Land Use in a Functional System.²⁴

The "Housing as an Economic Good" ethic treats housing as any other commodity and asks how government policies will distort the functioning of the market for housing.²⁵ The "Housing as Home" ethic explores the impact of policy on personal liberty, privacy and security.²⁶ The "Housing as a Human Right" speaks to how a policy furthers the goal of making decent housing available to all.²⁷ The "Housing as Providing Social Order" ethic speaks to how a housing policy will impact the community as it currently exists.²⁸ And the "Housing as One Land Use in a Functional System" ethic speaks to how a policy will impact the broader society, in particular the infrastructure, education and workforce sectors.²⁹

These five housing ethics are a useful survey of housing policy generally, but the "Housing as an Economic Good" and the "Housing as a Human Right" ethics play a greater role in *federal* housing policy in particular. Given the historic role that the states play in land use, law enforcement, and landlord/tenant law, it is not surprising that the federal government is not nearly as involved in implementing the other three ethics.³⁰

24. *Id.* Michael Diamond and J. Peter Byrne also attempt to provide some order to the vast literature about affordable housing. Michael Diamond & J. Peter Byrne, *Affordable Housing, Land Tenure, and Urban Policy: The Matrix Revealed*, 34 *FORDHAM URB. L.J.* 527 (2007).

25. Iglesias, *supra* note 11, at 519.

26. *Id.* at 531; *see also* Stephanie M. Stern, *Residential Protectionism and the Legal Mythology of the Home*, 107 *MICH. L. REV.* 1093 (2009) (critiquing the view that a homeowner's home is critical to his or her personal and psychological well-being).

27. Iglesias, *supra* note 11, at 541.

28. *Id.* at 553.

29. *Id.* at 570.

30. *See generally* EDWARD L. GLAESER & JOSEPH GYOURKO, *RETHINKING FEDERAL HOUSING POLICY* 29–32 (2008) (discussing various ways that localities regulate housing). It should be noted that post-Kelo, the "Housing as Home" ethic has taken on greater significance for the federal government than it had historically. *See generally* Ilya Somin,

The “Housing as an Economic Good” ethic is embedded throughout all federal housing policy discussions. Many past programs have come to be criticized for their unintended distortions of the housing market, which can reduce the supply and affordability of housing in the long-term even if they reduce the cost of housing in the short term.³¹ The affordability aspect of the “Housing as a Human Right” ethic is also imbued in housing policy debates, however, this ethic is more of the guiding force behind federal *rental* housing policy than federal *homeownership* policy.

Somewhat surprisingly, Iglesias does not emphasize what appears to me to be a completely separate sixth housing ethic: “Housing as a Bulwark of Democracy.”³² Reaching back at least as far as the time of Jefferson, the idea of the yeoman farmer who owns his homestead, is financially self-sufficient, and acts the part of a democratic citizen is central to America’s vision of itself.³³ Interestingly, other representatives of “current opinion” fail to highlight this ethic as well. I will argue below, however, that it is fundamental to an understanding of federal housing policy. Perhaps it is so deeply ingrained in the broader American ethic that it does not particularly surface in debates regarding housing policy.

As I survey “current opinions on the subject,” I will identify which of these ethics dominate political discourse today. It is worth quoting the

The Limits of Backlash: Assessing the Political Response to Kelo, 93 MINN. L. REV. 2100 (2009). Time will tell if this takes hold.

31. Rent control is the most commonly discussed example of a policy with a negative unintended distortion of the housing market, with housing economists nearly universal in their judgment that rent control ultimately reduces the supply of rental housing, particularly for low-income families, thereby increasing the aggregate cost of such housing. GLAESER & GYOURKO, *supra* note 30, at 58–62. Rent control was first implemented as a temporary measure during World War II. While very popular with those in rent regulated units, the policy has fallen out of favor as it appeared that rent regulation did not keep down rents generally but, rather, just for those in rent regulated units. Indeed, it is now commonly understood to depress the creation of new housing, thereby increasing average rents for the rental sector as a whole. *Id.* at 58–62. As there are only a few jurisdictions that even allow rent regulation, it is no longer considered a tool to be employed on behalf of tenants. *But see*, Arlo Chase, *Rethinking the Homeownership Society: Rental Stability Alternative*, 18 BROOK. J. L. & Pol. 61 (2009) (arguing that modest rent regulation should be resurrected as a housing policy tool to provide for housing stability in market economy).

32. Iglesias does note in passing that this ethic may be a subset of the “Housing as Providing Social Order” ethic, but just in passing. Iglesias, *supra* note 11, at 584. He also discusses a “housing as a focal point of self-governance” ethic in the context of common interest communities, like homeownership associations and condominiums, which touches on related themes. *Id.* at 518, n.28.

33. THOMAS JEFFERSON, *THE ESSENTIAL JEFFERSON* xvi (Jean M. Yarbrough ed., 2006) (discussing Jefferson’s idealization of the “yeoman farmer” in Query XIX of Jefferson’s NOTES ON THE STATE OF VIRGINIA).

national housing platforms of the Democratic and Republican parties in full because those two documents reflect two of the dominant housing ethics at play today in federal housing policy. I **bold** possible references to the “Housing as a Human Right” ethic and I *italicize* possible references to the “Housing as an Economic Good” ethic.

The 2008 Democratic National Platform states that

We will ensure that the foreclosure prevention program enacted by Congress is implemented quickly and effectively so that at-risk homeowners can get help and hopefully stay in their homes. We will work to reform bankruptcy laws to *restore balance between lender and homeowner rights*. Because we have an obligation to prevent this crisis from recurring in the future, we will *crack down on fraudulent brokers and lenders* and *invest in financial literacy*. We will pass a Homebuyers Bill of Rights, which will include establishing new lending standards to **ensure that loans are affordable** and fair, provide adequate remedies to make sure the standards are met, and ensure that homeowners have *accurate and complete information* about their mortgage options. We will support **affordable rental housing**, which is now more critical than ever. We will implement the newly created **Affordable Housing Trust Fund** to ensure that it can start to support the **development and preservation of affordable housing** in mixed-income neighborhoods throughout the country, restore cuts to public housing operating subsidies, and fully fund the Community Development Block Grant program. We will work with local jurisdictions on the problem of vacant and abandoned housing in our communities. We will work to end housing discrimination and to ensure equal housing opportunity. We will **combat homelessness** and target homelessness among veterans in particular by expanding proven programs and launching innovative preventive services.³⁴

This platform is imbued with two of the main federal housing ethics, but especially “Housing as a Human Right.” This ethic is seen in the efforts to promote the development and support of affordable rental housing and to combat homelessness. The “Housing as an Economic Good” ethic is seen, to a lesser extent, in efforts to correct for various market failures caused by information asymmetries between homeowners and lenders and unlawful practices by mortgage market players.

The Republican platform echoes many of the concerns of the Democratic platform, but emphasizes the “Housing as Economic Good” ethic:

Homeownership remains key to creating an *opportunity society*. We support timely and **carefully targeted aid** to those hurt by the housing

34. DEMOCRATIC NATIONAL CONVENTION COMMITTEE, THE 2008 DEMOCRATIC NATIONAL PLATFORM: RENEWING AMERICA'S PROMISE at 25.

crisis so that affected individuals can have a chance to trade a burdensome mortgage for *a manageable loan that reflects their home's market value*. At the same time, government action must not implicitly encourage anyone to borrow more than they can afford to repay. We support energetic federal investigation and, where appropriate, *prosecution of criminal wrongdoing in the mortgage industry and investment sector*. *We do not support government bailouts of private institutions*. *Government interference in the markets exacerbates problems in the marketplace and causes the free market to take longer to correct itself*. *We believe in the free market as the best tool to sustained prosperity and opportunity for all*. We encourage potential buyers to work in concert with the lending community to educate themselves about the responsibilities of purchasing a home, condo, or land.

Republican policy aims to make owning a home more accessible through *enforcement of open housing laws, voucher programs, urban homesteading* and—what is most important—*a strong economy* with low interest rates. Because **affordable housing is in the national interest**, any simplified tax system should continue to **encourage homeownership**, recognizing the tremendous social value that the home mortgage interest deduction has had for decades. In addition, sound housing policy should recognize the needs of renters so that apartments and multi-family homes remain important components of the housing stock.³⁵

As noted, the Republican platform emphasizes the “Housing as an Economic Good” ethic most of all, with its reliance on the free market; its wariness of government interference in the market; and its promise to punish those who illegally interfere with the market. But the Republican platform does not completely ignore the “Housing as a Human Right” ethic, with its reference to vouchers and affordable housing for owners and renters alike. While the two platforms reflect other housing ethics as well, to some small extent, it is clear that each party has chosen to identify itself with one main housing ethic.³⁶

Continuing our survey of “current opinion,” we see that the major special interest groups representing the housing industry echo these two main ethics, with a particular emphasis on “Housing as a Human Right.” This may be seen as a moral position, but it is also certainly consistent with the financial interests that these groups represent as well. The Na-

35. REPUBLICAN NATIONAL COMMITTEE, 2008 REPUBLICAN NATIONAL PLATFORM at 28.

36. The “Vision Statement” of the National Council of State Housing Agencies (which includes as members the housing finance agencies of every state) focuses on the affordability ethic: its concise vision is of an “affordably housed nation.” National Council of State Housing Agencies, About NCSHA, <http://www.ncsha.org/about-us>.

tional Association of Home Builders strives to create an environment in which:

- All Americans have access to the housing of their choice and the opportunity to realize the American dream of homeownership.
- Builders have the freedom to operate as entrepreneurs in an open and competitive environment.
- Housing and those who provide it are recognized as the strength of the nation.³⁷

And the Mortgage Bankers Association “invests in communities across the nation by ensuring the continued strength of the nation’s residential and commercial real estate markets; expanding homeownership and extending access to affordable housing to all Americans and supporting financial literacy efforts.”³⁸ The National Housing Conference, which draws its membership from every segment of the housing industry, promotes “policies, programs and legislation that help to provide affordable and suitable housing in a safe, decent environment.”³⁹ Unsurprisingly, housing advocates share this vision, but they come to that conclusion directly from their mission. The National Low Income Housing Coalition, for instance, “is dedicated solely to achieving socially just public policy that assures people with the lowest incomes in the United States have affordable and decent homes.”⁴⁰

III. A TAXONOMY OF POSSIBLE FIRST PRINCIPLES

Now that we have surveyed some of the leading “current opinions on the subject,” let us return to the three questions posed by our Aristotelian inquiry. The first question that such an inquiry asks is, what goal of politics is housing policy meant to flow from? In other words, what is the

37. National Association of Home Builders, Mission and Vision, <http://www.nahb.org/page.aspx/generic/sectionID=88> (last visited September 12, 2010); National Association of Realtors, <http://www.realtor.org/realtororg.nsf/pages/NAROverview> (last visited September 12, 2010).

38. Mortgage Bankers Association, <http://www.mbaa.org/AboutMBA> (last visited September 12, 2010).

39. National Housing Conference, <http://www.nhc.org/> (last visited September 12, 2010).

40. National Low Income Housing Coalition, <http://www.nlihc.org/template/index.cfm> (last visited September 12, 2010). Other advocacy organizations emphasize similar goals. *See, e.g.*, Neighborworks America, <http://www.nw.org/network/aboutUs/mission/default.asp> (last visited September 12, 2010) (stating that mission of this Congressionally-created not-for-profit is to create “opportunities for people to live in affordable homes, improve their lives and strengthen their communities.”).

end that housing policy is a means toward? In broad brush, housing policy typically involves the redistribution of income either to lower-income households or to a politically favored class of households such as homeowners. But housing policies do not merely achieve those ends. Rather they typically tie the redistribution to the households' housing status. Contrast, for instance, the Earned Income Tax Credit to the Section 8 voucher program. Whereas the former redistributes income to lower-income households with no strings attached, the latter only redistributes income to a similar population in the form of a housing subsidy. While housing policy may flow from broader policies, it also has elements that are intrinsically related to housing.

This brings us to the second Aristotelian question: what is the goal of housing policy? We must first ask whether there are goals of housing policy that are goods in themselves, and we must distinguish them from those that are means to other ends. For example, if a goal is to ensure that Americans live in safe, well-maintained, and affordable housing, such a goal would be a good in itself. On the other hand, if a goal of housing policy is just a particular application of the general principle of promoting economic efficiency, as suggested by Iglesias' "Housing as an Economic Good" ethic, then such a housing policy goal would be a means to an end. As we seek to identify what is unique to housing policy, we can set aside goals that treat housing as a means to a more general end. This does not mean that we ignore them in our policy discussions, just that we ignore them as we attempt to systemize our thinking about housing policy as a distinct field. As such, I reject "Housing as an Economic Good" as a candidate for a first principle of federal housing policy, at least in its purest form.⁴¹ I also reject straightforward income redistribution as a candidate because a housing policy intended to achieve that end would see housing as a mere means to that redistributive end.

What then is the aim of a housing policy? The answer to this is not nearly as clear cut as Aristotle found the answer to his question— what is the aim of politics (to be happy, to live well).⁴² As noted, many assert that a fundamental goal of housing policy is to assist Americans to live in a safe, well-maintained, and affordable housing unit. Such a view would be consistent with a rights-based view of "Housing as a Human Right." Another similar, but more modest, expectation is housing policy as a specialized form of income redistribution that ensures that the income

41. To be clear, Iglesias is certainly right that considerations of his "Housing as an Economic Good" ethic are reflected in nearly every policy discussion regarding housing. That just happens to be a different discussion than the one intended in this article.

42. ARISTOTLE, *supra* note 14, at 97.

transferred is consumed in increased housing. This is how a housing economist might approach the question applying a modified version of the "Housing as an Economic Good" ethic. Finally, one might argue that homeownership and stable housing is fundamental to the American notion of citizenship; and, indeed, that is how many politicians have approached the question, applying the "Housing as a Bulwark of Democracy" ethic. There are, of course, many other principles that impact housing policy debates but I begin the discussion with these three broad and broadly-held ones.⁴³

Safe, Well-Maintained and Affordable Housing. Let us start with the principle that Americans should live in well-maintained, safe, and affordable housing. What does that mean? What is the actual function of housing? Many consider it to be as fundamental as food and clothing as it addresses basic survival needs.⁴⁴

Our analysis cannot end there, however, as the concept of "well-maintained" and "safe" housing has changed over time. Reaching back at least as far as Jacob Riis's *HOW THE OTHER HALF LIVES*, society has taken an active interest in raising the minimum standard of decent housing for all.⁴⁵ The advocacy of Riis and others led to the Tenement Housing Law of 1901, which was "the first major advance in the fight against the tenement slum."⁴⁶ Over time the quality of the housing stock has improved because of increases in the standard of living as well as the implementation of construction and housing codes that imposed pro-

43. Arthur P. Solomon attempted a similar project in *A National Policy and Budgetary Framework for Housing and Community Development*, 5 AREUEA J. 147 (1977) (providing "an analytic foundation for a national policy and budgetary framework for housing, housing finance, and community development.").

44. See, e.g., Universal Declaration of Human Rights, art. 25, § 1, Dec. 10, 1948 G.A. res 217A (III), U.N. Doc. A/810:

Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.

(emphasis added); 42 U.S.C. §1441 (2009) (setting forth 1949 Congressional declaration of national housing policy: "The Congress declares that the general welfare and security of the Nation and the health and living standards of its people require . . . the realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family"); see also Bo Bengtsson, *Housing as a Social Right: Implications for Welfare State Theory*, 24 SCANDINAVIAN POL. STUDIES 255 (2001) (distinguishing between universal and selective "right to housing").

45. JACOB RIIS, *HOW THE OTHER HALF LIVES* (Garrett Press 1970) (1890).

46. *Id.*

consumer standards on developers. And as the housing stock has improved, the meaning of “safe” and “well maintained” housing has also evolved.

Whereas indoor plumbing could not be taken for granted 100 or even 50 years ago, it can now.⁴⁷ But whereas an inquiry into the quality of the housing stock was once limited to the condition of individual units, a comparable inquiry today would look to the housing stock as part of the fabric of its broader environment: being safe in one’s home is no longer considered sufficient if one’s community is unsafe; education, work and healthcare opportunities are scarce; and the residents cannot access a reliable transportation network.⁴⁸

The concept of “affordable” has also changed over time. As Glaeser and Gyourko have noted, “a consensus seems to have arisen that housing becomes ‘unaffordable’ when costs rise above 30% of household income,” a consensus that serves as the basis for federal housing policy⁴⁹ But until the early 1980s, these very same federal programs set a 25% ceiling for housing costs for various federal programs.⁵⁰ And much of the debate surrounding anti-foreclosure efforts focuses on determining what maximum percentage of adjusted family income spent on housing can be sustained by a household, with guidelines ranging from 31% to 38% for loan modifications.⁵¹

In evaluating whether housing is safe, well-maintained, and affordable in the context of contemporary American society, we then might view a primary function of housing to be to provide an environment where a

47. GLAESER & GYOURKO, *supra* note 30, at 29–32 (citing U.S. CENSUS BUREAU, DECENNIAL CENSUS, LONG FORM HOUSING CHARACTERISTICS (1940-2000)). *But see*, Rachel G. Bratt *et al.*, *Why a Right to Housing Is Needed and Makes Sense: Editors’ Introduction*, A RIGHT TO HOUSING: FOUNDATION FOR A NEW SOCIAL AGENDA 1, 3, 5 (Rachel G. Bratt *et al.* eds., 2006) (noting that poor housing “quality is still a problem facing millions of Americans” in terms of dangerous wiring, poor heating, vermin infestation and exposure to lead paint and mold and that HUD found in 2003 that about 5% of households have incomes less than 50% of Median Area Income; pay more than 50% of income in rent; and live in severely inadequate quarters).

48. Rachel G. Bratt *et al.*, *supra* note 47, at 2; *Cf.* EDUARDO M. PENALVER & SONIA KATYAL, *PROPERTY OUTLAWS: HOW SQUATTERS, PIRATES, AND PROTESTERS IMPROVE THE LAW OF OWNERSHIP* 115 (2010) (noting that thinkers from Aristotle to Adam Smith to Amartya Sen acknowledge that each society has “different material preconditions for participation in society” based on its own material circumstances).

49. GLAESER & GYOURKO, *supra* note 30, at 29–32 (identifying various HUD and other federal policies that incorporate this figure).

50. ALEX F. SCHWARTZ, *HOUSING POLICY IN THE UNITED STATES* 23 (2006).

51. FEDERAL DEPOSIT INSURANCE CORPORATION, FDIC LOAN MODIFICATION PROGRAM 8–9, *available at* <http://www.fdic.gov/consumers/loans/loanmod/FDICLoanMod.pdf>.

person can, in the words of Aristotle, exercise her “vital faculties,” or soul, as “happiness plainly requires external goods too . . . for it is impossible, or at least not easy, to act nobly without some furniture of fortune.”⁵² In more familiar lingo, we might say that the function of housing is to provide an environment where people exercise their rights of “Life, Liberty and the pursuit of Happiness.”⁵³ And indeed, leading right-to-housing activists use language that has echoes of Jefferson’s, with one “characterizing housing as the foundation for life and a launching pad which is fundamental to human development.”⁵⁴

In sum, providing safe, well maintained and affordable housing has consistently remained a broadly-held principle of housing policy even if the standards for such housing has changed over time.

Specialized Income Redistribution. A second widely-held “first principle” of housing policy is that many low and moderate-income households should receive a specialized form of income redistribution that ensures that the income transferred is consumed in increased housing. One of the main arguments in favor of such a specialized form of income redistribution is that low-income children benefit from policies that require their legal guardians to consume more housing (as opposed to other goods and services).⁵⁵

There are additional rationales for privileging housing expenditures over other household expenditures. First of all, housing is the largest budget item for all households, those of both renters and homeowners.⁵⁶ Indeed, in 2005 housing expenses accounted for nearly 32% of all consumer spending by homeowners and nearly 36% for renters.⁵⁷ Congress may believe that left to their own devices, people will under-consume housing as a proportion of their income in a manner which is bad for them or, perhaps, bad for their children and their communities.⁵⁸ Thus,

52. ARISTOTLE, *supra* note 14, at 104.

53. THE DECLARATION OF INDEPENDENCE para. 1 (U.S. 1776).

54. Iglesias, *supra* note 11, at 542 (summarizing views of Chester Hartman).

55. GLAESER & GYOURKO, *supra* note 30, at 55–56. One might argue that this first principle is just a watered down version of the first candidate discussed above. While that argument is not without some merit, this redistributionist first principle treats housing less as a right and more like a commodity. As such, it is worth separating the two of them out for the purposes of this analysis.

56. Anthony Downs, *Introduction: Why Rental Housing Is the Neglected Child of American Shelter*, in REVISITING RENTAL HOUSING 2 (Nicolas P. Retsinas & Eric S. Belsky, eds., 2008).

57. *Id.*

58. Many economists would likely disagree with such a belief. *See, e.g.*, GLAESER & GYOURKO, *supra* note 30, at 54 (“Economists generally prefer pure income redistribution to redistribution in-kind.”).

Congress may use subsidies and tax expenditures to encourage the greater consumption of housing.

Second, given the strong commitment in the United States to a market economy, as compared to other developed nations, some argue that government policies which smooth out the impact of market forces on such a key component of well-being such as housing are a necessary palliative for households as they face the unexpected challenges of the current financial environment.⁵⁹

Third, and particularly after the homelessness crisis that began in the 1980s, government has also taken a particular interest in preventing homelessness and addressing the housing situation of the neediest in society: the developmentally disabled; the mentally ill; very low-income families and individuals; and the elderly.⁶⁰

Glaeser and Gyourko rightly point out that policies that require low-income people to consume redistributed income on housing (which is just the flip side of privileging housing over other expenditures) are paternalistic and unsupported by any studies that convincingly demonstrate how low-income households' housing choices are particularly bad.⁶¹ They also challenge the belief that many Americans under-consume housing.⁶² That being noted, there is no question that much of housing policy is premised on the notion that people (indeed, people of all

59. Rachel G. Bratt et al., *supra* note 47, at 8 (“Housing problems are deeply ingrained in the operation of our economic system and in the ways in which society functions”); Stephanie M. Stern, *Residential Protectionism and the Legal Mythology of the Home*, 107 MICH. L. REV. 1093, 1132–33 (2009) (arguing that “major stumbling block to adopting a minimal approach to home protection has been the fear that homeowners will founder on the shoals of the free market.”).

60. *See, e.g.*, JOEL BLAU, *THE VISIBLE POOR: HOMELESSNESS IN THE UNITED STATES* 175–76 (1993) (reviewing government responses to homelessness in the 1980s); Stern, *supra* note 59, at 1133 (reviewing reasons to provide special protection to elderly). The irony of this government interest in homelessness is that the 1980s homelessness crisis was caused in part by government policies that disfavored single room occupancy hotels that were often residences of last resort for very low-income individuals. BRENDAN O’FLAHERTY, *MAKING ROOM: THE ECONOMICS OF HOMELESSNESS* 176 (1996) (noting that New York City’s 1961 zoning amendments were designed explicitly to “discourage subdividing apartments and buildings into small units”). While these programs are typically geared toward renters, there are also programs that target members of special needs populations that own their homes. *See, e.g.*, HUD, Home Equity Conversion Mortgages for Seniors, <http://www.hud.gov/offices/hsg/sfh/hecm/hecmhome.cfm> (describing FHA-insured Home Equity Conversion Mortgages (reverse mortgages) for senior citizens).

61. GLAESER & GYOURKO, *supra* note 30, at 55.

62. *Id.* at *passim*.

classes) should receive assistance in offsetting the large expense that housing entails.⁶³

This holds particularly true for renters as they tend to be quite a bit poorer than homeowners: in 2005, the median income of renter households was less than half that of owner-occupant households.⁶⁴ John Quigley writes that

‘Affordability’ is clearly the most compelling rationale for policies [sic] subsidizing rental housing. The high cost of rental housing, relative to the ability of low-income households to pay for housing, means that these households have few resources left over for expenditures on other goods—food, clothing, medicine—that are also necessities.⁶⁵

As such, affordability rationales frequently predominate in the rental housing policy arena.

A variety of programs implement this principle. In addition to programs like housing vouchers that reduce household rent payments for low-income families, the federal government has also implemented a variety of initiatives to make housing more affordable and sustainable for particular renters such as the special needs populations noted above.⁶⁶ If members of these populations are not able to secure and maintain housing because of their inability to earn an income, some argue that society is responsible for providing needy members of these populations with affordable housing.⁶⁷

63. If housing policy was based on a principle of straightforward income redistribution, then it would really be a means to an end, the end being decreased income inequality or the provision of a basic standard of living. Moreover, if it were merely intended to be a way of implementing income redistribution, housing policy would be an incredibly inefficient way to achieve that end. This is because it would limit to housing the ways that the recipients of the income redistribution could spend that money. This would lead to some recipients over-consuming housing when their preference would be to consume other goods (e.g., food) and services (e.g., education) instead. All of this is not to say that income redistribution concerns do not play a role in housing policy. Rather, it is to say that we should be careful not to lose sight of what makes housing policy *housing policy*.

64. Downs, *supra* note 56, at 2.

65. John M. Quigley, *Just Suppose: Housing Subsidies for Low-Income Renters*, in REVISITING RENTAL HOUSING: POLICIES, PROGRAMS, AND PRIORITIES 300, 308 (Nicholas P. Retsinas & Eric S. Belsky eds., 2008).

66. See generally LIBBY PERL, SECTION 811 AND OTHER HUD HOUSING PROGRAMS FOR PERSONS WITH DISABILITIES (2008), available at http://assets.opencrs.com/rpts/RL34728_20081103.pdf (also noting support services funding for such programs are intended to sustain long-term residency).

67. This argument obviously includes elements of the “Housing as a Human Right” ethic as well.

A related principle (although rarely stated because of its plainly instrumentalist nature) of some aspects of housing policy is to ensure that low-income people do not cause harm to other members of society.⁶⁸ This principle is based on the belief that society benefits from low-income households consuming more and better housing, just as it may benefit from them consuming more food (via the Food Stamp program) and medical care (via Medicaid).⁶⁹ Society's benefit from increased housing consumption by low-income households may take the form of reduced homelessness and increased social cohesion. It may also take the form of the increased public safety that results from minimal building and housing standards that protect the housing stock from casualties such as fire and earthquake damage and protect communities from diseases that more easily spread where certain health measures are not implemented.⁷⁰

Housing as a Bulwark of Democracy. While predominantly relating to homeownership (as opposed to rental) policy, the importance of this principle in American housing policy cannot be overstated. The centrality of homeownership to America's vision of itself as a society of equal citizens reaches at least as far back as Jefferson's idealized "yeoman farmer" and continued through to Lincoln's Homestead Act of 1862, which granted 160 acres to settlers.⁷¹ Jefferson's yeoman farmer was his ideal citizen because he was self-sufficient, earned his own keep, considered himself the equal of anyone else, and jealously protected his liberty and unalienable rights.

The "yeoman farmer" transformed into the "homeowner" in the 20th Century with presidents as varied as Herbert Hoover, Lyndon Johnson, Bill Clinton and George W. Bush making homeownership a key element of their agendas.⁷² Indeed, the extraordinary lengths that the Bush and

68. Rachel G. Bratt et al., *supra* note 47, at 1, 2–3 (arguing that one of the goals of tenement laws was "to protect the nonpoor who were living in" neighborhoods near to tenement slums).

69. GLAESER & GYOURKO, *supra* note 30, at 55.

70. RIIS, *supra* note 45, at viii.

71. JAMES M. MCPHERSON, *ABRAHAM LINCOLN AND THE SECOND AMERICAN REVOLUTION* 12 (1992).

72. Lawrence J. Vale, *The Ideological Origins of Affordable Homeownership Efforts*, in *CHASING THE AMERICAN DREAM: NEW PERSPECTIVES ON AFFORDABLE HOMEOWNERSHIP* 31–32 (William M. Rohe & Harry L. Watson eds., 2007) (discussing Hoover's efforts to increase the homeownership rate while Commerce Secretary and President); Rachel G. Bratt, *Homeownership for Low-Income Households: A Comparison of the Section 235, Nehemiah, and Habitat for Humanity Programs*, in *id.*, at 46–47 (discussing Johnson initiatives); *Political Perspectives*, in *id.*, at 67 (discussing Clinton and

Obama administrations have taken to stabilize the housing market during the credit crisis bears witness to the importance that both parties place on homeownership.⁷³

While a first principle of housing policy is to make people into better citizens by making them homeowners, the possible non-economic benefits of homeownership are not necessarily limited to the political sphere. As a result, homeownership policy has also been designed at times to encourage these other benefits. The connection between homeownership and these non-economic benefits has not, however, been clearly demonstrated.

There is a significant amount of research that argues that there are a range of other non-economic benefits from homeownership. These include better outcomes for residents in education, health, and employment.⁷⁴ These also include increased civic engagement, as demonstrated through higher levels of volunteerism and participation in community

Bush efforts); *See also* WILLIAM H. SIMON, SOCIAL-REPUBLICAN PROPERTY, 38 UCLA L. REV. 1335 (1990-1991) (noting that homeownership is consistent with republicanism).

73. *See, e.g.*, Edmund L. Andrews, *U.S. Sets Big Incentives to Head Off Foreclosures*, N.Y. TIMES, Mar. 5, 2009, at A1 (reporting \$75 billion Obama Administration to head off foreclosures); Stephen Labaton & Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes Over Mortgage Finance Titans*, N.Y. TIMES, Sept. 8, 2008, at A1 (reporting Bush Administration takeover of Fannie Mae and Freddie Mac).

74. Downs, *supra* note 56, at 9 (“high-poverty neighborhoods adversely affect the life chances of person living here, most of whom are renters, high rates of poverty, crime, drug abuse, broken homes, unemployment, and gang activity combine with low-quality public schools and lack of health care to make living in such areas much more harmful than living in most middle-income neighborhoods.”). A related argument is that children benefit from living in homes owned by their legal guardians. Empirical research has not, however, convincingly demonstrated that this benefit results from such policies, notwithstanding the fact that numerous studies have been conducted in this area. *See, e.g.*, GLAESER & GYOURKO, *supra* note 30, at 56; David Barker & Eric A. Miller, *Homeownership and Child Welfare*, 37 REAL ESTATE ECON. 279 (2009) (finding that homeownership has little or no effect on children’s welfare based on several indicators of well-being); Scott Holupka & Sandra J. Newman, *The Effects of Homeownership on Children’s Outcomes: Real Effects or Self-Selection?*, (Working Paper presented to the Colloquium on the Law, Economics, and Politics of Urban Affairs, NYU School of Law and Wagner School of Public Service, March 9, 2009) (on file with author) (finding no clear effects); Grace W. Bucchianeri, *The American Dream or The American Delusion? The Private and External Benefits of Homeownership*, available at <http://real.wharton.upenn.edu/~wongg/research/The%20American%20Dream.pdf> (after controlling for household income, housing quality and health, finding female homeowners are no happier than renters by a number of different measures and, indeed, derive more pain from their house and home).

activities.⁷⁵ Thus, an additional principle of homeownership policy is to achieve better outcomes regarding these non-economic benefits.

Some also argue that homeownership encourages wealth accumulation and forced savings (through principal repayment of the mortgage).⁷⁶ These goals are consistent with the principle of making contemporary Americans self-sufficient like Jefferson's yeoman farmers. There is plenty of evidence that homeowners have more wealth than renters, although researchers have only recently attempted to demonstrate the extent to which homeownership actually causes that greater wealth accumulation.⁷⁷ And while it might come as no surprise that historically homeowners accumulated greater wealth, recent events have at least temporarily put an end to that trend. The boom in housing prices that began in the 1990s along with easy access to credit for homeowners set them up for a fall when housing prices tumbled in the late 2000s. Indeed, more than a third of homeowners were underwater on their mortgages (that is, they owed more than their houses were worth) in 2009.⁷⁸

Other Principles. There are additional rationales for certain housing policies that are clearly not first principles of a housing policy, but rather are parallel goals, ones that reflect other aspects of politics (as an Aristotelian understands the term). It is not surprising that quite a few other social principles are enmeshed with housing policy, given the size of the housing sector and its role in the economy. The most important are:

- ending segregation and other racial inequities which are present in the housing market;
- increasing socio-economic diversity;
- promoting green construction practices and energy efficiency;
- promoting community and economic development; and
- preventing sprawl and promoting Brownfield (environmentally contaminated property) development.

1. Ending Segregation and Other Racial Inequalities. Racial segregation and racial discrimination have always permeated, and continue to permeate, the housing market. Racial discrimination is a harm in itself,

75. Bucchianeri, *supra* note 74, at 3–4 (reviewing literature).

76. See, e.g., Rachel G. Bratt et al., *supra* note 47, at 1, 4.

77. See, e.g., Zhu Xiao Dia et al., *Do Homeowners Achieve More Household Wealth in The Long Run?*, 6 J. HOUS. ECON. 274 (2007) (providing “first empirical evidence that homeownership, after controlling for other drivers of wealth accumulation, is positively and significantly associated with wealth accumulation over time.”); Thomas P. Boehm & Alan M. Schlottmann, *Wealth Accumulation and Homeownership: Evidence for Low-Income Households*, 10(2) CITYSCAPE 225 (2008) (finding “household wealth generally appears to be positively affected by homeownership”).

78. Bob Tedeschi, *The Depths of Mortgage Debt*, N.Y. TIMES, Aug. 30, 2009, at RE9 (providing second quarter 2009 data).

obviously inconsistent with fundamental American values. But racial discrimination in the housing market is also seen as having a pernicious influence on many other aspects of social welfare: education, health, and workforce issues being three of the most important.⁷⁹ Therefore, it is of the greatest import that racial discrimination be swept from the housing market. That being said, ending racial discrimination is not so much a principle of housing policy *per se* as it is a fundamental and parallel principle that must be implemented in housing and throughout the rest of society.

It must be noted that housing policies have often been used to *implement* racist and classist agendas. In the past, these policies were often explicitly racist, as with redlining policies implemented by the Federal Housing Administration.⁸⁰ Redlining, the practice of refusing to lend in certain communities, particularly African-American communities, was pioneered by the federal government through the Home Owners' Loan Corporation and the FHA in the 1930s and continued on for decades.⁸¹

Other housing policies only thinly veiled their discriminatory aims. Urban renewal, sometimes characterized as a policy to improve the life of low-income households, was implemented in such a way as to force low-income households from their admittedly substandard homes and replace them with buildings designed for higher-income residents or businesses.⁸² More recently, facially acceptable programs like Housing Opportunities for People Everywhere ("HOPE") VI (discussed below) have been criticized for effectively dispersing poor communities of color and replacing them with higher income residents.⁸³ The existence of such racist and classist policies, whether implicit in the design of the policy or its implementation, must be acknowledged in order to prevent them from being executed.

79. Nancy A. Denton, *Segregation and Discrimination in Housing*, in A RIGHT TO HOUSING: FOUNDATION FOR A NEW SOCIAL AGENDA 61, 71 (Rachel G. Bratt et al. eds., 2006).

80. There are also local government policies that can implement racist policies, such as exclusionary zoning. I do not reach such policies in this article. See generally Keith R. Ihlanfeldt, *Exclusionary Land-use Regulations Within Suburban Communities: A Review of the Evidence and Policy Prescriptions*, 41 URBAN STUDIES 261 (2004).

81. Denton, *supra* note 79, at 66.

82. Peter Marcuse & W. Dennis Keating, *The Permanent Housing Crisis: The Failures of Conservatism and the Limitations of Liberalism*, in A RIGHT TO HOUSING: FOUNDATION FOR A NEW SOCIAL AGENDA 139, 144-45 (Rachel G. Bratt et al. eds., 2006).

83. SUSAN J. POPKIN et al., A DECADE OF HOPE VI RESEARCH FINDINGS AND POLICY CHALLENGES 3 (2004) ("there is substantial evidence that the original residents of HOPE VI projects have not always benefited from redevelopment, even in some sites that were otherwise successful.").

Another classist policy that bears ongoing review is the manner in which tax expenditures on homeownership greatly favor wealthy homeowners over less wealthy homeowners and renters.⁸⁴ As noted above, 72 percent of all the income tax benefits accruing to homeowners go to those making more than \$75,000 per year, and only a tiny amount go to those making less than \$40,000 per year.⁸⁵ Such a policy is not innately repugnant like a racist policy, but it should give pause to those who believe that the tax system should be progressive and not regressive.

2. *Increased Socio-Economic Diversity.* A related principle is that increased socio-economic diversity should be incentivized in housing policy. It may be seen as a principle that respects the low-income residents of a gentrifying community and the fabric of the community itself.⁸⁶ Socio-economic diversity may also be seen as necessary for a community to function in a healthy manner.⁸⁷ Finally, it may be seen as something that particularly benefits residents of high poverty areas. One major federal initiative, the Moving to Opportunity for Fair Housing demonstration, gave rent vouchers to residents of poor urban areas to move to “low-poverty areas.”⁸⁸ One of the major rationales for the demonstration is that very low-income families would benefit from living among higher-income families.⁸⁹ Another major federal initiative, HOPE VI, demolishes dysfunctional public housing and replaces it with mixed-income housing (as well as providing housing vouchers to some of the original tenants who were displaced).⁹⁰ Congress’ stated objectives for HOPE VI included (1) improving “the living environment for residents of severely distressed public housing;” (2) revitalizing “sites on which such public housing projects are located and contribut[ing] to the improvement of the surrounding neighborhood;” and (3) providing “housing that will avoid

84. See *infra* notes 7–10 and accompanying text.

85. Adam Carasso, *supra* note 9.

86. LORETTA LEES ET AL., *GENTRIFICATION* 215 (2007).

87. See, e.g., ALYSSA KATZ, *OUR LOT: HOW REAL ESTATE CAME TO OWN US* 192–93, 200 (Bloomsbury 2009) (arguing that the creative classes “who made [New York City] what it is” are being forced out by Wall Street real estate investors); John Ingram Gilderbloom et al., *Why Cities Need Affordable Housing: A Case Study of Houston*, in JOHN INGRAM GILDERBLOOM, *INVISIBLE CITY: POVERTY, HOUSING AND NEW URBANISM* 203 (2008) (arguing that lack of affordable housing policy jeopardizes Houston’s future).

88. See generally LARRY ORR ET AL., HUD: OFFICE OF POLICY DEV. & RESEARCH, *MOVING TO OPPORTUNITY FOR FAIR HOUSING DEMONSTRATION: INTERIM IMPACTS EVALUATION* (2003), available at <http://www.huduser.org/Publications/pdf/MTOFullReport.pdf>.

89. *Id.*

90. See generally POPKIN ET AL., *supra* note 83.

or decrease the concentration of very low-income families.”⁹¹ In one program then, HOPE VI encompasses many of the rationales for increasing socio-economic diversity.⁹² This principle, like the first, goes way beyond the scope of a housing policy to touch upon key political goals relating to education, workforce development, and healthcare, to name a few.

3. *Promoting Green Construction Practices and Energy Efficiency.* Promoting green construction practices and energy efficiency has taken on a greater importance in housing policy in the last ten years.⁹³ Indeed, it is considered the cutting edge issue throughout the entire construction industry, including the affordable housing sector. Bringing environmental concerns to this sector of the economy makes particular sense given that heating and powering residential buildings is responsible for about 20 percent of total U.S. CO₂ emissions.⁹⁴ To some extent, the principle of housing affordability aligns well with that of green construction as operating costs (energy costs in particular) may be lower with green buildings.⁹⁵ But construction costs for green projects are typically higher, at least at present, which raises the cost of construction for each unit.⁹⁶ The

91. 42 U.S.C. § 1437v (2009).

92. In wealthy communities, there is often the opposite problem: not enough affordable housing for the local workforce of civil servants (e.g., teachers, firefighters, police officers). This is typically a more pressing issue for state and local governments than for the federal government. *See generally* RICHARD M. HAUGHEY, ULI LAND USE POLICY FORUM REPORT, WORKPLACE HOUSING: BARRIERS, SOLUTIONS, AND MODEL PROGRAMS 1–13 (2002). That being said, federal monies may be used to fund the creation of workforce housing if federal criteria are met by a particular affordable housing project. *Id.* at 4. Another tool used by state and local governments to increase socio-economic diversity is inclusionary zoning, although the federal government has no role to play in implementing this tool. *See generally* DANIEL R. MANDELKER, LAND USE LAW §§ 7.26–7.31 (5th ed. 2003 & 2009 Supp.).

93. *See* JERRY YUDELSON, THE GREEN BUILDING REVOLUTION 3–6 (2008) (reviewing history of green building movement from promulgation of Leadership in Energy and Environmental Design (LEED) standards in 2000).

94. D&R INTERNATIONAL, LTD., U.S. DEP'T OF ENERGY, 2009 BUILDINGS ENERGY DATA BOOK 2–24 (2009) (2006 data); *see* William McNerney & Elizabeth Mattern, *Greenhouse Gases and Commercial Real Estate*, THE PRACTICAL REAL ESTATE LAWYER 35, 35–36 (May 2009).

95. Piet Eichholtz et al., *Doing Well by Doing Good? Green Office Buildings*, AM. ECON. REV. (forthcoming), available at <http://ssrn.com/abstract=1480215> (noting that while “hard evidence on the financial performance of green buildings is limited and consists mainly of industry-initiated case studies,” green buildings appear to have slightly higher construction costs and lower operating costs); Norm Miller et al., *Does Green Pay Off?*, 14 J. REAL EST. PORTFOLIO MGMT. 385, 385 (2008) (arguing that “payoff from wise green investment is easy to justify even if it is based on purely profit motivations”).

96. Eichholtz et al., *supra* note 95, at 8.

affordable housing sector is, with its low margins, particularly sensitive to increased cost. As with the two previous parallel principles, green building is not so much a principle of housing policy, but a parallel principle that seeks to implement environmentally sound practices throughout broad swaths of the economy.

4. *Promoting Community and Economic Development.* Promoting community and economic development is often intertwined with housing policy, although not integral to housing policy itself. Community and economic development policy usually sees housing as one element of a broader strategy to ensure the long term health of a community. Typically, other important elements of a community and economic development policy include transportation, education, and infrastructure objectives, as well as “soft” elements such as developing social capital in low-income communities.⁹⁷

5. *Preventing Sprawl and Redeveloping Brownfields.* While preventing sprawl has become an issue of great concern for state governments with their historical responsibility for land use regulation,⁹⁸ federal housing policy may also encompass this principle.⁹⁹ Federal and state governments have also looked to Brownfield redevelopment as an element of housing policy, although they have trodden with care because of the environmental hazards that these properties present.¹⁰⁰ Addressing sprawl and Brownfields as part of a housing policy reflects a commitment to sustainable growth.¹⁰¹ But as with community and economic development initiatives, sustainable growth initiatives are generally much broad-

97. See generally WILLIAM H. SIMON, *THE COMMUNITY ECONOMIC DEVELOPMENT MOVEMENT: LAW, BUSINESS, AND THE NEW SOCIAL POLICY* (2001).

98. See Regina C. Gray, *Ten Years of Smart Growth: A Nod to Policies Past and a Prospective Glimpse into the Future*, 7 *CITYSCAPE* 109 (2007) (reviewing state and local smart growth strategies).

99. See, e.g., Bruce Katz, Director, Brookings Institution Metro. Policy Program, *A New Generation of Federal Housing Policy* (June 29, 2009) (transcript available at http://www.brookings.edu/speeches/2009/0629_housing_katz.aspx) (arguing for “energy wise and environmentally friendly” investments in housing). There is no question that, historically, federal transportation, housing finance, and infrastructure policies have had the effect of increasing sprawl. See generally KENNETH T. JACKSON, *CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES* (1985).

100. See *Responsible Housing*, NAT’L. CONF. OF STATE LEGISLATURES, <http://www.ncsl.org/?TabId=16767> (last visited April 16, 2010) (advocating that to make Brownfields “available for housing, Congress needs to give states flexibility to immunize project providers from future federal cleanup liability and provide the necessary funding to assist states in the clean-up of these sites”).

101. See generally John C. Dernbach, & Scott Bernstein, *Pursuing Sustainable Communities: Looking Back, Looking Forward*, 35 *URB. LAW.* 495 (2003).

er than just housing as they reflect environmental, energy and quality of life concerns as much as housing policy concerns.¹⁰²

* * *

Subordinate Principles. While the five parallel principles outlined directly above are best characterized as Aristotelian “goods in themselves,” there are also some subordinate principles of housing policy that relate to the size of the housing sector, particularly the mortgage and construction industries, and its importance to the overall economy that are clearly means to other ends. For instance, finance industry representatives argue for policies that stabilize the mortgage markets, also noting the impact that the mortgage industry has on the health and stability of the overall economy.¹⁰³ This has never been clearer than in the ongoing crisis where stabilizing mortgage lenders was identified as one of the key elements of the government’s response to the crisis.¹⁰⁴

Others argue that affordable housing expenditures by the government can also be counter-cyclical and help to smooth out the boom and bust cycle that characterizes the construction sector.¹⁰⁵ Housing and housing finance industry representatives, therefore, argue for policies that are intended to stabilize the construction and housing sectors during the financial crisis.¹⁰⁶

102. *Id.*

103. David Reiss, *Fannie Mae and Freddie Mac and the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege*, 61 ALA. L. REV. (forthcoming 2010), available at http://works.bepress.com/david_reiss/25 [hereinafter Reiss, *Regulatory Privilege*].

104. *See, e.g.*, Reiss, *supra* note 103 (discussing government attempts to stabilize mortgage finance giants Fannie and Freddie).

105. *See* Iglesias, *supra* note 11, at 548 n.186 (arguing that “[a] primary purpose of the public housing program was to act as an employment program to stimulate the construction industry” during and after the Great Depression).

106. *See, e.g.*, MORTGAGE BANKERS ASSOCIATION, 2009 MBA POLICY AGENDA TO STABILIZE THE HOUSING AND MORTGAGE MARKETS; National Multi Housing Council, <http://www.nmhc.org/Content/ContentList.cfm?NavID=424> (last visited Sept. 12, 2010) (proposing policy responses to stabilize industry during credit crisis); Press Release, NAHB, Builders Ready To Work With White House, Congress To Extend Home Buyer Tax Credit (Oct. 6, 2009), *available at* http://www.nahb.org/news_details.aspx?newsID=9809 (quoting NAHB Chairman Joe Robson, “Housing is the best opportunity to put this country back to work. Prompt congressional action on the tax credit is a crucial first step to shoring up the fragile housing recovery and leading the economy to higher ground”).

CONCLUSION

HUD's recently released Strategic Plan is notable for its incorporation of most of these first, parallel, and secondary principles.¹⁰⁷ The fact that it does not focus solely on first principles does not undercut its legitimacy—it is important to remember that first principles are not necessarily more important goals of government than parallel or secondary principles at any given time. Rather, they identify what is intrinsic to housing policy in order to analyze potential policy choices. And imposing some structure here is of key importance because federal housing policy is a morass.

In order to make sense of the morass, it is necessary to identify legitimate first principles of housing policy, then to evaluate housing programs to see whether they are designed to achieve goals consistent with some or all of those principles. Finally, it is necessary to evaluate the effectiveness of these programs individually and taken together in order to ensure that they do not work at cross purposes. Such an exercise should help to clarify debates surrounding American housing policy as the Obama Administration seeks to put its own stamp on this field.

I have argued that the three major first principles that inform federal housing policy are (i) allowing all Americans to live in a safe, well-maintained and affordable housing unit; (ii) providing a specialized form of income redistribution that ensures that the income transferred is consumed in increased housing; and (iii) incentivizing Americans to take on the key attributes of Jefferson's yeoman farmer; economic self-sufficiency and a jealous regard for one's liberty. I have also identified a number of parallel principles and subordinate principles that may be explicitly or implicitly at play in any given housing program.

The goal of this article was not to argue that all housing programs can be rationalized into one coherent whole—obviously, the major three principles can be in tension with one another within a particular housing policy initiative and across initiatives. It has the much more limited goal of developing a more systematic approach to the evaluation of housing policy.

And, of course, a housing policy primarily guided by each of these three first principles would look very different. One guided by the first would emphasize housing for very low-income households who would not be able to pay market rates for safe, well-maintained, and affordable housing. One guided by the second would likely contemplate some kind of progressive housing subsidy for a range of low- and moderate-income households. One guided by the third would seek to maximize the ho-

107. HUD, HUD STRATEGIC PLAN FY 2010-2015 (2010).

meownership rate for the nation as a whole at whatever income levels are the most efficient for achieving that goal.

We now have a rough answer to the three questions posed at the beginning of this article: (i) what broader goal of politics is housing meant to follow from; (ii) what the main goals of housing policy are and (iii) what parallel and subordinate policies inform housing policy? With that rough outline, we can now move to fill in the details of a study of housing policy. As Aristotle noted, once we have developed such an approach, "it requires no extraordinary genius to fill up the gaps" that remain.¹⁰⁸ This gives me hope for some further work on this topic.

108. ARISTOTLE, *supra* note 14, at 17.

COMMENTARY ON PANEL II: STATE AID AND DEVELOPMENTS IN THE EUROPEAN UNION

*William F. Kroener, III**

The presentations by Professors Cavalier and Reiss, and by Dr. Rugiero, cover a wide range of forms of state aid and intervention in the European Union and in the United States. It is challenging to pull together particular themes. The presentations deal specifically with state aid and structural reform in France, regulatory and supervisory concerns and possible reform of prudential supervision in the EU, and the long-range strategic pre-crisis intervention in U.S. Federal housing markets by the U.S. government as a precursor to current problems.

In considering the totality of these presentations, I would suggest that there is little indication that the French or EU approaches provide a new paradigm for possible modification of the U.S. regulatory model. Professor Cavalier's paper makes clear that intervention in France is of an extreme central national character. An important element of the French approach was to provide a direct state guarantee of the fundraising without the need for additional legislation. The detailed French state intervention described by Professor Cavalier, the more general European approach presented by Dr. Rugiero and the use of the instrumentalities of the U.S. housing agencies—Freddie Mac and Fannie Mae—as described by Professor Reiss do not suggest common themes but instead a set of ad hoc approaches informed by national history, culture and predispositions. In short, the situation is quite different for each country and from circumstance to circumstance.

Professor Cavalier outlines several instrumental steps in France. In contrast to the U.S. intervention, French intervention seems to be more structural. This is to be expected from the French state, which has a direct and more extensive continuing involvement than is the case in the U.S. The French state, unlike the U.S., established specialized single purpose vehicles (SPV's) for recapitalization and short-term funding matter, with state guarantees for both. Further, Professor Cavalier suggests a permanent role for the French government. This diverges from the U.S. where the effort is to intervene only temporarily, tweak and improve the regulatory system, and then withdraw.

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Two similarities with the U.S. noted by Dr. Rugiero are the need for improved prudential supervision and a broadened scope to encompass near financial institutions, however characterized. Dr. Rugiero's presentation focuses on the EU approach. He suggests that as a result of the economic dislocations there will be a focus in Europe on more extensive prudential regulation and greater transparency than has heretofore been the case. Dr. Rugiero also suggests that full implementation of fair value accounting may be too extreme. There is, of course, some similarity in this to U.S. concerns. Dr. Rugiero foresees measures to support greater independence and specific accountability as well as transparency. Surprisingly, Professor Rugiero also sees a role for legal actions in the E.U, so that the EU. would be moving more toward the U.S. situation. Whether this is truly the case, remains to be seen.

The presentation of Professor Reiss, by contrast, is directed at a long term aspect of U.S. federal housing policy. He suggests that U.S. housing policy headed off track and was a significant component of the crisis in the U.S. By implication, perhaps, one can conclude that this U.S. housing policy contributed to the seriousness of the financial crisis in the U.S. as compared to, for example, the French and EU experiences. Professor Reiss focused on policies of the U.S. that were not in response to the crisis but that were the very creation of the crisis. It suggests, at least in part, the important local differences in how the financial crisis develops and will play out.

In assessing these diverse presentations, it is apparent that although there is similarity in the rapidity of the responses, and the common themes of greater prudential supervision and wider scope to cover broader types of financial intermediaries, there are overall very considerable differences in the strategy and details. It is noteworthy that there may be a move in the EU toward more centralized regulation, but it does not appear that the U.S. will replicate this. In conclusion, these presentations are instructive in showing different approaches and in indicating that new paradigms for financial regulation in the EU are likely to be quite separate and without detailed similarities to U.S. regulatory changes.

THE CONTROVERSY OVER SYSTEMIC RISK REGULATION

Roberta S. Karmel^{*}

INTRODUCTION

There is widespread support for a systemic risk regulator in the United States and in Europe. There is, however, less agreement on which existing or new organization(s) should assume the task of regulating against systemic risk, on the authority such a regulator should have, or on the work such a regulator should undertake. In general, the debate about enhanced systemic risk regulation has been about whether central banks or other regulators should be required to assess systemic risk or whether such an assessment should be the job of others. The debate includes the issue of whether a systemic risk regulator should also be a prudential regulator and whether the regulator that assesses systemic risk should also have the authority to mandate changes in the financial markets or changes to financial institutions when dangers to the markets emerge. Much of this debate has been in the form of turf warfare between central banks and other regulators, and therefore the discussions have been less enlightened than one would have hoped for given the magnitude of the problems uncovered during the financial meltdown of 2008.

In the United States, the primary issue regarding a systemic risk regulator is whether the Federal Reserve Board (“Fed”) should become the systemic risk regulator or whether such new powers conflict with the Fed’s role with respect to monetary policy or with the Fed’s prudential regulation of individual bank holding companies. As an alternative or as an addition to making the Fed a systemic risk regulator, a Council of Regulators has been proposed as a replacement for the President’s Working Group.² Similarly, in Europe there has been a debate over whether

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1. *Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation: Hearing Before the Subcomm. on Domestic Monetary Policy and Technology of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of John B. Taylor, Professor of Economics and Senior Fellow of Hoover Institution, Stanford University).

2. After the stock market crash of 1987, the President appointed a Working Group on Financial Markets comprised of the Secretary of Treasury, and the Chairmen of the Securities and Exchange Commission, the Commodities Futures Trading Commission,

the European Central Bank (“ECB”), national central banks, or³ other regulators should be given systemic risk regulatory responsibilities. One of the problems with deciding on an appropriate risk regulator is that systemic risk can emerge from various corners of the financial system. It can be generated by financial firms or products beyond the purview of a central bank’s expertise or its usual jurisdiction. Further, in the eyes of many critics, the Fed⁴ did a poor job of predicting or preventing the 2008 financial meltdown. Moreover, in the United Kingdom, where the Financial Services Authority (“FSA”), rather than the Bank of England, was responsible for the regulation of financial firms, the FSA was equally inept.

This author believes that any systemic risk regulator should be an independent agency without responsibilities that would conflict with its duties to examine and make recommendations with regard to systemic risks. Further, important systemic risks will necessarily remain within the purview of existing regulators unless the United States moves to a model of regulation by many fewer agencies, a politically unlikely development. Some of these regulators currently are independent agencies, but some are not. Also, although the Council of Regulators contemplated by many of the pending reform proposals would be an improvement over the President’s Working Group, a committee of agency heads is unlikely to effectively blow the whistle on dangerous products or activities in the financial markets. Further, one or more agencies need to have the power to enforce any decision that a serious systemic risk exists. To suppose that some super-regulator or the Fed will have the sole power to enforce recommendations with regard to risky products or conduct in the financial markets, in our politically fractured and captured world is, in the author’s opinion, unrealistic.

Accordingly, the author recommends the creation of a new agency. This new agency could be modeled on the Office of Management and Budget (“OMB”), the Government Accounting Office (“GAO”), or the National Transportation Safety Board, but independent of the Executive and Congressional Branches. It could investigate and analyze systemic risks and propose action to the President, Congress, or individual regula-

and the Fed to agree on intermarket mechanisms to prevent another crash. Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

3. José Manuel González-Páramo, Member of the Exec. Bd. of the Eur. Cent. Bank, Presentation of the Report “Observatorio sobre la reforma de los mercados financieros 2009, realizado por la Fundación de Estudios Financieros,” (Jan. 22, 2010), available at <http://www.ecb.europa.eu/press/key/date/2010/html/sp100122.en.html>.

4. Robert Weissman, *Deregulation and the Financial Crisis*, HUFFINGTON POST, Apr. 12, 2010, http://www.huffingtonpost.com/robert-weissman/deregulation-and-the-fina_b_82639.html.

tory agencies, including the Fed. This systemic risk regulator should consult with the Council of Regulators, but implementation of any recommendations should be left to the responsible agencies, to the Executive, or to Congress. One of the problems with a more radical regulatory reform, that may well be in order, is that blame for the financial meltdown has been a political hot potato and many officials who were responsible have not yet accepted responsibility. Given the complex structure of the European Union (“EU”), it would seem that a systemic risk regulator for Europe would similarly have to be an advisory body within the framework of the E.U. The E.U. Commission has proposed such a regulator.⁵

Part I will define systemic risk and the various proposals for a systemic risk regulator that have been put forth in the United States. Part II will discuss the conflicts of interest between assessing systemic risk and acting as a prudential regulator. Part III will outline the consideration of similar issues in Europe. Part IV will delineate a proposal for a new systemic risk regulator.

I. PROPOSALS FOR A SYSTEMIC RISK REGULATOR

A. Defining Systemic Risk

There are various types of risk in the capital markets, both to individual firms and to the system as a whole.⁶ A financial product can pose counterparty credit risk, operational risk, and market risk.⁷ Undue concentrations, excessive leverage, or internal control failures can cause a financial firm to collapse. Systemic risk is risk to an entire financial system or market, as opposed to the collapse of one firm within that market.⁸ This risk comes about because firms price only internal costs and benefits and not risks to the financial system.⁹ Therefore, individual firms find it profitable to take on more risk and leverage than is socially optimal.¹⁰ Furthermore, the financial meltdown of 2008 demonstrated that financial contagion spread from the United States to other countries because there

5. Commission Communication for the Spring European Council, *Driving European Recovery*, COM (2009) 114 final (Apr. 3, 2009), available at http://ec.europa.eu/archives/commission_2004-2009/president/pdf/press_20090304_en.pdf.

6. Christine M. Cumming & Beverly J. Hirtle, *The Challenges of Risk Management in Diversified Financial Companies*, 3 J. FIN. TRANSFORMATION 89, 89 (2001).

7. Kathleen A. Scott, *Addressing the Conditions Leading to System Risk on a Global Basis*, N.Y. L.J., Mar. 18, 2009, at 2.

8. *Id.* at 3.

9. Matthew Beville, Comment, *Financial Pollution: Systemic Risk and Market Stability*, 36 FLA. ST. U. L. REV. 245, 245 (2009).

10. *Id.* at 246.

was no international architecture to prevent global crises from erupting.¹¹ National financial systems, like individual financial firms may thus become over-leveraged and take risks that will then infect the global markets.

The current financial crisis was sparked by unregulated or poorly regulated securitization of mortgages and credit default swaps.¹² Additional related causes, such as failures by credit rating agencies ("CRA's) to appropriately price rated securities, also were important. Systemic risk can also arise from poorly regulated financial institutions or speculative market conduct. Some of the tools currently in place to guard against the collapse of individual firms, such as capital adequacy rules by banking and securities regulators, did not ward off the collapse of individual firms that were important to the financial system. In fact, over-the-counter ("OTC") derivatives markets were not regulated at all. This paper will address the issue of whether the current proposals for a systemic risk regulator are likely to prevent systemic shocks to the financial markets in the future.

B. The Administration's Proposals and Counter-proposals

In March 2009, the U.S. Secretary of the Treasury outlined a framework for regulatory reform, initially focusing on containing systemic risk.¹³ This framework was important for what it covered, and also for the issues that it did not address. There were five components of the Treasury's framework: 1) a single independent systemic regulator with responsibility for systemically important firms, critical payment and settlement systems; 2) higher capital and risk management standards for systemically important firms; 3) registration of all hedge fund advisers of a certain size with the SEC; 4) a comprehensive framework of oversight, protections and disclosure for the OTC derivatives market; and 5) new requirements for money market funds to reduce the risk of rapid withdrawals.¹⁴

An alternative proposal for a Council of Regulators was put forth by some Republicans and advocated by the Chairman of the Federal Deposit

11. DICK K. NANTO, U.S. CONG. RESEARCH SERV., THE GLOBAL FINANCIAL CRISIS: ANALYSIS AND POLICY IMPLICATIONS 23 (2009), available at <http://www.fas.org/sgp/crs/misc/RL34742.pdf>.

12. See generally Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1327 (2009).

13. See Press Release, Dep't of Treasury, Treasury Outlines Framework for Regulatory Reform (Mar. 26, 2009), available at <http://www.financialstability.gov/latest/tg72.html>.

14. *Id.*

Insurance Corporation (“FDIC”). This Council would address issues that pose risks to the financial system as a whole and would include a Chairman of the Council, the Secretary of the Treasury, Chairman of the Fed, the Chairman of the FDIC, the Chairman of the National Credit Union Administration, the Chairman of the Securities and Exchange Commission (“SEC”) and the Chairman of the Commodity Futures Trading Commission (“CFTC”).¹⁵ The Chairman of the Council of Regulators would serve as the principal advisor to the President on matters related to overseeing, monitoring, and preventing systemic risk and would make recommendations to the Council on systemic risk regulatory policy.¹⁶ This proposal would centralize the responsibility for supervising systemically important financial institutions and would identify and mitigate the build-up of risk by individual firms. The Council would identify systemically important institutions, practices and markets, implement actions to address those risks, ensure information flow, analyze and make recommendations on potential systemic risks, set capital adequacy standards, and ensure that key regulators apply those standards. The Council would have the authority to overrule or force actions on behalf of other regulators.¹⁷

Other Republican proposals would limit the Fed’s authority to overseeing monetary policy and transfer the Fed’s authority for prudential regulation of bank holding companies to a new financial institutions regulator. In addition, the Republicans proposed a Market Stability and Capital Adequacy Board to identify systemic risks in the entire financial system. This, in addition to the Council members described above, would include five private, presidentially-appointed members with no more than three members from the same political party.¹⁸ Further, one of the eleven members would be reserved for someone who had served as a state insurance commissioner or supervisor.¹⁹

In June 2009, the Obama Administration issued a White Paper on Financial Regulatory Reform,²⁰ followed by legislative texts to implement

15. Financial System Stabilization and Reform Act of 2009, S. 664, H.R. 1754, 111th Cong. (2009).

16. *Id.* at § 112(a)(1)(A).

17. *Regulation and Resolving Institutions Considered “Too Big To Fail”*: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. (May 6, 2009) (statement of Sheila C. Bair, Chairman, FDIC)

18. Press Release, Committee on Financial Services, Republicans Announce Comprehensive Regulatory Reform Plan (June 11, 2009), available at http://republicans.financialservices.house.gov/index.php?option=com_content&task=view&id=600.

19. *Id.*

20. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM A NEW FOUNDATION:

the White Paper.²¹ The Administration's proposals would require the Fed to designate all large, highly leveraged and substantially interconnected financial companies as Tier 1 financial holding companies ("FHCs").²² This designation would not be limited to bank holding companies, and it could extend to foreign financial institutions with sufficient operations in the United States.²³ The Fed would then regulate FHCs. Such regulation would encompass capital adequacy standards, the ordering of corrective action, liquidity standards and overall risk management requirements. Nevertheless, a working group headed by the Treasury would conduct a reassessment of regulatory capital requirements for Tier 1 FHCs and others.²⁴ This reassessment would necessarily be in the context of the Basel Committee standards for bank capital adequacy. Although the Fed would essentially become the primary federal systemic risk regulator, a great deal of systemic risk regulation would in fact fall to others because the White Paper would leave most of the existing federal financial regulators in place.²⁵

A new Financial Services Oversight Council ("Council")²⁶ would have the Secretary of the Treasury as its Chairman and would have, as its members, the chairs of the federal financial regulatory agencies.²⁷ The Council would act essentially as an advisory group responsible for identifying gaps in regulation and detecting emerging risks. It would, however, have no power to take direct action or to compel the Fed to do so.²⁸ The Council would replace the President's Working Group.

REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

21. See FinancialStability.gov, U.S. Dep't of the Treasury, Proposed Text of Bank Holding Company Modernization Act of 2009, available at <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf>.

22. DEPARTMENT OF THE TREASURY, *supra* note 20.

23. *Id.*

24. *Id.*

25. The Office of Thrift Supervision and the Comptroller of the Currency would be folded into a new government agency, the National Bank Supervisor. An Office of National Insurance would be created, but it would have no real power other than to enter into international agreements and facilitate greater cooperation on insurance regulation by the states. A Consumer Financial Protection Agency would be created to protect consumers of financial services, and this agency would take away some powers from the Fed and other agencies, but this controversial proposal has little to do with systemic risk regulation.

26. See FinancialStability.gov, U.S. Dep't of the Treasury, Proposed Text of Financial Services Oversight Council Act of 2009, available at <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleI.pdf>.

27. Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong. (2009).

28. *Id.*

Various tasks related to systemic risk would remain with the SEC, the CFTC, or others. Advisers to private pools of capital, including hedge funds, private equity funds and venture capital funds would be required to register with the SEC if their assets under management exceed some specified threshold. Although the funds would not be required to register, and the connection between hedge funds in particular and systemic risk is more a matter of suspicion than proof, information regarding assets under management, leverage, off-balance sheet exposures and other matters related to systemic risk would have to be reported to the SEC. The SEC would then share such reports with the Fed.²⁹ The White Paper also assigns to the SEC the task of continuing with plans to strengthen the regulatory framework for money market mutual funds and the regulation of CRAs, including³⁰ wherever possible, the reduction of the use of ratings in regulations.

Neither the White Paper, nor the proposed legislation implementing it, would merge the SEC and the CFTC or clarify their respective areas of jurisdiction with regard to financial futures products. Rather, the SEC and the CFTC would be required to harmonize futures and securities regulation, and if unable to do so, the Secretary of the Treasury would decide any jurisdictional disputes.³¹ Also, the SEC and the CFTC would be given unlimited authority to police market abuses involving over-the-counter (“OTC”) derivatives.³²

The White Paper requested the SEC and the CFTC to identify conflicts in statutes and regulations with respect to similar types of financial instruments and explain why such differences are essential to achieve underlying policy objectives or to make recommendations for change.³³ After hearings, these agencies issued such a report on October 16, 2009.³⁴ Among the topics that specifically relate to systemic risk discussed in the report were oversight of new products, segregation, insolvency, margin regulations, and clearing systems.

29. On April 29, 2009, the E.U. proposed legislation that would require European hedge fund managers with 100 million Euros or more under management to report regularly to their competent national authorities on their main investments, performance and risks, and funds would be subject to rules on minimum capital, risk management and auditing.

30. DEPARTMENT OF THE TREASURY, *supra* note 20.

31. *Id.*

32. *See Bill Would Split Oversight Between SEC, CFTC; Goal to ‘Preserve’ Markets*, 41 Sec. Reg. & L. Rep. (BNA), at 1397 (July 27, 2009).

33. DEPARTMENT OF TREASURY, *supra* note 20, at 50–51.

34. *See U.S. SEC. & EXCH. COMM’N & U.S. COMMODITY FUTURES TRADING COMM’N, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION (2009)*, available at <http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf>.

In order to contain systemic risk, the White Paper would require all standardized OTC derivatives to be cleared through central counterparties that impose margin requirements and more stringent capital requirements on OTC derivatives dealers.³⁵ Also, standardized derivatives contracts would be required to be transacted on regulated exchanges or electronic trading platforms.³⁶ These recommendations are strongly endorsed by the Fed.³⁷

An important component of the Administration's proposal is the creation of a new financial products consumer protection agency. The White Paper proposed that the Council head this agency. The pros and cons of creating such an agency will not be discussed in this article. Although it can be argued that "the lack of meaningful federal oversight of consumer credit exacerbated the off-loading of risk to investors," sending a shock wave across the financial markets.³⁸ In the author's view, the creation of a financial consumer protection agency is unlikely to mitigate systemic risk. On the other hand, the Fed's lax attitude toward consumer credit was symptomatic of its deregulatory philosophy.

Another important component of financial regulatory reform is resolution authority for large, interconnected financial firms, outside of the bankruptcy courts.³⁹ Since the Administration's proposals were floated, a draft law from the Treasury and the House Financial Services Committee would give the Fed sweeping powers over systemically significant firms short of winding up.⁴⁰ For example, the Fed could order a firm to sell a risky division or stop dangerous trading activity, since the draft bill allows the Fed to require any systemically significant company to "sell or

35. DEPARTMENT OF THE TREASURY, *supra* note 20.

36. See Dawn Kopecki, *JPMorgan, Hedge Funds May Lose as Derivatives Proposal Advances*, BLOOMBERG, Aug. 12, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a4bIfOU56Oxo>.

37. *Over-the-Counter Derivative: Hearing Before Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (testimony of Patricia White, Assoc. Director, Division of Research and Statistics).

38. See INVESTORS' WORKING GROUP, CFA INST. CTR. FOR FIN. MKT. INTEGRITY AND COUNCIL OF INST. INVESTORS, U.S. FINANCIAL REGULATORY REFORM: THE INVESTORS' PERSPECTIVE 18 (2009), available at [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors%20Working%20Group%20Report%20(July%202009).pdf).

39. See FinancialStability.gov, U.S. Dep't of the Treasury, Proposed Resolution Authority for Large, Interconnected Companies Act of 2009, available at http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf.

40. See Tom Braithwaite et al., *Draft Law Gives Fed Sweeping Powers*, FIN. TIMES, Oct. 28, 2009, at 1.

otherwise transfer assets or off-balance sheet items to unaffiliated firms, to terminate one or more activities or to impose conditions on the manner in which the identified financial holding company conducts . . . activities.”⁴¹

The White Paper’s proposals were controversial, and arguments broke out not only between the Administration and members of Congress, but also among various federal regulators over the merits of taking powers away from the Fed, giving more powers to the Fed, creating a Council of Regulators, with or without enforcement powers, and many other matters. Political realities militate against merging the SEC and the CFTC or creating a federal insurance regulator. Considered together with those realities, the White Paper’s compromise proposal for moving some authority to or from particular agencies met resistance by the agencies, their Congressional oversight committee members, as well as industry lobbyists.⁴²

Subsequently, the House passed regulatory reform legislation,⁴³ and Senator Dodd proposed a companion Senate bill.⁴⁴ The House bill tracked the White Paper’s proposals in most important respects. It would create a Council of regulators to oversee systemic risk and prepare strategies for threats to the stability of the U.S. financial system.⁴⁵ Primary financial regulatory agencies would be empowered to enforce prudential standards. The Fed would have the power to treat systemically important non-bank financial holding companies as if they were bank holding companies.⁴⁶ OTC derivatives would be forced into clearinghouses and on to exchanges. An independent financial products consumer protection agency would be created. A new resolution authority would be created for bank holding companies or any systemically important financial company whereby the FDIC would act as receiver according to bank resolution rules rather than bankruptcy rules.

The Senate bill also would assign systemic risk assessment functions to a Council, chaired by the Secretary of the Treasury, but it would in addition create an Office of Financial Research within the Department of the Treasury to act as an advisor⁴⁷ to the Council. This Office would collect and analyze financial data. Two important differences between the

41. *Id.*

42. *Id.*

43. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

44. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2009).

45. H.R. 4173.

46. *Id.*

47. S. 3217.

House and Senate bills relating to systemic risk concern resolution authority and the financial consumer protection agency. The Senate bill would set up an Orderly Liquidation Authority Panel composed of three judges from the U.S. Bankruptcy Court for the District of Delaware that could appoint the FDIC as a receiver. The Senate bill also would place the financial consumer protection agency inside the Fed as an independent agency.

In view of the partisanship on display in Washington, it is difficult to predict whether there will be any meaningful regulatory reform during this session of Congress. Further, both the House and Senate bills would result in only incremental changes in the structure and powers of financial regulators. Nevertheless, it can be expected that existing regulators will exercise their powers to increase capital adequacy requirements, mandate risk management systems and otherwise guard against systemic risk more forcefully.

C. Conflicts between Systemic and Prudential Regulation

There are several reasons why proposals that give the Fed the responsibility for being the systemic risk regulator have generated opposition. Many observers feel the Fed was a systemic risk regulator and it failed to prevent the speculative boom in structured finance products that led to the financial meltdown. They charge that the Fed's easy money policy enabled financial firms to amass large concentrations of risky and complex securitized products.⁴⁸ Alan Greenspan, as Chairman of the Federal Reserve Board, embraced derivatives since he believed they were good for banks because they spread risk.⁴⁹ He argued that derivatives were essential to the stability of the banking system and therefore should not be regulated.⁵⁰ Further, he "attributed the substantial increase in U.S. wealth and productivity in part to the derivatives markets."⁵¹ However, by keeping interest rates too low, the Fed fueled a stock market bubble and then a credit bubble.⁵²

48. Braithwaite et. al., *supra* note 40, at 25.

49. David Blake, *Greenspan's sins return to haunt us*, FIN. TIMES, Sept. 19, 2008, at 17.

50. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1023-24 (2007).

51. Kai Kramer, Comment, *Aren't We Still in the "Garden of the Forking Paths"?* A Comment on Consolidation of the SEC and CFTC, 4 HOUS. BUS. & TAX L.J. 410, 417 (2004).

52. See Greg Ip, *In Treating U.S. After Bubble, Fed Helped Create New Threats*, WALL ST. J., June 9, 2005, at A1.

Other critics believe that the Fed has too much power now and should not get more power without greater congressional oversight.⁵³ More than 250 Republicans co-sponsored a bill that would allow the GAO to conduct audits of Fed decisions on monetary policy.⁵⁴ Members of this group argued that the Fed's role should be limited to overseeing monetary policy and the payments system, and regulatory responsibilities and systemic oversight detract from focus on fighting inflation.⁵⁵

Others have focused on the conflicts of interest inherent in having a prudential regulator of financial holding companies also act as a systemic regulator. As the prudential regulator of bank holding companies and Tier 1 FHCs, would the Fed have the backbone to put an end to the sale of financial products or to financial businesses that are lucrative for the banks? Alan Greenspan not only did not do so, but encouraged the expansion of derivatives trading because it seemed to enhance the balance sheets of banks.⁵⁶ It has been argued that the capital rules of the Basel II accords, endorsed by the world's leading central banks increased market instability during the financial crisis.⁵⁷ While a different Fed Chairman, less enamored of deregulation than Alan Greenspan, might take a different approach to financial products that increase the earnings of banks, the conflict between systemic regulation, prudential regulation and monetary policy are difficult to reconcile. These conflicts have become worse since the bailout because Wall Street banks are buying massive amounts of securities to help stabilize the markets.⁵⁸ Some advocates of giving the Fed enhanced powers and responsibilities as a systemic regulator have therefore argued that prudential regulation of banks should be transferred to a consolidated federal bank regulator.⁵⁹ One additional reason given for not making the Fed the systemic regulator is that the Fed favors

53. Edmund L. Andrews, *Two Authorities on Fed Advise Congress Against Expanding Its Power*, N.Y. TIMES, July 10, 2009, at B3.

54. *Id.*

55. Jon Hilsenrath, *Revamp Could Hurt Central Bank, Warns Head of Philadelphia Fed*, WALL ST. J., July 28, 2009, at A6; John Taylor, *Fed Needs Better Performance, Not Powers*, FIN. TIMES, Aug. 10, 2009, at 7.

56. Blake, *supra* note 49.

57. Beville, *supra* note 9, at 249. All of the largest investment banks including Bear Stearns, Goldman Sachs, and J.P. Morgan were using Basel II net capital calculations.

58. Brooke Masters & Henny Sender, *Wall St Profits from Fed Role*, FIN. TIMES, Aug. 3, 2009, at 1.

59. *Reducing Systemic Risk in the Financial Sector: Before the H. Comm. on Fin. Serv.*, 111th Cong. (2009) (testimony of Alice M. Rivlin, Senior Fellow, Brookings Institution); Alan Blinder, *Early Warnings System, Run by the Fed*, N.Y. TIMES, July 26, 2009, at BU5; Robert C. Pozen, *Systemic Risk and the Fed*, WALL ST. J., July 9, 2009, at A13; Mark Warner, *America Needs A Single Bank Regulator*, FIN. TIMES., Aug. 6, 2009, at 11.

secrecy over public disclosure and would not be sufficiently transparent.⁶⁰

The Administration's proposals set off a turf war. Some agencies, together with their congressional oversight committees, are afraid of losing power; thus, various arguments have been raised in favor of the status quo.⁶¹ These arguments are generally in the form of advocating that a Council of Regulators should become the systemic risk regulator.⁶² Yet, the President's Working Group has been in existence since 1987 and it has been largely ineffectual in identifying products or practices that pose risks to the financial system.⁶³ A committee of regulators frequently engaged in turf warfare is unlikely to solve system wide risks to the financial markets.

The Securities Industry and Financial Markets Association ("SIFMA") has recommended that all important financial institutions and systems should be subject to a systemic risk regulator, regardless of their charter or primary functional regulator.⁶⁴ The systemic risk regulator should have access to information about any institution that might be systemically important, as it determines. Further, market sectors where individual firms are not systemically important, but where such firms in the aggregate may have a significant impact on systemic risk,⁶⁵ should be included within the purview of a systemic risk regulator.⁶⁵ According to SIFMA, systemically important institutions are those likely to have "serious adverse effects on economic conditions or the financial stability of other entities if they were allowed to fail."⁶⁶ Although SIFMA endorsed

60. INVESTORS' WORKING GROUP, *supra* note 38, at 25.

61. Stephen Labaton, *Regulators Spar for Turf in Financial Overhaul*, N.Y. TIMES, July 25, 2009, at B1; Sarah O'Connor, *Geithner Urges End to 'Dumb Regulation'*, FIN. TIMES, July 25, 2009, at 7; *see also* Kara Scannell, *Big Companies Go to Washington to Fight Regulations on Fancy Derivatives*, WALL ST. J., July 10, 2009, at B1.

62. *Regulation and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. On Banking, Housing, and Urban Affairs*, 111th Cong. (2009) (statement of Sheila C. Bair, Chairman, FDIC); Mary Shapiro, Chairman, Sec. & Exch. Comm'n, *Address to the Investment Company Institute: Building a Stable and Efficient Financial System* (May 8, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch050809mls.htm>.

63. *See generally* John P. Hunt, *Hedge Fund Regulation: The President's Working Group Committees' Best Practices Reports—Raising the Bar but Missing Risks 9* (June 2008) (unpublished manuscript), [http://www.law.berkeley.edu/files/HedgeFundRegulationJune08-21\(1\).pdf](http://www.law.berkeley.edu/files/HedgeFundRegulationJune08-21(1).pdf).

64. *See Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 96 (July 17, 2009) (statement of Randolph C. Snook, Executive Vice President of SIFMA).

65. *Id.* at 97.

66. *Id.*

a single oversight body as a systemic risk regulator, it was neutral as to whether the Fed should be that body.⁶⁷

Most commentators share the opinion that the Fed should remain independent and any systemic risk regulator should be independent.⁶⁸ The meaning of independence in this context is generally left undefined, however. Does it mean independent from the Executive and/or Congressional branches of government, or does it mean independent from regulated entities? Such entities generally exert their influence through the congressional oversight committees for the financial regulators, and given the corrupting influence of campaign contributions on U.S. politics, such influence is difficult to resist. Although a stable source of funding is sometimes considered a way for a financial regulator to remain independent, some argue that such funding necessarily leads to the agency's loss of independence if it comes from regulated entities. As an example, the Fed has been criticized for the heavy influence that banks have on its governance.⁶⁹

II. THE EUROPEAN DEBATE

The E.U. Commission issued a Communication in May 2009 recommending that the European Council:

1) endorse the creation of a new European Systemic Risk Council ("ESRC") chaired by the President of the ECB and composed of governors of national central banks, the chairpersons of the three European Supervisory Authorities and a member of the Commission . . . [and]

. . . .

2) agree on the establishment of a new European System of Financial Supervisors ("ESFS") composed of three new European Supervisory Authorities to develop common supervisory approaches and a single set of harmonized rules for all financial firms

67. *Id.* at 93.

68. See *The Value of Bank Independence; Critics Should Realize Central Bank Did Wrong Job Well*, FIN. TIMES (London), Aug. 3, 2009, at 6; see also David Wessel, *Experts Tell Congress to Lay Off the Fed*, WALL ST. J., July 16, 2009, at A3; Letter from Karl J. Ege, Chair, ABA, Section of Business Law, to The Honorable Barney Frank (Apr. 29, 2009), available at <http://meetings.abanet.org/webupload/commupload/CL116000/newsletterpubs/SystemicRiskLetter.pdf>.

69. INVESTORS' WORKING GROUP, *supra* note 38, at 2.

70. Commission of the European Communities, *European Financial Supervision*, at 15, COM (2009) 252 final (May 27, 2009), available at http://ec.europa.eu/intenl_market/finances/docs/committees/supervision/communication_may2009/C-2009_715_en.pdf.

The role of the ESRC would be to collect and analyze information in order to monitor and assess potential threats arising from macro-economic developments and developments within the financial system as a whole.⁷¹ The ESRC would identify and prioritize systemic risks and then issue warnings, to make recommendations and to monitor the agencies responsible for taking remedial action.⁷² The ESRC would not have legally binding powers, and would be accountable to the Council and European Parliament.⁷³ In the view of the Commission, Finance Ministers should not be members of this systemic risk regulator because such membership would blur the ESRC's role in providing independent technical analysis of macro-prudential risks.⁷⁴

The E.U. currently has three Committees of Supervisors for different financial industry segments, which act as advisory committees to coordinate E.U. regulation. These are the Committee of European Banking Supervisors ("CEBS"), Committee of European Insurance and Occupational Pensions Committee ("CEIOPS") and the Committee of European Securities Regulators ("CESR"). These committees were created pursuant to the Lamfalussy process designed to streamline and integrate financial regulation.⁷⁵ The May Communication asserted that these committees had reached the limits of what they could accomplish and so they should be replaced by three new European Supervisory Authorities, one for banking, one for insurance and occupational pensions, and a securities authority. These new Supervisory Authorities would then be authorized to develop binding technical standards and to draw up interpretive guidelines in order to ensure a single set of harmonized rules. It would also ensure consistent application of E.U. rules to achieve a common supervisory culture with consistent practices. The Authorities would regulate CRAs and counterparty clearing houses, coordinate responses in crisis situations, collect micro-prudential information, and undertake an international role.⁷⁶ These three Supervisory Authorities would then be combined to form the ESFS.⁷⁷ The Supervisory Authorities should be designed to be independent and transparent.⁷⁸

71. *Id.* at 3.

72. *Id.*

73. *Id.* at 5.

74. *Id.* at 6.

75. *Id.* at 8 n.5. See generally Niamh Moloney, *The Committee of European Regulators and level 3 of the Lamfalussy Process*, in PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION 449 (Michel Tison, et al. eds., 2009).

76. Commission of the European Communities, *supra* note 70, at 9–11.

77. *Id.* at 13.

78. *Id.*

The May Communication paid some attention to the legal authority required to form the ESRC and the ESFS.⁷⁹ There has long been a debate over the question of whether E.U.'s wide regulators for financial services could be created without an amendment to the E.U. treaties providing for them.⁸⁰

The Communication was based on a Report by a Group chaired by Jacques de Larosiere,⁸¹ followed by a Communication by the Commission and a comment period.⁸² The de Larosiere Group Report argued that while it supports an enlarged role for the ECB in macro-prudential oversight, it did not support any role for the ECB in micro-prudential oversight. Some of its reasons were rooted in the special problems of E.U. law and politics, while others resonated with the debates in the United States. The Group argued that adding micro-supervisory duties to the ECB's brief could impinge on its fundamental mandate of monetary stability.⁸³ Also, the ECB is not entitled to deal with insurance companies.⁸⁴

The United Kingdom has frequently parted company with other E.U. countries with regard to financial regulation, so it is interesting that the U.K. has been supportive of the Commission's Communication, and in particular endorsed the idea of establishing the ESFS and the ESRB.⁸⁵ Within the U.K., the Treasury has argued for maintaining the existing regulatory structure where the Financial Services Authority is a unified regulator for all financial services, and the Bank of England is responsible for financial stability.⁸⁶

Both the U.S. and the E.U. need to consider how to incorporate into domestic law the recommendations and decisions of the Financial Stability Board, which was created and enlarged by the G-20 to supersede the Financial Stability Forum. The mandate of the Financial Stability Board is "to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stabili-

79. *Id.* at 8, 14.

80. See Gilles Thieffry, *The Case For a European Securities Commission*, in *REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY* 222–23 (Eilís Ferran & Charles A.E. Goodhart eds., 2001).

81. JACQUES DE LAROSIÈRE ET AL., *THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU* (2009), available at http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf.

82. *Driving European Recovery*, *supra* note 5, at 4–5.

83. DE LAROSIÈRE ET AL., *supra* note 81, at 43–44.

84. *Id.*

85. HM TREASURY, *REFORMING FINANCIAL MARKETS*, 2009, Cm. 7667.

86. *Id.* at 11. Opposition parties, however, have other proposals. See *Britain: More to Do; Financial Reform*, *ECONOMIST*, July 25, 2009, at 55.

ty.”⁸⁷ It has focused on critical reforms underway in a number of areas, including reducing the moral hazard posed by systemically important financial firms and expanding oversight of the financial system.⁸⁸

III. THE CREATION OF A NEW SYSTEMIC RISK REGULATOR

The specifications for a systemic risk regulator in the United States would not be so difficult or so controversial if the regulatory system for financial institutions was not already so balkanized. Almost every study of the U.S. financial regulatory system has recommended consolidation of the plethora of agencies regulating financial institutions and products.⁸⁹ Although there have been different proposals for two peaks, three peaks or more peaks regulation, none of the studies recommend that the present system should remain in place. The Administration’s proposals in this regard are exceedingly timid. Only the Office of Thrift Supervision would be abolished; the SEC and the CFTC would remain separate agencies; and insurance supervision would remain with fifty state regulators.⁹⁰ The Senate bill would further consolidate the banking agencies, however. The idea that the Fed should take on the responsibility of designating Tier 1 financial holding companies, act as their systemic regulator, and also continue to supervise bank holding companies as a prudential regulator is a substitute for more far reaching reform of financial regulation. Further, it is a poor substitute because it involves too many conflicts of interest and it is unlikely to be effective when some of the Tier 1 FHCs are regulated by the states and others by a variety of federal agencies. If the Fed were to shed its prudential regulatory powers, and a consolidated banking agency were to be created, I would be in the camp of believing the Fed could function as a systemic regulator. But if such a consolidation is not to occur, I believe a new systemic risk regulator should be created. Furthermore, if the United States makes the Fed its systemic regulator, it will be out of step with the ongoing reforms in the E.U., and international coordination may be more difficult as a result.

Unfortunately, the creation of a new systemic risk regulator would merely add to the excessive mix of federal regulators. But if appropriately structured, it could at least be objective and independent. The Inves-

87. Financial Stability Board, <http://www.financialstabilityboard.org>.

88. *Id.*

89. U.S. GOV’T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. REGULATORY SYSTEM (2009), available at <http://www.gao.gov/new.items/d09216.pdf>

90. Gail C. Bernstein, Matthew A. Chambers, Sara A. Kelsey & Martin E. Lybecker, *Are We Halfway There Yet? House Passes Major Financial Services Bill With Senate Expected to Act Early This Year*, 127 BANKING L.J. 12, 12 (2010).

tors' Working Group has proposed an independent systemic risk regulator that would supplement existing financial regulators, and would consist of a chair and four other members, all of whom would be Presidential appointees.⁹¹ Its mission would include collecting and analyzing the exposures of financial institutions, whether banks or non-banks, as well as products and practices that could threaten the stability of the U.S. financial system and economy. It would undertake reporting on those systemic risks and recommending steps by regulators to reduce those risks.⁹² This oversight would require aggregating and analyzing risk exposures across firms, securities instruments, and markets.⁹³ The Investors' Group would not give the systemic risk regulator the power to compel financial regulatory agencies to adopt regulations or otherwise halt systemic risks. But it would make regulators comply with its regulations or provide policy justifications for not doing so.⁹⁴

The Office of Financial Research, proposed in the Senate bill, would be a step in the direction of creating a systemic risk monitor. This Office would collect data on behalf of the Council, standardize the types and formats of data reported and collected, perform research, and develop risk measurement tools.⁹⁵ It would, however, be a part of the Department of the Treasury, an Executive Branch Agency, and therefore it would not be an independent agency. Conceivably, it could develop a tradition of independence, similar to the culture of the Antitrust Division of the Department of Justice.

The author generally agrees with the concept proposed by the Investors' Working Group with an important exception. Their proposal contemplates that the systemic risk regulator would be accountable primarily to Congress.⁹⁶ In my experience, Congress is at least as political as the Executive branch,⁹⁷ and the systemic regulator needs to be independent and highly professional. How an agency can be independent of both Congress and the Executive and still be constitutional is a somewhat daunting challenge, but such independence in fact, if not in law, should be the objective. One way to achieve such independence is to provide the

91. INVESTORS' WORKING GROUP, *supra* note 38, at 26.

92. *Id.* at 24.

93. *Id.*

94. *Id.* at 25.

95. Matt Cover, *Obama-Backed Financial Reform Bill Would Create New Bureaucracy with Power to Subpoena 'Any Data' from 'Any Financial Company,'* CNS NEWS, April 6, 2010, <http://www.cnsnews.com/news/article/63756>.

96. *Id.* at 26.

97. Congressional interference in financial regulation is generally based on lobbying by regulated entities and can be highly destructive of agency independence. A recent example is the outcry about mark-to-market accounting.

systemic regulator with stable funding sufficient to attract a professional staff of experts. But another factor is for the Executive and Congress to exercise restraint in interfering with the systemic regulator's work. It is conceivable that the inability of such a regulator to enforce its recommendations may make such restraint possible.

The GAO is a possible organizational model for a systemic risk regulator. The GAO is an independent, nonpartisan agency that investigates how the federal government spends taxpayer dollars. Among other things, at the request of a congressional committee or subcommittee, it audits agency operations, reports on how well government programs and policies are meeting their objectives. The GAO also performs policy analyses and outlines options for congressional consideration.⁹⁸ The head of the GAO, the Comptroller General of the United States, is appointed to a 15-year term by the President from a slate of candidates, and is subject to Senate confirmation.⁹⁹ This slate is composed of the Speaker of the House of Representatives, the President Pro Tempore of the Senate, the majority and minority leaders of the House and Senate, the Chairman and Ranking Member of the Senate Committee on Homeland Security and Governmental Affairs, and the Chairman and Ranking Member of the House Committee on Oversight and Government Reform.¹⁰⁰ Although this selection process is cumbersome, it is designed to ensure that the Comptroller is independent and nonpartisan. A similar selection process for the Chairman of a systemic risk regulator could be appropriate.

Some lessons could also be taken from the operation of the Office of Information and Regulatory Affairs ("OIRA") within OMB. Since OMB is a cabinet within the Executive Branch, the head of OMB is not independent.¹⁰¹ However, the OIRA within OMB monitors agencies to implement government-wide policies and standards with respect to federal regulations and guidance documents. The OIRA also monitors the quality, utility, and analytic rigor of information used to support public policy, particularly with respect to cost/benefit analyses.¹⁰² To some extent, OIRA is an Executive Branch analogue of OMB with regard to its interaction with Federal agencies.

Another possible model for a systemic risk agency is the National Transportation and Safety Board ("NTSB"), an independent federal

98. U.S. Gov't Accountability Office, About GAO, <http://www.gao.gov/about/index.html>.

99. *Id.*

100. U.S. Gov't Accountability Office, How the Comptroller General is Selected, <http://www.gao.gov/about/cgprocess.html>

101. The White House Office of Management and Budget, Information and Regulatory Affairs, http://www.whitehouse.gov/omb/regulatory_affairs/default.

102. *Id.*

agency that investigates every civil aviation accident in the United States and accidents in other transportation modes as well.¹⁰³ It has a board composed of five members appointed by the President, with a term of five years. No more than three of the five members can be of the President's party, and the President designates the Chairman and Vice Chairman for a term of two years.¹⁰⁴ Initially, the NTSB was dependent on the Department of Transportation for its funding and administrative support, but in 1975 all ties to that department were severed.¹⁰⁵ Although the NTSB has no regulatory authority, its "fiercely independent" identity allows it to maintain its credibility in investigating accidents, providing "careful and conclusive forensic analysis," and making recommendations to avoid future accidents.¹⁰⁶ Although neither GAO, OMB, nor the NTSB have the power to compel agencies to act or refrain from acting, they nevertheless are powerful actors within the Federal government and influence rulemaking and other policies. My vision of an appropriate systemic regulator is a similar type of agency—responsive both to Congress and the Executive—that could investigate and analyze financial data to determine whether systemic risks are emerging. This systemic regulator should have the power to advise financial regulators of dangers, and suggest mitigating actions, perhaps by forwarding its reports to the Council of Regulators. However, it would be the duty of the financial regulators, Congress and the Executive Branch to deal with implementing action. In the final analysis, the problem of dealing with systemic risk is a political problem. A systemic risk regulator cannot, and should not, bear all of the responsibility for preventing financial market meltdowns. But a good regulator could uncover dangers to the financial system and assign responsibility for preventing collapses to those charged with regulating financial institutions and markets. Although the Office of Financial Research that would be established by the Senate bill is a step in the direction, its independence and mission would have to be better articulated for it to function effectively.

CONCLUSION

The causes of the financial meltdown and ongoing recession are complex. At their root the causes are economic, such as government budget deficits and trade imbalances. But poor regulation made this crisis much

103. Andrew W. Lo, *The Financial Industry Needs Its Own Crash Safety Board*, FIN. TIMES, Mar. 2, 2010, at 20.

104. 49 U.S.C. § 1111(b) (2006).

105. See Nat'l Transp. Safety Bd., NTSB History and Mission, http://www.nts.gov/Abt_NTSB/history.htm.

106. Lo, *supra* note 103.

worse.¹⁰⁷ Fixing the U.S. and E.U. regulatory systems is exceedingly difficult. But because there are genuine differences of opinion about what solutions are optimal, even if all of the experts were to agree on the needed reforms, politics stand in the way of a genuine reform. As critics of the de Larosiere Report remarked: "If even a group of experts cannot muster the courage to lay out imaginative blueprints, one can hardly expect politicians who have failed thus far to rise to the occasion and face head-on Europe's current challenges, to go beyond the timidity of the Report they commissioned."¹⁰⁸ Similar criticism can be leveled against the Obama Administration's proposals. Bowing to perceived political realities, the Treasury's program does very little to address the balkanized regulatory system, where financial firms can choose their regulators and compromise the agencies charged with their supervision. Meanwhile, the regulators do not have the funds, the staff, or the technology to keep pace with what is happening in the markets, and they are hobbled rather than emboldened by their Congressional oversight committees.¹⁰⁹

If some firms are too big or too interconnected to fail, they should be dismantled.¹¹⁰ This does not necessarily mean going back to the wall between investment and commercial banking, but it may require such measures. When the SEC was initially formed it was tasked with breaking up the public utility holding companies that contributed to the speculative stock market of the 1920s.¹¹¹ The U.S. taxpayer should never again be asked to bailout Wall Street, but the proposed reforms do not prevent such a reoccurrence. The purpose of credit and securities markets is to finance business, not to generate trading profits. But all of the regulatory agencies over the past quarter of a century have inevitably encouraged trading and speculation over capital formation and have emphasized efficiency over fairness.¹¹²

107. See George Soros, *Do Not Ignore the Need for Financial Reform*, FIN. TIMES, Oct. 26, 2009, at 13.

108. Laurens Jan Brinkhorst, Jean-Victor Louis & René Smits, *De Larosière Report Fails to Tackle Main Issues* (Apr. 6, 2009), available at <http://www.euractiv.com/en/financial-services/larosire-report-fails-tackle-main-issues/article-181014>.

109. Edward Wyatt, *As Lawmakers Grapple with Financial Overhaul, They Call for More Studies*, NY TIMES, Mar. 17, 2010, at B3; Liz Moyer, *How Regulators Missed Madoff: Limited Resources, Fragmented Oversight and a Lack of Coordination Between Agencies Allowed the Alleged \$50 Million Ponzi to Flourish*, FORBES, Jan. 27, 2009, available at http://www.forbes.com/2009/01/27/bernard-madoff-sec-business-wall-street_0127_regulators.html.

110. See Soros, *supra* note 107, at 11.

111. See SECHistorical.org, William O. Douglas and the Growing Power of the SEC, <http://www.sechistorical.org/museum/galleries/douglas/academia.php>.

112. CME Group, *Reform: What Does it Mean?*, OPEN MARKETS, Feb. 22, 2010,

The proposed reforms may lead to minor improvements in financial regulation, but they are unlikely to prevent another speculative securities market and its inevitable collapse. They are also unlikely to restore the confidence of investors in the fairness or safety of the markets. At one time, stock market panics affected only a few. But today, most Americans and many Europeans invest their retirement savings in the stock market.¹¹³ Market collapses therefore lead to widespread pain. The public deserves better reform than the politicians are offering.

<http://openmarkets.cmegroup.com/features/reform-what-does-it-mean/>.

113. MAURICIO SOTO, URBAN INSTITUTE, HOW IS THE FINANCIAL CRISIS AFFECTING RETIREMENT SAVINGS? (Mar. 9, 2009), *available at* http://www.urban.org/UploadedPDF/901283_retirement_savings_update.pdf.

REFLECTIONS ON SYSTEMIC RISK REGULATION IN RESPONSE TO KARMEL'S PAPER

*Annette L. Nazareth**

In her very thoughtful article, Professor Karmel proposes the establishment of a systemic risk regulator modeled after the Government Accountability Office (GAO) or the Office of Management and Budget (OMB). The proposed systemic risk regulator would be primarily responsible for issuing warnings and making recommendations relating to systemic risks. It would have no regulatory and supervisory authority and would be highly independent with limited accountability. This essay takes a contrary position—that a systemic risk regulator that has no regulatory and supervisory functions and that is institutionally segregated or independent from those functions is unlikely to be effective and competent in policing systemic risks. It then discusses the information needs for systemic risk regulation and argues that systemic risk regulation and prudential regulation are closely interconnected and highly complementary. Finally, it briefly touches on the issue of accountability.

Systemic risk analysis is an information and data intensive endeavor. Thus, a crucial element in any institutional design for systemic risk regulation is how to collect and aggregate relevant information and make informed decisions in an efficient and effective manner.

Systemic risk regulation involves regular collection and analysis of a large amount of disparate information encompassing the entire financial system both at the macro- and micro-levels. At the macro-level, the information consists of those relating to macroeconomic conditions, financial markets and related infrastructures, payment and settlement systems, and the intersections between financial sectors and the real economy. At the micro-level, it involves regular collection and monitoring of a wide range of firm-level information, particularly for systemically important

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financial institutions, such as on- and off-balance sheet items with appropriate breakdowns of exposures and identification of counterparties, capital, liquidity and risk management, compensation, and governance practices.¹

In particular, systemic risk analysis often entails horizontal reviews of information across groups of financial institutions, focusing on particular risks or activities, common exposures, and “crowded trades,” preferably on a real-time basis.² A systemic risk regulator must possess deep market and institutional knowledge, analytical sophistication and supervisory expertise to be competent in carrying out such analysis.³ What makes this type of analysis particularly challenging in practice is the constantly changing and continuously evolving nature of the financial markets as a result of market movements, innovations and financial integration.⁴ New market developments appear to occur at an ever-accelerating pace. Even the most intimate and sophisticated market observers, regulators and market participants find it challenging to stay abreast of and comprehend the impact of these changes. The effects of the “originate to distribute” model of securitized credit intermediation and the accompanying explosive growth in subprime lending that contributed to the present financial crisis is one case in point.

Thus, whether the Federal Reserve adds a systemic risk function to its current supervisory and regulatory responsibilities, or a council of regulators aggregates their collective information and experience to serve the systemic risk role, ultimately, functional regulators must play a key role

1. See Lorenzo Bini Smaghi, Exec. Bd. Member, Eur. Cent. Bank, *Going Forward: Regulation and Supervision after the Financial Turmoil*, Speech at the International Conference of Financial Regulation and Supervision (June 19, 2009), available at <http://www.ecb.int/press/key/date/2009/html/sp090619.en.html>.

2. See Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve System, *Reducing Systemic Risk*, Speech at the Federal Reserve Bank of Kansas City Annual Symposium (Aug. 22, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm>; see also Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve System, *Financial Regulation and Supervision after the Crisis: The Role of the Federal Reserve*, Speech at the Federal Reserve Bank of Boston Economic Conference (Oct. 23, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20091023a.htm>.

3. See Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve System, *Financial Reform to Address Systemic Risk*, Speech at the Council on Foreign Relations (Mar. 10, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>.

4. See Lorenzo Bini Smaghi, Exec. Bd. Member, Eur. Cent. Bank, *Going Forward: Regulation and Supervision after the Financial Turmoil*, Speech at the International Conference of Financial Regulation and Supervision (June 19, 2009), available at <http://www.ecb.int/press/key/date/2009/html/sp090619.en.html>.

in an effective systemic risk regulatory regime.⁵ A systemic risk regulator that has no supervisory and regulatory role could theoretically rely on data provided by the functional regulators, but the information would be derivative and may lag real-time events due to coordination issues. This could be problematic, particularly in times of crisis. Given that the U.S. regulatory framework will likely remain fragmented after the anticipated legislative reforms to financial regulation, a council of regulators would be conducive to the information aggregation process, whether as an advisory body to a systemic risk regulator or as a body with systemic risk authority itself.

Additionally, systemic risk regulation and functional regulation are closely interconnected and highly complementary. A distinct separation of systemic risk regulation and functional regulation runs the risk that neither regulatory function performs satisfactorily. In practice, most important macro-prudential instruments for systemic risk regulation have to work through the micro-prudential regulatory and supervisory process in a dynamic, tailored fashion in response to evolving market conditions and risk correlations over the economic cycle.⁶

Theoretical literature on systemic risk regulation considers two dimensions: “cross-sectional dimension” and “time dimension.”⁷ Cross-

5. In the European Union, the proposed European Systemic Risk Board (ESRB) and the European System of Supervisory Authorities (ESSA) are institutionally inter-locked in that the members of the ESRB include the three Chairs of the ESSA. To ensure further coordination and cooperation with the national prudential regulators, a representative from one national supervisory authority for each EU country may attend the meetings of the ESRB, though they will have no voting rights.

6. See e.g., Andrew Crockett, Gen. Manager, Bank for Int'l. Settlements, & Chairman, Fin. Stability Forum, *Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability* (Sept. 21, 2000), available at <http://www.bis.org/review/rr000921b.pdf>; Paul Tucker, Deputy Governor for Fin. Stability, Bank of Eng., *The Debate on Financial System Resilience: Macroprudential Instruments*, Speech at Barclays Annual Lecture (Oct. 22, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech407.pdf>; Jukka Vesala, Deputy Dir. Gen., Finnish Fin. Supervisory Auth., *How to Bring In Systemic Risk Considerations into Financial Regulation and Supervision?*, Speech at the SUERF Colloquium on “The Quest for Stability” (Sept. 3-4, 2009), available at http://www.finanssivalvonta.fi/fi/Tiedotteet/Esitelmat/Documents/Vesala_SUERF_speech_030909.pdf.

7. See, e.g., Claudio Borio, *Towards a Macroprudential Framework for Financial Supervision and Regulation?* (Bank for Int'l Settlements, Working Paper No. 128, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=841306; Andrew Crockett, Gen. Manager, Bank for Int'l. Settlements, & Chairman, Fin. Stability Forum, *Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability* (Sept. 21, 2000), available at <http://www.bis.org/review/rr000921b.pdf>; Jaime Caruana, Gen. Manager, Bank for Int'l. Settlements, *The International Policy Response to Financial Crises: Mak-*

sectional dimension refers to the distribution of risk within the financial system at a given point in time by acting on its inter-connectedness. A key policy concern of cross-dimensional dimension is how to address common exposures that could ripple through the system and impose stresses on a significant number of financial institutions. Time dimension relates to how aggregate risks evolve over time in an economic cycle. A key policy concern of time dimension is how to address the problems of pro-cyclicality. Both dimensions of systemic risk regulation require a calibrated approach through the regulatory and supervisory review process. For the cross-sectional dimension, capital, liquidity, and risk management requirements need to be tailored and dynamically adjusted based on the systemic significance of individual institutions. Further, the larger, more complex or systemically important financial institutions warrant particular attention. Examples of such calibration include a “systemic capital surcharge” or an institution-specific systemic insurance premium calculated along a spectrum, rather than based on categorical classification. For the time dimension, regulatory regimes for countercyclical capital buffers and more forward-looking countercyclical loan provisioning are currently under consideration by national regulators and international bodies. To reduce the amplitude of the economic and financial cycles, appropriate levels of buffers or provisioning may need adjustment over time.

To effectively identify emerging strains and imbalances and address them through proper regulatory calibration in a timely manner, a systemic risk regulator must have a deep knowledge and understanding of, and have regular and close contacts with, financial markets and intermediaries. In particular, to implement such calibrated prudential standards, a robust regime for systemic risk regulation must ensure that all systemically important financial institutions are subject to consolidated supervision. A systemic risk regulator that is functionally separate from the regulatory and supervisory process is unlikely to be competent in carrying out such an extraordinarily complex task.

Lastly, systemic risk regulation is a multifaceted and multidisciplinary task that requires policy coordination and cooperation involving many authorities with different perspectives and responsibilities, both domesti-

ing the Macroprudential Approach Operational, Remarks at the Federal Reserve Bank of Kansas City Annual Symposium (Aug. 21-22, 2009), *available at* <http://www.bis.org/speeches/sp090911.htm>; Paul Tucker, Deputy Governor, Fin. Stability, Bank of Eng., The Debate on Financial System Resilience: Macroprudential Instruments, Speech at Barclays Annual Lecture (Oct. 22, 2009), *available at* <http://www.bankofengland.co.uk/publications/speeches/2009/speech407.pdf>.

cally and internationally.⁸ For instance, to design a regulatory regime for dynamic loan provisioning would require the involvement of accounting standard setters, tax authorities and functional regulators. In particular, regardless of the institution framework for financial supervision, information-sharing and decision-making linkages between the central bank and other regulatory agencies are necessary to effectively identify and address systemic risks.⁹ In addition to its critical role as a lender of last resort, the Federal Reserve has broad expertise and deep knowledge in financial markets, infrastructures, and intermediaries. This is due to its role as an umbrella supervisor for bank holding companies, its role in the payment and settlement systems and its active monitoring of the capital markets in support of its monetary policy. Thus, as a practical matter, it is essential to have involvement of the Federal Reserve in systemic risk regulation, whether or not it is in the lead role.¹⁰

INDEPENDENCE AND ACCOUNTABILITY

Professor Karmel's proposal to establish a highly independent systemic risk regulator is rooted in the notion that prior to the recent financial crisis, prudential regulators were either subject to political interference or "captured" by the industries they regulated.

Agency independence has two dimensions—*independence from political interference and independence from industry interests*. Critics of agency independence hold that independence could make agencies too powerful and jeopardize the democratic accountability of the regulatory process. In particular, without proper political oversight and control, independent agencies are prone to "regulatory capture."¹¹ Agencies that

8. See Andrew Crockett, Gen. Manager, Bank for Int'l. Settlements, & Chairman, Fin. Stability Forum, *Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability* (Sept. 21, 2000), available at <http://www.bis.org/review/rr000921b.pdf>; see also Jaime Caruana, Gen. Manager, Bank for Int'l. Settlements, *The International Policy Response to Financial Crises: Making the Macroprudential Approach Operational*, Remarks at the Federal Reserve Bank of Kansas City Annual Symposium (Aug. 21-22, 2009), available at <http://www.bis.org/speeches/sp090911.htm>.

9. See GROUP OF THIRTY, *THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE*, (2008), available at <http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0223cb1-837-3-e.pdf>.

10. See Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve System, *Financial Reform to Address Systemic Risk*, Speech at the Council on Foreign Relations (Mar. 10, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm>.

11. See generally Cosmo Graham, *Is There a Crisis in Regulatory Accountability?*, in *A READER ON REGULATION* (Robert Baldwin et al. eds., 1998); BARRY M. MITNICK, *THE POLITICAL ECONOMY OF REGULATION* (1980); Katjia Sander Johannesen, AFK FORLAGET,

suffer from regulatory capture promote industry interests or individual private interests over the public interest. These justifiable concerns call for proper accountability arrangements as the countervailing power to agency independence. However, independence and accountability are not necessarily mutually exclusive. With properly designed accountability arrangements, independence and accountability can be highly complementary.¹² Proper accountability arrangements reinforce an agency's independence by enhancing its legitimacy and encouraging it to adhere to high standards of governance and performance. In addition, they enhance an agency's integrity and thus reduce the possibility of regulatory capture.

Few will quibble with the notion that functional regulators made mistakes leading up to the financial crisis. However, the more likely causes were neither political interference nor regulatory capture, but rather an inability to comprehend what was occurring across the financial system due to regulatory fragmentation and a failure to detect certain signals that were clearly evident.

After many months of debate, there appears to be widespread consensus that a systemic risk regulator with a broad perspective and pervasive authority over financial market activity is necessary and advisable to ensure the stability of the financial system. It will be imperative that whatever agency performs this essential role operate under clear legislative mandates and to the full extent possible, free of political interference. That said, this essential function must be reportable to Congress and, ultimately, the American taxpayers who will bear the consequences of its actions.

Regulatory Independence in Theory and Practice—A Survey of Independent Energy Regulators in Eight European Countries (2003), available at www.akf.dk/udgivelser/2003/pdf/regulatory_independence.pdf.

12. See, e.g., Marc Quintyn, *Independent Agencies: More Than a Cheap Copy of Independent Central Banks?*, 20 CONST. POL. ECON. (2009); Marc Quintyn & Michael W. Taylor, *Regulatory and Supervisory Independence and Financial Stability*, (Int'l Monetary Fund, Working Paper No. 02/46, 2002), available at www.imf.org/external/pubs/ft/wp/2002/wp0246.pdf; Eva Hupkes, March Quintyn & Michael W. Taylor, *Accountability Arrangements for Financial Sector Regulators*, IMF ECON. ISSUES 39 (2006), available at www.imf.org/external/pubs/ft/issues/issues39/ei39.pdf.

BILATERAL INVESTMENT TREATIES AND THE EU LEGAL ORDER: IMPLICATIONS OF THE LISBON TREATY

INTRODUCTION

Foreign direct investment (“FDI”)¹ is the “lifeblood of the global economy.”² Foreign investors of developed, capital-exporting countries pursue opportunities abroad in efforts to obtain the highest returns on their investments, as well as to solidify positions in emerging markets.³ Meanwhile, developing, capital-importing countries seek to attract capital flows and new technologies in efforts to enhance their economies and improve their competitive standing in the global marketplace.⁴ In recent decades FDI flows dramatically surged,⁵ a trend that is

1. The International Monetary Fund and the Organisation for Economic Co-operation and Development define direct “foreign investment” as cross-border investment made by a resident entity in one economy (the “direct investor” or “multinational enterprise”) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the direct investor (the “foreign affiliate”). See International Monetary Fund [IMF], *Balance of Payments Manual*, at 86, (5th ed. 1993); see also Organization for Economic Co-operation and Development [OECD], *Detailed Benchmark Definition of Foreign Direct Investment*, at 7–8, (3d ed. 1996).

2. See Bernardo M. Cremades & David J. A. Cairns, *Contract and Treaty Claims and Choice of Forum in Foreign Investment Disputes*, in *ARBITRATING FOREIGN INVESTMENT DISPUTES* 325, 325 (Norbert Horn & Stefan Kroll, eds., 2004); see also Karl P. Sauvant & Lisa E. Sachs, *THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS* lx (2009) (stating that “[o]ne uncontroversial truth is that virtually all countries value FDI as a means to advance their economic development” and thus “compete with each other to attract investment”).

3. See U.N. Conference on Trade and Dev. [UNCTAD], *World Investment Report 2003: FDI Policies for Development; National and International Perspectives*, xv, U.N. Doc. UNCTAD/WIR/2003 (Sept. 4, 2003) (stating that “intense competition continues to force [transnational corporations] to invest in new markets and to seek access to low-cost resources and factors of production”).

4. See *id.* at iii (stating that due to its “enormous potential to create jobs, raise productivity, enhance exports and transfer technology, foreign direct investment is a vital factor in the long-term economic development of the world’s developing countries”).

5. See MIRIAN KENE OMALU, *NAFTA AND THE ENERGY CHARTER TREATY: COMPLIANCE WITH, IMPLEMENTATION, AND EFFECTIVENESS OF INTERNATIONAL INVESTMENT AGREEMENTS* 1–2 (NAFTA Law and Policy Series vol. 5, 1998) (stating that in 1980, FDI was estimated at \$40 billion; in 1994 it jumped to \$222 billion; by 1995 it had reached \$315 billion); see also UNCTAD, *Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows*, 3, U.N. Doc. UNCTAD/DIAE/IA/2009/3 (Jan. 19, 2009) (stating that the year 2007 saw unprecedented levels of FDI flows, “reaching a historic record of \$1.8 trillion”); Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment*

expected to continue.⁶ Coinciding with this surge is the proliferation of a dense network of international agreements pertaining to the protection of foreign investment,⁷ most notably bilateral investment treaties (“BITs”).⁸ BITs are agreements between two countries that provide substantive standards for the protection of foreign investment, as well as procedures for dispute settlement.⁹ In the absence of a comprehensive international legal framework or general customary international law governing foreign investment,¹⁰ BITs have become the “dominant international vehicle through which investment is regulated.”¹¹ In recent decades, BITs have flourished to unprecedented levels.¹²

While the legal infrastructure created by the BIT network operates on an international scale, BITs have become especially prevalent in the Eu-

Treaties and Their Grand Bargain 46 HARV. INT'L L. J. 67, 71 (2005) (stating that between 1973 and 2000, FDI growth exceeded that of international trade twelvefold).

6. See UNCTAD, *World Investment Prospects Survey 2009–2011*, 9, U.N. Doc. UNCTAD/DIAE/IA/2009/8 (2009) (stating that while the global economic and financial crisis caused significant declines in global FDI flows in 2008 and 2009, a recovery is expected beginning in 2010 and will continue to gain momentum through 2011).

7. See Kenneth J. Vandeveld, *A Brief History of International Investment Agreements*, 12 U.C. DAVIS J. INT'L L. & POL'Y 157, 157 (2005).

8. See Efraim Chalamish, *The Future of Bilateral Investment Treaties: A De Facto Multilateral Agreement?*, 34 BROOK. J. INT'L L. 303, 305 (2009). BITs are part of the larger category of international investment agreements (IIAs), which also includes free trade agreements (FTAs) and regional trade agreements. FTAs and regional trade agreement contain foreign investment-related provisions, but such provisions are not their primary focus. This Note is concerned only with BITs, which typically deal exclusively with foreign investment and are the most proliferated type of IIA.

9. See Stephen M. Schwebel, *The Overwhelming Merits of Bilateral Investment Agreements*, 32 SUFFOLK TRANSNAT'L L. REV. 263, 263 (2009).

10. See *infra* Part I.A; see also Kelly Connolly, Note, *Say What You Mean: Improved Drafting Resources as a Means for Increasing the Consistency of Interpretation of Bilateral Investment Treaties*, 40 VAND. J. TRANSNAT'L L. 1579, 1609–1610 (2007).

11. Andrew T. Guzman, *Explaining the Popularity of Bilateral Investment Treaties*, in THE EFFECT OF TREATIES ON FOREIGN DIRECT INVESTMENT: BILATERAL INVESTMENT TREATIES, DOUBLE TAXATION TREATIES, AND INVESTMENT FLOWS 73 (2009).

12. See Salacuse & Sullivan, *supra* note 5, at 75 (stating that the impetus of this proliferation is the “desire of companies of industrialized states to invest safely and securely in developing countries, as well as the consequent need to create a stable international legal framework to facilitate and protect those investments”); see also ANDREW NEWCOMBE & LLUIS PARADELL, LAW AND PRACTICE OF INVESTMENT TREATIES 46–48 (2009) (By 1979, states had entered into approximately 100 BITs, by 1987, 265 BITs had been concluded, and by the end of the 1990s, 1,857 BITs had been concluded); Press Release, UNCTAD, *Bilateral Investment Treaties Quintupled During the 1990s*, U.N. Doc. TAD/INF/2877 (Dec. 15, 2000) (stating that there were 1,857 BITs by the end of the 1990s, while there had only been 385 at the end of the 1980s).

ropean Union (“EU”).¹³ The modern BIT originated in Europe when the first BIT was concluded¹⁴ between the Federal Republic of Germany and Pakistan on November 25, 1959.¹⁵ Since that time, EU Member States have constituted a majority of the most prolific negotiators of these treaties.¹⁶ Central and Eastern European countries in particular have concluded a large number of BITs¹⁷ and continue to be considered attractive locations for FDI by foreign investors.¹⁸

As the number of BITs concluded by EU Member States continues to grow, the nature of the relationship between these treaties and the EU legal order garners increasing attention.¹⁹ This is because the relatively recent accession of many Central and Eastern European countries implicates the potential for conflict between EU legal requirements and BITs both between EU Member States (hereinafter, intra-EU BITs) and between EU Member States and non-EU Member States (hereinafter, extra-EU BITs).²⁰ In the context of BITs between Member States, the obligations under these BITs may be inconsistent with or superseded by EU law and, therefore, should be terminated.²¹ With respect to BITs between

13. Seventy new BITs were concluded between June 2005 and June 2006. Of those seventy, EU Member States (excluding South-East Europe and the Commonwealth of Independent States) concluded the highest number of BITs, with forty-nine new agreements during this time period. UNCTAD, *International Investment Rule-Setting: Trends, Emerging Issues and Implications*, 3, 5, U.N. Doc. TD/B/COM.2/73 (Jan. 5, 2007).

14. To conclude a treaty is to ratify or formalize it. BLACK’S LAW DICTIONARY 126 (3d ed. 2006).

15. See Treaty for the Promotion and Protection of Investments, Pak.–F.R.G. Nov. 25, 1959, 457 U.N.T.S. 23 [hereinafter Pak.–F.R.G. BIT].

16. Germany, Switzerland, the UK, Italy, France, the Netherlands, and Belgium Luxembourg were seven among the top ten signatories of BITs up until 2008. UNCTAD, *Recent Developments in International Investment Agreements*, 3, U.N. Doc. UNCTAD/WEB/DIAE/IA/2009/8 (2008).

17. See Anca Radu, *Foreign Investors in the EU—Which ‘Best Treatment’? Interactions Between Bilateral Investment Treaties and EU Law*, 14 EUR. L. J. 237, 238 (Mar. 2008).

18. See Stanimir Alexandrov, *The Future of Investment Treaty Protection in Eastern Europe*, EUR. & MIDDLE E. ARB. REV. (2009), available at <http://www.globalarbitrationreview.com/reviews/14/sections/53/chapters/511/the-future-investment-treaty-protection-eastern-europe/>, for a description of the recent, dramatic increase in FDI in Eastern Europe.

19. See Michele Potesta, *Bilateral Investment Treaties and the European Union. Recent Developments in Arbitration and Before the ECJ*, 8 LAW AND PRACTICE OF INTL. COURTS AND TRIBUNALS 225, 230 (2009).

20. See Thomas Eilmansberger, *Bilateral Investment Treaties and EU Law*, 46 COMM. MKT. L. REV. 383, 387 (2009).

21. See Christer Soderlund, *Intra-EU Investment Protection and the EC Treaty*, 24 J. INT’L. ARB. 455, 455 (2007).

Member States and Non-Member States, the potential exists for direct conflict between BITs and EU law, since EU law requires Member States to take all necessary steps to eliminate incompatibility between the EC Treaty and any other agreements to which they are a party.²²

While the current interface between BITs and the EU legal order reveals a degree of legal uncertainty in need of reconciliation, the individual EU Member States have retained jurisdiction over foreign investment, and thus the ability to negotiate and conclude international investment agreements.²³ However, this may change now that the Lisbon Treaty entered into force on December 1, 2009.²⁴ The Lisbon Treaty is an international agreement between EU Member States that amends the current sources of EU law, namely the EU Treaty and the EC Treaty.²⁵ Its provisions seek to “enhanc[e] the efficiency and democratic legitimacy of the Union and to improv[e] the coherence of its action.”²⁶ In one of its most novel provisions, the Lisbon Treaty transfers competence²⁷ over FDI from the Member States to the EU by bringing it under the ambit of the EU’s Common Commercial Policy (“CCP”).²⁸ While the treaty’s language with respect to FDI appears unequivocal, it is nevertheless unclear how it will be interpreted and applied, and therefore, the practical effects it will have on the current EU BIT network. Many questions remain unanswered:

22. See Treaty Establishing the European Economic Community, 25 March 1957, 298 U.N.T.S. 3 [hereinafter EC Treaty]; see also Radu, *supra* note 17, at 238.

23. See Radu, *supra* note 17, at 238.

24. All 27 Member States ratified the Lisbon Treaty. The treaty passed by referendum in Ireland, and on November 3, 2009, it was signed by the president of the Czech Republic, the final country to sign on. *Lisbon Treaty*, N.Y. TIMES (Feb. 25, 2010), available at <http://www.nytimes.com/info/treaty-of-lisbon/>.

25. See generally Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, Dec. 3, 2007, 2007 O.J. (C 306) 1 [hereinafter Lisbon Treaty].

26. See Lisbon Treaty, *supra* note 25, at 3 (preamble); see also Dr. Simon Duke, *The Lisbon Treaty and External Relations*, Bulletin of the European Institute of Public Administrations No. 2008/01, 13 (“[T]he Lisbon Treaty holds enormous potential for a more coherent Union on the international stage”).

27. Competence is akin to sovereignty. See DANIEL C. K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL TRADE LAW: PROBLEMS, CASES AND MATERIALS 124 (2008) (stating that the “debate over the external relations power in the EC/EU concerns primarily whether the EC/EU has exclusive competence to negotiate and conclude international treaties binding upon its member states or whether there is a shared competence with its member states allowing the states to participate in the negotiations and conclusion of the agreements”).

28. See Marc Bungenberg *Going Global? The EU Common Commercial Policy After Lisbon* in EUROPEAN YEARBOOK OF INTERNATIONAL LAW 124 (C. Herrmann & J.P. Terhechte eds., 2009).

- Will EU Member States retain the competence to negotiate and conclude BITs in the future?
- What is the legal status of existing BITs concluded by EU Member States?
- Is the EU capable of concluding international investment agreements comparable to BITs?

This Note argues that the EU's current system of BITs should remain intact in the short term because it provides for investment protection and arbitral dispute mechanisms of which there are no viable equivalents under the Lisbon Treaty. Part I provides a brief history of the development of the modern BIT. Part II offers an overview of the current, well-established system of both intra-EU BITs and extra-EU BITs. Part III describes the changes pertaining to FDI introduced by the Lisbon Treaty. Part IV examines the problems that will likely arise as a result of these changes and proposes the implementation of interim measures to facilitate the gradual transition from a system of Member States mixed competence to a system of EU exclusive competence. This Note concludes that while EU competence over FDI is a logical step in the movement toward a more streamlined, comprehensive, multilateral EU trade and investment system, an expedited overhaul of the current legal structure would foster uncertainty and be detrimental to the EU's continued ability to attract FDI and manage foreign-investor expectations.

I. BILATERAL INVESTMENT TREATIES AND THE EU LEGAL ORDER

A. A Brief History of BITs Concluded by EU Member States

The development of the modern BIT originated in Europe in the period following World War II,²⁹ at which time individual European countries began to negotiate treaties dealing exclusively with foreign investment.³⁰ The objective of these treaties was to protect foreign investors against uncompensated expropriation,³¹ an area not covered by customary inter-

29. See Salacuse & Sullivan, *supra* note 5, at 68 (stating that in the period after World War II, "foreign investors who sought the protection of international investment law encountered an ephemeral structure consisting largely of scattered treaty provisions, a few questionable customs, and contested general principles of law").

30. See RUDOLF DOLZER & MARGARET STEVENS, *BILATERAL INVESTMENT TREATIES* 10–11 (1995) (providing a historical context of BITs as an outgrowth of FCNs).

31. See Rodney Neufeld, *Trade and Investment*, in *THE OXFORD HANDBOOK OF INTERNATIONAL INVESTMENT LAW* 636–637 (Daniel Bethlehem et al. eds., 2009) (stating that "direct expropriation involves the taking of an investment by the host State through

national law.³² The first BIT was concluded between the Federal Republic of Germany and Pakistan in 1959,³³ after which several other European countries followed suit.³⁴ In the late 1980s, in efforts to attract foreign investment and to encourage economic development, several of the countries that now comprise Central and Eastern Europe concluded BITs with developed countries.³⁵ European countries alone concluded forty-seven BITs between January 2005 and June 2006.³⁶ While less than five hundred BITs were in force in the 1990s,³⁷ there are currently more than 2,600 in force.³⁸ BITs were initially concluded asymmetrically between a developed and a developing country,³⁹ but this arrangement is slowly

seizure of the property or interest, or through its compulsory transfer, for example, to a state-owned enterprise or domestic investor . . . an indirect expropriation often consists of a series of government acts that has the effect of rendering the investor's property rights useless").

32. See NEWCOMBE & PARADELL, *supra* note 12, at 41 (stating that the development of international investment agreements "was primarily a response to the uncertainties and inadequacies of the customary international law of state responsibility for injuries to aliens and their property"); see also M. SORNARAJAH, *THE INTERNATIONAL LAW ON FOREIGN INVESTMENT* 89 (2d ed. 2004) (stating that while it is a principle of customary law that when a host country unlawfully takes the property of the foreign investor it must compensate the foreign investor for this taking, there is considerable disagreement on this standard of compensation and how it should be calculated); Andrew T. Guzman, *Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639, 641 (1998) (Prior to WWII, expropriation of a foreign investor's property was governed by the "Hull Rule" under customary international law, which required that compensation for expropriation be "prompt, adequate, and effective." However, this rule fell out of favor following WWII).

33. See Pak.-F.R.G. BIT, *supra* note 15; see also UNCTAD, *Bilateral Investment Treaties in the Mid-1990s*, 177-179, U.N. Doc. UNCTAD/ITE/IIT/7 (1998) (reporting historical statistics of all of the BITs entered into by Germany); UNCTC, *Bilateral Investment Treaties*, 7, U.N. Doc. ST/CTC/65 (stating that Germany was particularly concerned with the future protection of its foreign investments, as it had lost all of its foreign assets following WWI and WWII).

34. See NEWCOMBE & LLUIS PARADELL, *supra* note 12, at 42-43 (stating that the capital-exporting states of Switzerland, the Netherlands, Italy, the Belgo-Luxembourg Economic Union (BLEU), Sweden, Denmark, Norway, France, and the UK began to conclude BITs soon after Germany).

35. See UNCTAD, *International Investment Rule-making: Stocktaking, Challenges and the Way Forward*, 15, U.N. Doc. UNCTAD/ITE/IIT/2007/3 (2008).

36. See Radu, *supra* note 17, at 238.

37. See *id.* at 237.

38. 2,676 BITs were in effect as of 2009. UNCTAD, *World Investment Report 2009: Transnational Corporations, Agricultural Development and Development*, xxii, U.N. Doc. UNCTAD/WIR/2009 (2009).

39. See UNCTAD, *Bilateral Investment Treaties 1959-1999*, 1-2, U.N. Doc. UNCTAD/ITE/IIA/2 (2000) (stating that BITs were initially concluded between a developed, capital-exporting country and a developing, capital-importing country. Developing

eroding as developing countries enter into BITs with other developing countries and transition economies pursue BITs on their own.⁴⁰

This expansive and growing network of BITs is a by-product of repeatedly failed efforts to establish an international investment framework.⁴¹ In 1995, the Organisation for Economic Co-operation and Development (“OECD”)⁴² attempted to negotiate the Multilateral Agreement on Investment (“MAI”).⁴³ The MAI sought to consolidate rules on international foreign investment into a single legal instrument that would be open to accession by both OECD and non-OECD members.⁴⁴ However, this agreement met a great deal of opposition and was consequently abandoned in 1998.⁴⁵ The objective of the MAI was resurrected in 2001 when the WTO Doha Ministerial Conference agreed to take up negotiations on trade and investment beginning in 2003, and established a negotiating group on trade and investment.⁴⁶ This plan was similarly abandoned in 2004.⁴⁷ Due to the lack of an international framework governing FDI, the dense network of BITs “[f]or all practical purposes . . . has become the fundamental source of international law in the area of foreign investment.”⁴⁸

B. The Basic Features of BITs

BITs contain substantive provisions for the protection of foreign investment as well as procedural provisions for investment dispute resolution.⁴⁹ In terms of substantive provisions, the vast majority of BITs iden-

countries entered into BITs in order to attract foreign investors and reap the benefits of FDI. However, beginning in the late 1980s, this paradigm shifted and BITs were increasingly concluded between two developing countries).

40. See Andrea K. Bjorklund, *Reconciling State Sovereignty and Investor Protection in Denial of Justice Claims* 45 VA. J. INT’L L. 809, 832 (2005).

41. See UNCTAD, *Lessons from the MAI*, U.N. Doc. No. UNCTAD/ITE/ITT/Misc.22 (1999).

42. The OECD, “based in Paris, is an organization of thirty leading industrialized countries that deals with economic and social issues of concern to its members.” It works with the Bretton Woods institutions and the WTO. CHOW & SCHOENBAUM, *supra* note 27, at 20–21.

43. See SORNARAJAH, *supra* note 32, at 291.

44. See Alfred Escher, *The Multilateral Investment Treaty*, in LEGAL ASPECTS OF FOREIGN DIRECT INVESTMENT 69 (Daniel D. Bradlow & Alfred Escher, eds. 1999).

45. See UNCTAD, *Lessons from the MAI*, *supra* note 41.

46. See CHOW & SCHOENBAUM, *supra* note 27, at 324.

47. *Id.*

48. SALACUSE & SULLIVAN, *supra* note 5, at 70.

49. See Theresa McGhie, *Bilateral and Multilateral Investment Treaties*, in LEGAL ASPECTS OF FOREIGN DIRECT INVESTMENT 109 (Daniel D. Bradlow & Alfred Escher eds., 1999).

tify the scope of investments covered under the respective treaty.⁵⁰ The very first BIT, between Germany and Pakistan, provided for a broad definition of “investment.”⁵¹ This inclusiveness is characteristic of the BITs concluded over the past fifty years.⁵² While the breadth of coverage of investment articulated in a BIT can vary based upon the intentions of the negotiating parties,⁵³ the prevailing definition adopted by BITs concluded by EU Member States describes “investment” as including “every kind of asset.”⁵⁴ This encompassing definition, thus, goes beyond the coverage of FDI⁵⁵ and can even extend protection to portfolio investments.⁵⁶

50. See DOLZER AND STEVENS, *supra* note 30, at 25–26.

51. See Pak.–F.R.G. BIT, *supra* note 15, art. 8 (stating that the term “investment shall comprise capital brought into the territory of the other Party for investment in various forms in the shape of assets such as foreign exchange, goods, property rights, patents and technical knowledge. The term “investment” shall also include the returns derived from and ploughed back into such “investment” . . . Any partnerships, companies or assets of similar kind, created by the utilization of the above-mentioned assets shall be regarded as “investment”).

52. “Investment” is typically defined very broadly in BITs, and includes both the tangible and intangible assets of the foreign investor. See SORNARAHAH, *supra* note 32, at 220–221.

53. See UNCTAD, *Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking*, 7, U.N. Doc. UNCTAD/ITE/IIA/2006/5 (2007) [hereinafter UNCTAD, *BITs 1995–2006*] (stating that some BITs define “investment” broadly, but additionally provide for a list of clarifications limiting or excluding particular kinds of investments).

54. DOLZER AND STEVENS, *supra* note 30, at 27; see also UNCTAD, *BITs 1995–2006*, *supra* note 53, at 8 (stating that the “asset-based” definition of “investment” usually includes “five categories of assets: first, movable and immovable property and any related property rights such as mortgages, liens or pledges, second, various types of interests in companies, such as shares, stock, bonds, debentures or any other form of participation in a company, business enterprise or joint venture; third, claims to money and claims under a contract having a financial value and loans directly related to a specific investment; fourth, intellectual property rights; and fifth, business concessions, that is rights conferred by law or under contracts”).

55. See UNCTAD, *BITs 1995–2006*, *supra* note 53, at 8; see also Neufeld, *supra* note 31, at 621 (“To ‘invest’ means to expend money, effort, or time into an undertaking with the intention of deriving profit. However, ‘foreign direct investment’ (FDI) implies something more than the mere purchase of shares for the sake of the interest, dividends or profits. Traditionally, States have distinguished FDI from other investment . . . FDI distinguishes itself from portfolio investment in that it ‘consists of a transaction made by a foreigner in a host state which is intended to set up a long term relationship with a party in the host state’”).

56. See Neufeld, *supra* note 31, at 622 (stating that portfolio investment is any type of foreign investment that is not classified as FDI); see also SORNARAHAH, *supra* note 32, at 227 (describing portfolio investment as “[investment] instruments connected with companies like shares or unconnected with them like promissory notes and bonds”).

BITs can vary in substantive detail, but their structure and general composition are relatively uniform.⁵⁷ They contain preliminary statements that articulate their purpose and aim, typically the “reciprocal encouragement and protection of investment flows between the two states.”⁵⁸ They provide for core protections including national treatment,⁵⁹ most favored nation (“MFN”) treatment,⁶⁰ compensation for expropriation,⁶¹ and rights to transfer capital and returns.⁶² Due to this protective framework for substantive rights, BITs play an important role in alleviating the concerns and vulnerabilities of foreign investors who assume the inherent risks associated with FDI.⁶³

In the event that a party to a BIT does not comply with its treaty obligations, BITs also contain provisions for investment dispute resolution.⁶⁴ Arguably, the most significant facet of BITs is their provision for investor-state dispute settlement, in which foreign investors may directly sub-

57. See SORNARAHAN, *supra* note 32, at 89.

58. *Id.* at 217.

59. In the context of BITs, national treatment refers to the “obligation of contracting parties to grant investors of the other contracting party treatment no less favourable than the treatment they grant to investments of their own investors. The effect is to create a level playing field between foreign and domestic investors in the relevant market.” UNCTAD, *BITs 1995–2006*, *supra* note 53, at 33.

60. In the context of BITs, the MFN treatment standard “means that investments or investors of one contracting party are entitled to treatment by the other contracting party that is no less favourable than the treatment the latter grants to investments or investors of any other third country.” *See id.* at 38.

61. J. Frederick Truitt, *Expropriation of Foreign Investment: Summary of the Post World War II Experience of American and British Investors in Less Developed Countries*, 1 J. INT’L BUS. STUDIES 21, 24 (1970) (defining expropriation as “an official taking by a sovereign state of the tangible property of alien corporate ownership with a view toward the continued exploitation of that property for the public utility of the expropriating state in lieu of continued ownership and control by private foreign enterprise”); *see also* Schwebel, *supra* note 9, at 265–266 (“If there is a taking by the state of the foreign investment, by means direct or indirect, the state is treaty-bound to pay prompt, adequate and effective compensation”).

62. *See* NEWCOMBE & PARADELL, *supra* note 12, at 43; *see also* Press Release, UNCTAD, *Analysis of Bilateral Investment Treaties Finds Growth in Agreements, New Areas of Focus*, UNCTAD/PRESS/IN/2007/014 (Dec. 4, 2007), *available at* <http://www.unctad.org/templates/Webflyer.asp?docID=8270&intItemID=1528&lang=1> (report concludes that “more countries concluding these treaties are placing greater emphasis on public concerns such as health, environment, core labour rights, national security, transparency in information exchange and rulemaking”).

63. The “basic assumptions behind BITs are that a bilateral treaty with clear and enforceable rules to protect and facilitate foreign investment reduces risks that the investor would otherwise face and that such reductions in risks, all things being equal, encourage investment.” Salacuse & Sullivan, *supra* note 5, at 77.

64. *See id.* at 87.

mit violations of BITs by a host state to international arbitration.⁶⁵ Foreign investors consider these arbitration proceedings, which are outside the jurisdiction of the host state, preferable to filing a claim against the host state in its domestic courts.⁶⁶ This is because this system prevents the host state from enjoying a “home court advantage.”⁶⁷

The main forum chosen for dispute settlement is the International Centre for Settlement of Investment Disputes (“ICSID”),⁶⁸ which was formally established in 1965 for the primary purpose of resolving disputes between host countries and foreign private investors.⁶⁹ Other forums for dispute arbitration include the International Center for Dispute Resolution, the International Chamber of Commerce, and the Arbitration Institute of the Stockholm Chamber of Commerce.⁷⁰ According to statistics from the United Nations Conference on Trade and Development, by the end of 2007, there were two hundred and ninety known investment treaty arbitrations, the majority of which were commenced under BITs.⁷¹ While

65. See Alexandrov, *supra* note 18. (The judgments awarded in these arbitrations are binding, and may require that the host state “pay substantial monetary damages to the injured investor”); see also Jarrod Wong, *Umbrella Clauses in Bilateral Investment Treaties: Of Breaching of Contract, Treaty Violations, and the Divide Between Developing and Developed Countries in Foreign Investment Disputes*, 14 GEO. MASON L. REV. 135, 142 (2006). Wong explains: “[s]ignificantly, only states (and not the investors) enter into BITs. Notwithstanding, the investor is able to enforce directly its rights under the BIT through the BIT’s dispute settlement provisions.” *Id.* at 142; Salacuse & Sullivan, *supra* note 5, at 88 (stating that “granting a private party the right to bring an action in an international tribunal against a sovereign state with respect to an investment dispute is a revolutionary innovation that now seems to be taken for granted”); Schwebel, *supra* note 9, at 267 (stating that “[t]his extraordinary innovation displaces the uneven intervention of states in exercise of their right of diplomatic protection of the interests of their nationals by according the foreign investor standing under international law, by virtue of the treaty, to pursue arbitration against the host state”).

66. See Schwebel, *supra* note 9, at 263 (Foreign investors seeking legal recourse for the violation of BIT provisions may consider the domestic courts to be biased against them. The foreign investor could alternatively seek legal intervention from the country of which they were a national, but this too was not always an effective route for the foreign investor).

67. George M. von Mehren, *Navigating Through Investor-State Arbitrations – An Overview of Bilateral Investment Treaty Claims*, 59 DISP. RESOL. J. 69, 70 (1994).

68. Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, Mar. 18, 1965, 17 U.S.T. 1270, 575, U.N.T.S. 159 [hereinafter ICSID Convention].

69. See SORNARAJAH, *supra* note 32, at 250.

70. See von Mehren, *supra* note 67, at 70.

71. Between 1987 and 2007, seventy-eight percent of investment treaty arbitrations were brought on allegations of the violation of a BIT. See UNCTAD, *Latest Developments in Investor-State Dispute Settlement*, 1, U.N. Doc. UNCTAD/WEB/IIA/2008/3 (2008).

these arbitrations have been criticized for their lack of uniformity and transparency in decision-making,⁷² they nevertheless offer benefits to host countries and investors.⁷³ Dispute settlement provisions in BITs providing for this type of arbitration enable host countries to attract foreign investment, and allow foreign investors to “manage the risk associated with investing in a foreign country.”⁷⁴

II. THE RELATIONSHIP BETWEEN BITS AND THE PRE-LISBON EU LEGAL ORDER

A. The Division of Competences

The structure of the EU legal order is quite complex, consisting of a supranational legal system which coexists alongside the legal systems of the individual Member States.⁷⁵ Under this arrangement, Member States transfer some of their national sovereignty to the European Community (“EC”),⁷⁶ and in effect become governed by Community law.⁷⁷ Up until the passage of the Lisbon Treaty, the primary sources of Community law were a set of treaties which formed the basis for “everything the EU does.”⁷⁸ The most important of these treaties are the EC Treaty⁷⁹ (also

72. For an in-depth discussion of the negative impact of inconsistent interpretations of BITs by ad hoc arbitration panels, see CONNOLLY, *supra* note 10. See generally Susan Franck, *The Legitimacy Crisis in Investment Treaty Arbitration: Privatizing Public International Law Through Inconsistent Decisions*, 73 *FORDHAM L. REV.* 1521 (2005).

73. See von Mehren, *supra* note 67, at 76.

74. *Id.*

75. See Matej Avbelj, *The EU and the Many Faces of Legal Pluralism. Toward a Coherent or Uniform EU Legal Order?*, 2 *CROATION YEARBOOK OF EUROPEAN LAW AND POLICY* 377, 380 (2006).

76. See DERRICK WYATT & ALAN ASHWOOD, *EUROPEAN UNION LAW* 125 (5th ed. 2006); see also Case 26/62, *Van Gend en Loos V. Nederlandse Administratie der Melastingen*, 1963 *E.C.R.* 3, Summary ¶ 3 (stating that “the European Economic Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights, albeit within limited fields, and the subjects of which comprise not only the Member States but also their nationals”); CHOW & SCHOENBAUM, *supra* note 27, at 124 (stating that the EU’s structure consists of “three pillars,” one of which is the EC which carries out the legal functions of the EU).

77. See JEAN-VICTOR LOUIS, *THE COMMUNITY LEGAL ORDER* 11 (European Communities 2d ed. 1990).

78. The Lisbon Treaty amends, but does not replace these treaties. To avoid confusion, Part II.C of this Note discusses the EC Treaty and the EU Treaty in the present tense, as the majority of their provisions remain intact; see also KAREN DAVIES, *UNDERSTANDING EUROPEAN UNION LAW* 48 (3rd ed. 2007) (stating that these treaties include the Treaty establishing the European Coal and Steel Community 1951; the Treaty establishing the European Atomic Energy Community 1957; the Treaty establishing the European Economic Community 1957; the Merger Treaty 1965; the Budgetary Treaties

known as the Treaty of Rome or the Treaty establishing the European Economic Community) and the EU Treaty⁸⁰ (also known as the Maastricht Treaty or the Treaty on the European Union). The EC Treaty is the major governing instrument in the EU, regarded as a kind of constitution.⁸¹ Its scope includes economic, social, environmental, and regional policies.⁸² The EC Treaty seeks “to lay the foundation of an ever closer union among the peoples of Europe,” and to “strengthen the unity” of the Member State economies.⁸³ The EU Treaty, which entered into force in 1994, created the “three pillar” structure that forms the basis of the “European Union.”⁸⁴ In its preamble, the EU Treaty sets as its objective the “strengthening and the convergence” of the Member State economies.⁸⁵ Thus, together these treaties set forth the broad goals of integrating the EU Member States and facilitating cooperation at the political, social, and in particular, economic level.

Despite the EU’s broad goal of an integrated Europe, it may only act within the confines of the powers attributed to it by Community law under various treaties.⁸⁶ Community competence, or sovereignty, is divided into three principal categories: exclusive, shared, and supporting.⁸⁷ In areas of exclusive Community competence, power is held solely by the

1970 and 1975; the Single European Union Act 1986; the Treaty on European Union 1992; the Treaty of Amsterdam 1997; the Treaty of Nice 2000.)

79. See EC Treaty, *supra* note 22.

80. See Treaty on European Union (EU), 7 February 1992, 1992 O.J. (C 191) 1, 31 I.L.M. 253 [hereinafter EU Treaty].

81. LINDA SENDEN, *SOFT LAW IN EUROPEAN COMMUNITY LAW* 37 (2004). Because the EC Treaty is the most comprehensive treaty governing the EU, the EU law discussed in this Note relies predominantly on the EC Treaty.

82. See *Id.*

83. EC Treaty, *supra* note 22, at preamble.

84. See *How the European Union Works: Your Guide to the EU Institutions*, E.U. Commission, <http://www.eurunion.org/infores/HowEUWorks072007.doc> (last visited June 2010).

85. See EU Treaty, *supra* note 80, at preamble. For the sake of avoiding confusion, this Note refers to the European Union to mean both the European Economic Community created by the EC Treaty and the European Union as it stands today.

86. See *e.g.*, EC Treaty, *supra* note 22, art. 5(1) (stating that the Community “shall act within the limits of the powers conferred upon it by this Treaty and all of the objectives assigned to it herein”); see also EC Treaty, *supra* note 22, art. 5(2) (stating that “in areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives if the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community; EC Treaty, *supra* note 22, art. 5(3) (stating that “any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty”).

87. See WYATT & ASHWOOD, *supra* note 76, at 91–97.

Community.⁸⁸ Member States cannot act autonomously, but rather, can only act if authorized by the Community.⁸⁹ In the category of shared competence, both the Community and the Member States are competent to exercise their shared regulatory power in a given area.⁹⁰ However, in exercising this power, Member States must concurrently comply with their obligations under the provisions of the various treaties.⁹¹ Finally, under the category of supporting competence, the Community establishes broad goals in a field, but the Member States retain exclusive regulatory power to act.⁹² In summary, the Community cannot act unless it has the authority to do so under the Treaties; Member States retain competence in areas that have not been specifically delegated to the EC.⁹³

Based on the division of competences under the EC Treaty, both the EU and the Member States retain regulatory control over different aspects of foreign investment.⁹⁴ The EU can exercise its competence by adopting measures relating to foreign investment to the extent that it acts “within the limits of the power conferred upon it” by the EC Treaty.⁹⁵ The EC Treaty contains a number of provisions relating to foreign investment. Under Articles 43 and 48 through 56, the Treaty provides for rights of establishment.⁹⁶ Articles 56 through 60 deal with movement of capital.⁹⁷ Under Article 310, the Treaty gives the Community the power to conclude agreements relating to reciprocal rights and obligations.⁹⁸ Finally, under Article 181, the EU can conclude agreements with developing countries.⁹⁹ Thus, all of these provisions touch upon the EU’s internal and external competence relating to foreign investments. For that reason, these provisions are coterminous with BITs.¹⁰⁰ However, while

88. See DAVIES, *supra* note 78, at 25; see also WYATT & ASHWOOD, *supra* note 76, at 91–92 (Under the EC Treaty, exclusive competence has been uncontroversial in only three cases: the regulation of external trade under the common commercial policy, which is based upon Article 133 EC; the conservation of marine biological resources; and monetary policy for those Member States which have adopted the euro).

89. See WYATT & ASHWOOD, *supra* note 76, at 91.

90. *Id.* at 92.

91. *Id.*

92. *Id.* at 95.

93. *Id.*

94. See Eilmansberger, *supra* note 20, at 389.

95. See EC Treaty, *supra* note 22, art. 5(1); see also Jan Ceysens, *Towards a Common Investment Policy? – Foreign Investment in the European Constitution*, 32 *LEGAL ISSUES OF ECON. INTEGRATION* 260 (2005).

96. EC Treaty, *supra* note 22, art. 43–48.

97. *Id.* art. 56–60.

98. *Id.* art. 310.

99. *Id.* art. 181.

100. See *supra* Part I.B.

the EC Treaty contains investment-related provisions, because it does not confer exclusive competence over foreign investment upon the EU, nor does it confer upon the EU the power to conclude international investment agreements with non-EU countries, these areas fall within the competence of the EU Member States.¹⁰¹

Since the EU has limited powers to adopt measures pertaining to foreign investment under the EC Treaty, EU Member States predominantly exercise competence in this field.¹⁰² Member States have largely implemented this power through the negotiation and conclusion of BITs.¹⁰³ However, the interaction between provisions contained in BITs and the EU legal order can lead to overlap and incompatibility issues.¹⁰⁴ The interface between BITs entered into by EU Member States and the EU legal order is significant in two contexts: intra-EU BITs, and extra-EU BITs.¹⁰⁵

B. Intra-EU BITs

The majority of intra-EU BITs resulted from the relatively recent accession of twelve Central and Eastern European nations to the European Union.¹⁰⁶ These countries entered into BITs with EU Member States prior to their accession, creating the current situation in which both parties to the BIT are now Member States.¹⁰⁷ The number of intra-EU BITs is quite significant;¹⁰⁸ approximately 190 BITs of this nature are current-

101. See WYATT & ASHWOOD, *supra* note 76, at 91–97.

102. See Ceysens, *supra* note 95, at 259; see also Soderlund, *supra* note 21, at 461.

103. See Ceysens, *supra* note 95, at 268.

104. See Radu, *supra* note 17, at 238 (explaining the difficulty encountered by EU Member States in concluding BITs that do not conflict with EU law and that do not prejudice foreign investors).

105. See Potesta, *supra* note 19, at 225.

106. In 2004, 10 countries acceded to the EU, including Malta, Cyprus, Slovenia, Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, and Hungary. Most recently, Bulgaria and Romania acceded in January 2007. *2000-Today: A Decade of Further Expansion*, EUROPA.EU, http://europa.eu/abc/history/2000_today/index_en.htm (last visited Dec. 21, 2009); see also Soderlund, *supra* note 21, at 455 (stating that there are two BITs concluded between “old” EU Member States. Germany concluded BITs with Portugal and Greece prior to their accession to the EU in 1980 and 1986, respectively. However, no foreign investor has invoked either of these BITs in bringing an investment dispute against one of these countries).

107. See Soderlund, *supra* note 21, at 455.

108. “The top signatories – Germany, UK France, Italy, The Netherlands, Belgium and Luxembourg – count more than 500 BITs. From January 2005 to June 2006 only, European countries concluded 47 BITs.” Radu, *supra* note 17, at 237.

ly in force.¹⁰⁹ The recent influx of intra-EU BITs has generated a number of questions concerning the relationship between EU law and the obligations these countries have undertaken through BITs.¹¹⁰ These questions include whether intra-EU investment issues are governed by EC law or the domestic law of the Member States, whether intra-EU BITs are superseded by EC law, and whether intra-EU investor-state arbitration mechanisms conflict with the EC legal order.¹¹¹

These uncertainties were recently addressed through arbitral proceedings in *Eastern Sugar B.V. v. Czech Republic*.¹¹² In 1991, the Czech and Slovak Federal Republic, seeking to attract FDI to its newly established free market economy, entered into a BIT with the Netherlands.¹¹³ In 1993, the Czech and Slovak Federal Republic separated into two sovereign states, and the Czech Republic assumed the international obligations arising from the BIT concluded with the Netherlands.¹¹⁴ In 2003, an investment dispute arose between Dutch sugar producer Eastern Sugar B.V. and the Czech Republic.¹¹⁵ In December 2003, the dispute was submitted to an ad hoc arbitral tribunal of the United Nations Commission on International Trade Law (“UNCITRAL”) pursuant to Article 8 of the BIT.¹¹⁶ Article 8 provides in pertinent part that “[e]ach Contracting Party hereby consents to submit a dispute . . . to an arbitral tribunal . . . [which] shall determine its own procedure applying the arbitration rules of UNCITRAL.”¹¹⁷ Subsequently, in 2004, the Czech Republic acceded to the EU pursuant to the Accession Treaty of April 16, 2003.¹¹⁸ Because

109. For figures on BITs entered into by each EU Member State, see Country-Specific Lists of BITs, UNCTAD, <http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1> (last visited Dec. 22, 2009); see also Radu, *supra* note 17, at 238 (stating that the proliferation of BITs between countries in the Eastern bloc exceeded 150 prior to these countries acceding to the EU).

110. See Alexandrov, *supra* note 18.

111. See Soderlund, *supra* note 21, at 460.

112. *Eastern Sugar B.V. v. Czech Republic*, Partial Award, SCC No. 088/2004, UNCITRAL (Mar. 27, 2007) [hereinafter *Eastern Sugar*].

113. Agreement on Encouragement of Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic, Neth.-Czech Rep.-Slovk., Apr. 24, 1991. See also *Eastern Sugar*, *supra* note 112, ¶ 2 (stating that until 2002, the Czech Republic had concluded BITs with all countries that are currently EU Member States).

114. See *Eastern Sugar*, *supra* note 112, ¶ 5.

115. See *id.* ¶ 12.

116. See *id.* ¶ 13.

117. See Agreement on encouragement and protection of investments, Czech Republic-Netherlands, *supra* note 112, art. 8.

118. See *Eastern Sugar*, *supra* note 112, ¶ 14.

the Netherlands was already an EU Member State, the BIT effectively became an intra-EU BIT.

In this investment dispute, the foreign investor of Eastern Sugar B.V. alleged that Czech authorities discriminated against him by issuing three decrees that adversely affected Eastern Sugar.¹¹⁹ The tribunal found that the Czech Republic had violated the fair and equitable treatment standard set forth in Article 3(1) of the BIT because one of the decrees that it issued unduly “targeted” Eastern Sugar and constituted a “discriminatory and unreasonable measure,”¹²⁰ and awarded 25 million Euros in damages to Eastern Sugar.¹²¹ While this award was substantial, the tribunal’s decision is particularly significant for its discussion of intra-EU BITs and the tribunal’s holding that the mere fact of accession of a country to the EU does not render an intra-EU BIT irrelevant or invalid.¹²²

The Czech Republic argued that the arbitral tribunal lacked jurisdiction over claims brought by Eastern Sugar to the extent that they pertained to a time subsequent to the Czech Republic’s accession to the EU.¹²³ According to the Czech Republic, when it became an EU Member State, “this changed the relationship that it had with the Netherlands sufficiently to terminate or limit the application of the BIT implicitly, and as a result, to put an end to the benefits and protection enjoyed under the BIT by a Dutch investor such as Eastern Sugar.”¹²⁴

Pursuant to the UNCITRAL Arbitration Rules, it was the role of the arbitral tribunal to determine on its own whether or not it had jurisdiction over the dispute.¹²⁵ The tribunal noted that neither the Europe Agreement, under which the Czech Republic became a candidate for EU accession, nor the Accession Treaty, pursuant to which the Czech Republic ultimately acceded to the EU, “provide *expressly*” that the BIT would be terminated.¹²⁶ Furthermore, the BIT itself did not state that it would be

119. See Potesta, *supra* note 19, at 227.

120. See Eastern Sugar, *supra* note 112, ¶¶ 335–338. See also Agreement on encouragement and protection of investments, Czech Republic-Netherlands, *supra* note 113, art. 3(1) (stating that “[e]ach Contracting Party shall ensure fair and equitable treatment to the investors of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors”).

121. See Eastern Sugar, *supra* note 112, ¶ 368.

122. See Marek Wierzbowski & Aleksander Gubrynowicz, *Conflict of Norms Stemming from Intra-EU BITs and EU Legal Obligations: Some Remarks on Possible Solutions in INTERNATIONAL INVESTMENT LAW FOR THE 21ST CENTURY* 552–553 (2009).

123. See Eastern Sugar, *supra* note 112, ¶ 112.

124. *Id.* ¶ 117.

125. *Id.* ¶ 116.

126. *Id.* ¶ 143.

terminated in the case that both parties became EU Member States.¹²⁷ The arbitral tribunal proceeded to analyze the relationship between the Czech Republic-Netherlands BIT and the EC Treaty under the Vienna Convention on the Law of Treaties (“VCLT”).¹²⁸

Under Article 42 of the VCLT, a treaty is only terminated according to its own terms, or the terms of the VCLT.¹²⁹ Article 59 of the VCLT provides that a treaty is terminated if 1) all the parties to it conclude a later treaty relating to the “same subject matter,” 2) the later treaty established that the parties “intended to be governed by that treaty,” or 3) the provisions of the later treaty “are so far incompatible with those of the earlier one that the two treaties are not capable of being applied at the same time.”¹³⁰ The arbitrators concluded that none of these conditions were

127. See Agreement on Encouragement and Protection of Investments, Czech Republic-Netherlands, *supra* note 113, art. 13(2) (“Unless notice of termination has been given by either Contracting Party at least six months before the date of the expiry of its validity, the present Agreement shall be extended tacitly for periods of ten years, each Contracting Party reserving the right to terminate the Agreement upon notice of at least six months before the date of expiry of the current period of validity”).

128. Vienna Convention on the Law of Treaties, *opened for signature* May 23, 1969, 115 U.N.T.S. 331 (entered into force on Jan. 27, 1980) [hereinafter Vienna Convention]. The Vienna Convention is a treaty concerning customary international law on treaties between states, and is binding upon its signatories. As of May 2009, it has been ratified by 109 parties, including the Czech Republic and the Netherlands. The treaty provides the general rules for treaty interpretation.

129. Vienna Convention, *supra* note 128, art. 42. Article 42 of the Vienna Convention, *Validity and continuance in force of treaties*, reads in its entirety:

- (1) The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the present Convention.
- (2) The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the present Convention. The same rule applies to suspension of the operation of a treaty.

130. Vienna Convention, *supra* note 128, art. 59. Article 59 of the Vienna Convention, *Termination or suspension of the operation of a treaty implied by conclusion of a later treaty*, reads in its entirety:

- (1) A treaty shall be considered terminated if all the parties to it conclude a later treaty relating to the same subject matter and (a) it appears from the later treaty or is otherwise established that the parties intended that the matter should be governed by that treaty; or (b) the provisions of the later treaty are so far incompatible with those of the earlier one that the two treaties are not capable of being applied at the same time;

met, and affirmed the tribunal's jurisdiction over the proceedings.¹³¹ Thus, the tribunal held that "EU law has not *automatically* superseded the BIT as a result of the accession of the Czech Republic to the EU."¹³²

Considering the number of intra-EU BITs currently in force and the potential for the interaction between those BITs and the EU legal order to be a factor raised in future arbitral proceedings, the *Eastern Sugar* decision is significant beyond this particular tribunal's decision. The EC Commission has pressured the Member States to terminate, or at the very least to renegotiate, the BITs to which they are a party in order to avoid the disparate obligations that stem from the BITs and EU Law.¹³³ The Commission takes the position that "there appears to be no need for agreements of this kind in the single market" because "it would appear that their content is superseded by Community law."¹³⁴ Some countries have followed this suggestion.¹³⁵ For example, in 2008, the BIT between Italy and Hungary was terminated, and in 2009, the Czech Republic initiated the termination process for 23 BITs it had concluded with EU Member States prior to its EU-accession.¹³⁶

However, the majority of Member States believe that the existing BIT framework should be maintained.¹³⁷ According to their position, Member States should be able to conclude treaties amongst themselves, and those

(2) The earlier treaty shall be considered as only suspended in operation if it appears from the later treaty or is otherwise established that such was the intentions of the parties.

131. See *Eastern Sugar*, *supra* note 112, ¶¶ 159–171.

132. See *id.* ¶ 172; see also Soderlund, *supra* note 21, at 455 (stating that in future scenarios like that of *Eastern Sugar* in which host states raise the jurisdictional defense that a BIT is no longer operative because it became an intra-EU BIT, these foreign investors will be likely unsuccessful in invoking this defense).

133. See Wierzbowski, *supra* note 122, at 555.

134. EU Members Review Intra-European BITs in Light of Potential Overlap with EU Law, INVESTMENT TREATY NEWS, 20 June 2007.

135. See *id.*; see also Alfred Escher, *Current Developments, Legal Challenges and Definition of FDI*, in LEGAL ASPECTS OF FOREIGN DIRECT INVESTMENT 16–19 (Daniel D. Bradlow & Alfred Escher eds., 1999) for a brief discussion of the EU's goal of "furtherance of economic integration and the facilitation of cross-border investments within the EU." *Id.* at 18.

136. See UNCTAD, *Recent Developments in International Investment Agreements*, *supra* note 16, at 5; see also *Bilateral Investment Treaties and the EU*, <http://www.cms-aacs.com/bilateral-investment-treaties-and-the-eu-05-26-2009> (last visited Dec. 16, 2009) (stating that despite a degree of uncertainty regarding the interface between intra-EU BITs and the EU legal order, the Czech Republic should reconsider its plans to terminate its intra-EU BITs, as they provide comfort to foreign investors).

137. See *EU Member States Reject the Call to Terminate Intra-EU Bilateral Investment Treaties*, INVESTMENT TREATY NEWS, 10 February 2009.

treaties currently in force between Member States should remain so as long as the Member States comply with their obligations under the EC Treaty.¹³⁸ At this time, the issue has not been brought to the European Court of Justice (“ECJ”),¹³⁹ and thus, the potential for inconsistent decisions by arbitral tribunals leaves the status of intra-EU BITs unclear.¹⁴⁰

C. Extra-EU BITs

Incompatibility problems also arise in the context of extra-EU BITs. Under Article 307(2) of the EC Treaty, Member States “shall take all appropriate steps to eliminate the incompatibilities” between their treaty obligations with non-EU countries and their obligations under the EC Treaty.¹⁴¹ This treaty provision suggests that recently acceded Member States must renegotiate their BITs with non-EU Member States in order to eliminate inconsistency with EU law.¹⁴² However, under Article 307(1) of the EC Treaty, the “rights and obligations arising from agreements . . . or acceding States, before the date of their accession, between one or more Member State on the one hand, and one or more third countries on the other, shall not be affected by the provisions of this Treaty.”¹⁴³ Nonetheless, several Member States have followed the suggestion of the Commission. For example, in 2003, the European Commission, the United States, and eight Central Eastern European Countries preparing to join the European Union, signed a Memorandum of Understanding (MOU), which ensured that the BITs concluded between the U.S. and these acceding countries were compatible with the EU’s laws and regula-

138. See Lorenza Mola, *Which Role for the EU in the Development of International Investment Law?* para. 5.1 (Soc’y of Int’l Econ. Law, Working Paper No. 27/08, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1154583.

139. The jurisdiction of the ECJ includes the power to bring enforcement actions against Member States. In the future the European Commission may bring a direct action against Member States that it deems are failing to fulfill its obligations under EU law by refusing to terminate intra-EU BITs. See DAVIES, *supra* note 78, at 40–41; see also CHOW & SCHOENBAUM, *supra* note 27, at 125 (stating that the ECJ consists of one judge from each EU Member State and has the final word in interpreting the EC Treaty).

140. See Potesta, *supra* note 19, at 238.

141. EC Treaty, *supra* note 22, art. 307.

142. See UNCTAD, *Recent Developments in International Investment Agreements*, *supra* note 16, at 5 (stating that “in 2008 the Czech Republic concluded five protocols on the amendment to original BITs, a process reported as negotiations of BITs. These negotiations are in response to article 307 of the Treaty establishing the European Community (EC Treaty) and seek to bring the country’s BITs into conformity with EU law”); see also UNCTAD, *World Investment Report 2003: FDI Policies for Development; National and International Perspectives*, *supra* note 3, at 59 (stating that “EU-accession countries will have to harmonize their FDI regimes with EU regulations”).

143. EC Treaty, *supra* note 22, art. 307.

tions.¹⁴⁴ While the MOU represents forward progress in the elimination of existing incompatibilities, it does not have legal force and only applies to the specific BITs designated in the memorandum.¹⁴⁵ For that reason, all other extra-EU BITs remain susceptible to compatibility issues.¹⁴⁶

The incompatibility problems arising from the relationship between the EU legal order and extra-EU BITs were recently addressed in *European Commission v. Republic of Austria*¹⁴⁷ and *European Commission v. Republic of Sweden*.¹⁴⁸ In these cases, the European Commission brought infringement proceedings under Article 307(2) of the EC Treaty against Austria and Sweden; the Commission alleged that the countries had failed to harmonize provisions contained in BITs with non-EU Member States negotiated prior to their accession to the EU with EU law.¹⁴⁹ Prior to their accession to the EU, Austria and Sweden entered into BITs with several non-European countries.¹⁵⁰ All of these BITs contained clauses “under which each party guarantee[d] to the investors of the other party . . . the free transfer . . . of payments connected with an investment.”¹⁵¹ In

144. See *Eight Acceding Countries and U.S. Sign Bilateral Investment Understanding*, EUR. UNION DELEGATION TO THE U.S.A. (Sept. 23, 2003), http://www.eurunion.org/eu/index.php?option=com_content&task=view&id=2079&Itemid=58 (stating that “A number of provisions in the BITs were contrary to the existing EU legislation and needed to be amended prior to accession. The acceding countries concerned are Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Poland, Romania and Slovakia. The European Commission is pleased that a satisfactory solution has been found, showing that EU enlargement can be beneficial to third countries”).

145. See Radu, *supra* note 17, at 238.

146. See *id.*

147. See C-205/06, *European Commission v. Republic of Austria*, [2009] E.C.R. [hereinafter *Austria Proceedings*].

148. See C-249/06, *European Commission v. Republic of Sweden*, [2009] E.C.R. [hereinafter *Sweden Proceedings*].

149. See *Austria Proceedings*, *supra* note 147; *Sweden Proceedings*, *supra* note 148; see also EC Treaty, *supra* note 22, art. 226 (explaining that if the Commission believes that a Member State has failed to fulfill an obligation under the EC Treaty, it shall give the country formal notice of its opinion on the matter and provide the country with the opportunity to submit its own observations. If the country does not comply with the Commission’s opinion, the Commission can commence infringement proceedings against a Member State which it believes has infringed upon Community law); EC Treaty, *supra* note 22, art. 230 (stating that the ECJ has jurisdiction over infringement proceedings brought by the European Commission against Member States); Potesta, *supra* note 19, at 238.

150. See *Austria Proceedings*, *supra* note 147, ¶ 1 (listing the countries that Austria entered into BITs with prior to its EU-accession); *Sweden Proceedings*, *supra* note 148, ¶ 1 (listing the countries that Sweden entered into BITs with prior to its EU-accession).

151. See *Austria Proceedings*, *supra* note 147, ¶ 3; *Sweden Proceedings*, *supra* note 148, ¶ 3.

both cases, the Commission objected to these clauses, maintaining that they precluded Austria and Sweden from complying with their obligations under the EC Treaty.¹⁵² Because these EC Treaty provisions guaranteed the free transfer of capital, they clashed with Article 57(2),¹⁵³ Article 59,¹⁵⁴ and Article 60¹⁵⁵ of the EC Treaty, which enable the EU to regulate movement of capital between EU Member States and non-EU countries, as well as restrict the flow of capital in exceptional circumstances.¹⁵⁶ Thus, the Commission argued that Austria and Sweden failed to take appropriate steps to eliminate incompatibilities with their obligations under these BITs and under the EC Treaty.¹⁵⁷

The major point of contention in *European Commission v. Republic of Austria* and *European Commission v. Republic of Sweden* was the extent to which Article 307(2) of the EC Treaty requires Member States to ensure that their BITs with non-EU countries comply with EU law.¹⁵⁸ In regards to the pertinent EC Treaty articles, the Commission had never before had the opportunity to exercise its powers.¹⁵⁹ In other words, no situation had ever arisen in which the Commission found it necessary to exercise its competence and adopt measures pursuant to Article 57(2), Article 59, or Article 60 of the EC Treaty. Therefore, the incompatibility alleged by the Commission was “merely hypothetical until the Council adopt[ed] the relevant provisions.”¹⁶⁰ The Commission argued that the Member States were required to eliminate even potential compatibilities

152. See Austria Proceedings, *supra* note 147, ¶ 6; Sweden Proceedings, *supra* note 148, ¶ 6.

153. See EC Treaty, *supra* note 22, art. 57(2). Under Article 57(2), the European Council may adopt measures on the movement of capital to and from non-EU countries “which constitute a step back in Community law as regards the liberalisation of the movement of capital to or from third countries.”

154. See EC Treaty, *supra* note 22, art. 59. Under Article 59, the Council may take safeguard measures restricting capital flows to non-EU countries in “exceptional circumstances” if it deems such measures to be “strictly necessary.”

155. See EC Treaty, *supra* note 22, art. 60. Under Article 60, the Council may “take the necessary urgent measures on the movement of capital and on payments as regards the third countries concerned.”

156. See Austria Proceedings, *supra* note 147, ¶ 11; Sweden Proceedings, *supra* note 148, ¶ 11.

157. See Austria Proceedings, *supra* note 147, ¶ 6; Sweden Proceedings, *supra* note 148, ¶ 6.

158. See Potesta, *supra* note 19, at 241.

159. *Id.* at 238.

160. *Id.* at 241.

when Article 307 is read in conjunction with Article 10 of the EC Treaty.¹⁶¹ Article 10 sets forth a duty of loyalty and cooperation, under which:

Member States shall take all appropriate measures, whether general or particular, to ensure fulfillment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks. They shall abstain from any measure which could jeopardize the attainment of the objectives of this Treaty.¹⁶²

While the ECJ did not adopt the Commission's reasoning, it nevertheless held that the Member States had breached their obligations under Article 307 of the EC Treaty.¹⁶³

As was the case in *Eastern Sugar*, the implications of the court's decisions extend beyond the BITs concluded by Austria and Sweden, as other EU Member States are parties to hundreds of BITs with non-EU countries. In its judgments, the ECJ clarified that its holding does not apply only to Austrian and Swedish BITs entered into with non-EU countries, but to all Member States that are parties to BITs containing similar provisions.¹⁶⁴ In general, the judgments reflect a broad interpretation of Article 307, suggesting that Member States must eliminate even potential incompatibilities between the BITs and EC law.¹⁶⁵ In this way, endless scenarios for incompatibility can be envisioned.¹⁶⁶ Unless the Council takes it upon itself to bring infringement proceedings against Member States that are encroaching on EU law through their BITs, the individual Member States are unlikely to examine their BITs on their own accord, identify potential incompatibilities, and then work with the non-EU country to amend the treaty.¹⁶⁷

III. BITS AND THE EU LEGAL ORDER POST-LISBON

On December 1, 2009, the Lisbon Treaty entered into effect.¹⁶⁸ The treaty amends the current principal sources of law of the EU, namely the

161. See *Austria Proceedings*, *supra* note 147, ¶ 11; *Sweden Proceedings*, *supra* note 148, ¶ 11.

162. See EC Treaty, *supra* note 22, art. 10.

163. See *Austria Proceedings*, *supra* note 147, ¶ 45; *Sweden Proceedings*, *supra* note 148, ¶ 45.

164. See *Austria Proceedings*, *supra* note 147, ¶ 43; *Sweden Proceedings*, *supra* note 148, ¶ 43.

165. See Potesta, *supra* note 19, at 243.

166. See *id.*

167. See *id.* at 237.

168. See *Treaty of Lisbon: Taking Europe into the 21st Century*, EUROPA.EU, http://europa.eu/lisbon_treaty/index_en.htm (last visited June 1, 2010); see also Dan Bi-

EC Treaty and the EU Treaty.¹⁶⁹ After years of debate, the Lisbon Treaty extends EU competence to the fields of trade and services, trade related aspects of intellectual property, and, in a “major innovation, to foreign direct investment.”¹⁷⁰ These fields are all brought within the ambit of the Common Commercial Policy (“CCP”), the section of the Lisbon Treaty which establishes the basis of the EU’s legal position in its international economic relations, as well as one of the few areas in which the EU retains exclusive competence.¹⁷¹ This marks a significant departure from the EC Treaty prior to the Lisbon amendments, under which the CCP only extended to the field of external trade.¹⁷² In this way the Lisbon Treaty “reflects a new governance arrangement and legal order that was not contemplated by the current investment system.”¹⁷³

Because the Lisbon Treaty very recently entered into effect, it remains to be seen how its new provisions under the CCP will be interpreted and applied. However, the Lisbon Treaty certainly has the potential to present considerable implications for the relationship between the EU legal order and the system of BITs with respect to the contentious realm of FDI.¹⁷⁴ While neither the EC Treaty nor the EU Treaty contain provisions specifically referencing FDI, Article 206 and Article 207(1) of the Lisbon Treaty unequivocally bring FDI under the auspice of the CCP.¹⁷⁵ The

lefsky & Stephen Castle, *Way is Clear to Centralize Europe’s Power*, N.Y. TIMES, Nov. 4, 2009, at A6 (stating that on November 3, 2009, the Lisbon Treaty “cleared its last major hurdle,” as the president of the Czech Republic was the last European leader to sign the treaty).

169. See *Treaty of Lisbon: Taking Europe into the 21st Century*, *supra* note 168.

170. See Stephen Woolcock, *The Potential Impact of the Lisbon Treaty on European Union External Trade Policy*, SWEDISH INST. FOR EUR. POL’Y ANALYSIS, June 2008, at 1.

171. See Bungenberg, *supra* note 28, at 124.

172. EC Treaty, *supra* note 22, art. 133.

173. See L. Yves Fortier, Chairman, Address at the British Institute of International and Comparative Law 50th Anniversary Series, Investment Protection and the Rule of Law: Change or Decline? (Mar. 17, 2009).

174. See Woolcock, *supra* note 170, at 4.

175. See Lisbon Treaty, *supra* note 25. The Lisbon Treaty inserts the new heading “External Action by the Union.” Under this heading, Title II sets forth the “Common Commercial Policy.” Article 131 of the EC Treaty, *supra* note 22, read: “By establishing a customs union between themselves Member States aim to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers.” Under the Lisbon Treaty, this wording is replaced by the following: “By establishing a customs union in accordance with Articles 23 to 27, the Union shall contribute, in the common interest, the harmonious development of world trade, the progressive abolition of restrictions on international trade and on *foreign direct investment*, and the lowering of customs and other barriers.” Article 133(1) of the EC Treaty read: “The common commercial policy shall be based on uniform principles, particularly in regard to changes in tariff rates, the conclu-

Lisbon Treaty adds the term “foreign direct investment” within the scope of coverage of the CCP, but the intent of this language is ambiguous, and, thus, it remains unclear whether these FDI provisions in effect circumscribe the existing domestic competence of the Member States.¹⁷⁶ In other words, it is uncertain whether the Lisbon Treaty grants the EU exclusive competence over liberalization, protection, and promotion of FDI,¹⁷⁷ or only to the liberalization of FDI¹⁷⁸ in general.¹⁷⁹ At the same time, employing a strict textual reading, the language of the Lisbon Treaty now grants the EU exclusive power over the field of FDI, and does not cite any exceptions.¹⁸⁰

IV. PROBLEMS ARISING FROM THE TRANSFER OF COMPETENCE OVER FDI AND SOME PROPOSED SOLUTIONS

The EU’s objective in bringing FDI under the auspice of the CCP is to improve efficiency in foreign investment negotiations, and to eliminate the complications that arise from a system of intertwined competences.¹⁸¹ However, this aim will be thwarted if there is an expedited overhaul of the current legal structure for the protection of foreign investment. If the EU seeks to improve its competitive position in the global economy as an

sion of tariff and trade agreements, the achievement of uniformity in measures of liberalization, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies.” Under the Lisbon Treaty, this is replaced as follows: “The common commercial policy shall be based on uniform principles, particularly with regard to changes in tariff rates, the conclusion of tariff and trade agreements relating to trade in goods and services, and the commercial aspects of intellectual property, *foreign direct investment*, the achievement of uniformity in measures of liberalization, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies. The common commercial policy shall be conducted in the context of the principles and objectives of the Union’s external action.” (emphasis added). Furthermore, the Lisbon Treaty adds the following language: “For the negotiation and conclusion of agreements in the field of trade in services and the commercial aspects of intellectual property, as well as *foreign direct investment*, the Council shall act unanimously where such agreements include provisions for which unanimity is required for the adoption of internal rules.” (emphasis added).

176. See Eilmansberger, *supra* note 20, at 394.

177. Significantly, the liberalization, promotion and protection of FDI are considered the three fundamental goals of BITs. See Salacuse & Sullivan, *supra* note 5, at 68.

178. Investment liberalization generally refers to the creation of an investment climate in which foreign investors undertake investments that they judge to be in *their* interest rather than in the interest of the host country. See *id.* at 78–79.

179. See Mola *supra* note 138, para. 3.2.

180. Bungenberg, *supra* note 28.

181. See *supra* Part II; see also Ceyssens, *supra* note 95, at 269 (“[T]he current procedures involving both Member States and the EU in the conclusion and implementation of international agreements are excessively burdensome”).

economic superpower, it needs to maintain a transparent, stable system for the regulation of foreign investment.¹⁸² If foreign investors believe that the EU's system does not provide adequate protection, they may choose to retract their investments. This will make it difficult for the EU to attract new foreign investors who will likely forego opportunities in the EU to avoid the problems associated with an unstable investment regime. Furthermore, the BITs entered into by EU Member States are part of a dense international network of BITs, and a disruption of this system could be detrimental to the EU's foreign relations. Therefore, in responding to the challenges that lie ahead, it is crucial that the EU make a gradual, deliberate transition from a system in which Member States have the competence to conclude BITs, to a system in which the EU retains exclusive competence over FDI. While the transfer of competence over FDI from the individual EU Member States to the EU creates a number of problems, if these problems are adequately dealt with, then the changes to FDI embodied in the Lisbon Treaty will represent an improvement over the EU's prior international investment regime.

A. Will EU Member States Retain the Competence to Negotiate and Conclude BITs in the Future?

Article 207 of the Lisbon Treaty does not define the scope of the EU's authority over FDI, leaving the provision open to disparate interpretations.¹⁸³ According to Dr. Stephen Woolcock, some Member States interpret Article 207 to grant the EU exclusive competence over FDI only as it relates to investment liberalization.¹⁸⁴ Under this narrow interpretation, the EU would have exclusive power to negotiate and conclude international investment agreements providing for pre-establishment national treatment,¹⁸⁵ but not to the protection of foreign investment once it has entered the country.¹⁸⁶ Therefore, Member States would retain their competence to conclude BITs. Alternatively, some Member States, as

182. See Bungenberg, *supra* note 28, at 125 ("Economic growth, employment and prosperity can only be achieved if the EU itself is competitive on the international level, which from a legal point of view is primarily determined by its constitutional basis and options").

183. See Woolcock, *supra* note 170, at 4; see also Alexandrov, *supra* note 18.

184. See Woolcock, *supra* note 170, at 4.

185. See OECD, STABILITY PACT: SOUTHEAST EUROPE COMPACT FOR REFORM, INVESTMENT, INTEGRITY AND GROWTH, 11 (Oct. 2003) ("National treatment in pre-establishment is the commitment of a (host) country to accord to the investment by non-resident enterprises in its territory, including the right of establishment, treatment no less favourable than that accorded in like situations to resident enterprises.")

186. See Woolcock, *supra* note 170, at 4.

well as the Commission, interpret Article 207 more broadly, so that FDI includes both investment liberalization and investment protection.¹⁸⁷ Under this broader interpretation, EU Member States would no longer be able to negotiate and conclude BITs on their own, as the substantive aspects of investment protection would fall exclusively under the competence of the EU.¹⁸⁸ Because these two interpretations have such different implications for the future of the EU's international investment policy, there is a need for legal certainty.

The EU must approach this issue pragmatically. If the EU adopts the narrow interpretation of Article 207, then it will not achieve its objectives in bringing FDI under the auspice of the CCP. This is because the EU would still need to deal with the incompatibility and inconsistency problems that arise from a system of shared competence.¹⁸⁹ On the other hand, the EU's adoption of the broader interpretation of Article 207 would entail an immediate, disruptive overhaul of the legal infrastructure created by the BIT network. In order to avoid these problems, the EU should adopt the broader interpretation so that both the liberalization and the protection of FDI fall under the competence of the EU, but the EU should exercise its newfound competence gradually.

While the Lisbon Treaty itself does not provide for any kind of transition period, this does not prevent the EU from establishing one. In *Donckerwolcke v. Procureur de la République*,¹⁹⁰ the ECJ held that even though the EU has exclusive competence with regard to the CCP, derogation is permitted where the EU specifically authorizes the Member States to act.¹⁹¹ Thus, the EU could authorize the Member States to continue to negotiate and conclude BITs, but could establish a definitive timeline so that eventually the Member States will no longer have this power. This approach will enable the EU to articulate its long-term objective by stating that it retains the exclusive authority over all aspects of FDI, but is temporarily deviating from this policy in order to ensure a smoother transition to a system of exclusive competence. This type of transition period will make the policy clear to non-EU countries, prepare EU Member States and foreign investors for what is to come, and avoid an immediate overhaul of a well-established system. By gradually phas-

187. *Id.*

188. *See supra* Part II.C.

189. *Id.*

190. *See* C-41/76, *Donckerwolcke v. Procureur de la République* [1976] E.C.R. 1921.

191. *See id.* ¶ 32 (“As full responsibility in the matter of the commercial policy was transferred to the Community by means of Article 113(1) measures of commercial policy of a national character are only permissible . . . by virtue of specific authorization by the Community”).

ing out BITs, the EU will have the opportunity to further develop its own foreign investment policy and conclude international investment treaties that provide foreign investors with adequate protection.

Finally, the EU should also commence discussions on “portfolio investment,” which is not encompassed by the EU’s authority over FDI.¹⁹² Many BITs provide for an expansive definition of “investment,” which includes “portfolio investment.”¹⁹³ Therefore, by explicitly referring only to FDI in the CCP, the Lisbon Treaty leaves some types of foreign investment outside the scope of the EU’s exclusive competence. This will most likely permit individual Member States to continue to conclude BITs, albeit only in terms of the regulation of portfolio investment. While the Lisbon Treaty aims for a streamlined approach in the conclusion of these types of agreements, the EU’s failure to conclude comprehensive agreements pertaining to foreign investment will certainly frustrate this objective by maintaining a fragmented system. Foreign investors will need to enter into investment agreements with the EU for the protection of FDI, and will separately need to enter into bilateral agreements with the individual Member States in order to protect their portfolio investments.

B. What is the Legal Status of Existing BITs Concluded by EU Member States?

Another problem arising from the transfer of competence over FDI from Member States to the EU is the unclear legal status of existing BITs between EU Member States and non-EU countries. Pursuant to Article 307(2) of the EC Treaty, EU Member States “shall take all appropriate steps to eliminate the incompatibilities” between their treaty obligations with non-EU countries and their obligations under the EC Treaty.¹⁹⁴ Article 351 of the Lisbon Treaty incorporates this exact language.¹⁹⁵ Therefore, EU Member States must ensure that incompatibilities stemming from their BIT obligations with non-EU countries conform to EU law now that the EU has been granted exclusive competence over FDI. If an expansive definition of FDI were adopted, then it would appear that in order to conform to Article 351, Member States must either terminate their BITs or dramatically amend their provisions, as they deal predomi-

192. See *supra* Part II.B.

193. See *id.*

194. See EC Treaty, *supra* note 22, art. 307(2).

195. See Lisbon Treaty, *supra* note 25, art. 351.

nantly with FDI. However, this is impractical given the number of BITs to which Member States are parties.¹⁹⁶

Furthermore, requiring EU Member States to terminate their BITs is contrary to customary international law.¹⁹⁷ Under Article 27 of the VCLT, “a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”¹⁹⁸ Under Article 42 of the VCLT, “the termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or the present Convention.”¹⁹⁹ Under Article 59 of the VCLT:

[A] treaty shall be considered as terminated if all the parties to it conclude a later treaty relating to the same subject matter and . . . it appears from the later treaty or is otherwise established that the parties intended that the matter should be governed by that treaty . . . or the provisions of the later treaty are so far incompatible with those of the earlier one that the two parties are not capable of being applied at the same time.²⁰⁰

Based on these VCLT provisions, Member States cannot be legally forced to terminate their BITs.

The majority of BITs provide that the agreement shall remain in force for a period of ten years, and at the end of each ten-year period either party may choose to terminate the BIT by providing notice to the other party.²⁰¹ Furthermore, BITs often provide that if a party terminates a BIT according to its terms, the investments covered by its provisions will continue to be protected under the agreement for a specified number of years.²⁰² Forcing EU Member States to immediately terminate their BITs would be at odds with Article 42 of the VCLT because termination must be governed by the termination terms contained within each individual BIT. Furthermore, Article 59 is inapplicable because the non-EU Member States that are parties to the BITs with EU Member States are not

196. See Bungenberg, *supra* note 28, at 135 (Of the nearly 2,600 BITs concluded worldwide, the 27 EU Member States are parties to 1,300 of those treaties).

197. See Vienna Convention, *supra* note 128.

198. *Id.* art. 27.

199. *Id.* art. 42.

200. *Id.* art. 59.

201. For example, in the BIT concluded between Pakistan and Germany, the provision related to termination reads: “[This Agreement] shall remain in force for a period of ten years and shall continue in force thereafter for an unlimited period unless notice of termination is given in writing by either Party on year before it expiry.” Pak.–F.R.G. BIT, *supra* note 15, art. 13(2).

202. *Id.* art. 13(3) (“In respect of investments made prior to the date of expiry of the present Treaty, the provisions of Articles 1 to 13 shall continue to be effective for a further period of ten years from the date of expiry to the present Treaty”).

also parties to the Lisbon Treaty. While the Lisbon Treaty arguably covers the same subject matter, the Lisbon Treaty is not binding on these countries and, therefore, cannot supersede existing BITs.

Because it would be both impractical and contrary to international law to call for the immediate termination of extra-EU BITs, an interim system needs to be established in order to facilitate a gradual transition to exclusive EU competence over FDI. This could be accomplished by allowing the BITs to terminate according to their own terms. At the end of the ten-year periods, the EU Member States could give notice to the other party that they intend to terminate the respective treaty. As these BITs expire, they can then be replaced by agreements negotiated and concluded by the EU. At the same time, Member States must ensure, as is required by Article 307 of the EC Treaty and now Article 351 of the Lisbon Treaty, that their BITs comply with all other provisions of EU law.²⁰³ If not, these EU Member States should renegotiate and amend these treaties.²⁰⁴ This approach is in the best interest of the EU because it will reduce the likelihood that foreign investors withdraw their investments in EU countries out of the concern that these investments are not protected under an investment treaty. Furthermore, EU Member States will be complying with customary international law under the VCLT, and therefore will not be destroying their legitimacy and harming their relations with foreign countries.

C. Is the EU Capable of Concluding International Investment Agreements Comparable to BITs?

Prior to the Lisbon Treaty entering into force, the EU negotiated treaties addressing investment-related issues, but none which dealt exclusively and comprehensively with the liberalization and protection of a broad range of investments.²⁰⁵ These EU treaties differ significantly from BITs which provide for both substantive and procedural protections of foreign investment.²⁰⁶ Because the EU is not accustomed to negotiating and concluding BITs, it could take the transition period proposed in the previous two sections of this Note to further develop its investment policy platform. It could create a “Model International Investment Agreement” that contains provisions comparable to those contained in BITs.

203. See EC Treaty, *supra* note 22, art. 307(2); see also Lisbon Treaty, *supra* note 25, art. 351.

204. See *supra* Part II.C. The ECJ Infringement Proceedings Brought Against Austria and Sweden did not only apply to those two particular countries, but rather the decision applies to all EU Member States.

205. See *supra* Part II.A.

206. *Id.*

This model agreement should provide for the main substantive protections afforded under BITs, including national treatment, most favored nation, compensation for expropriation, and rights to transfer capital and returns.²⁰⁷ In particular, the EU should develop a procedural mechanism for the settlement of investment disputes that will likely arise under its newly negotiated and concluded agreements.²⁰⁸ By taking these steps, the EU will be able to maintain a stable regime for the regulation of foreign investment. If not, foreign countries will be reluctant to enter into investment agreements with the EU that do not provide for conditions as favorable as those provided under BITs.

The EU does not currently have an international dispute settlement regime comparable to the ad hoc system prescribed in BITs.²⁰⁹ Therefore, as the situation stands, foreign investors would need to bring their investment dispute claims against the EU before the ECJ.²¹⁰ According to Peter Ondrusek, a consultant for the United Nations Industrial Development Organization:

[T]here are not necessarily any real obstacles in principle for the EC to become a party to an international investment-dispute arbitration system. However, there are some obstacles on the part of the current international investor-State arbitration system to be able to accommodate reliably the EC.²¹¹

The main forum chosen for dispute settlement under BITs is the International Centre for Settlement of Investment Disputes (ICSID).²¹² However, the EU is not a party to the ICSID.²¹³ Under Article 67 of the ICSID Convention, the convention is open for signature on behalf of States that are members of the International Bank for Reconstruction and Development, as well as States that are parties to the Statute of the International Court of Justice and have been invited to sign the convention by the Administrative Council of the International Centre for Settlement of Investment Disputes.²¹⁴ While the EU is not a state, it should neverthe-

207. See *supra* Part I.B.

208. See Wierzbowski, *supra* note 122, at 546 (“[I]n many ways a BIT, with its unique opportunity to force a host State to respond to arbitrators, is a clear advantage and no comparable mechanism is at investors’ disposal under EC law rules”).

209. Mola, *supra* note 138, at para. 1.5.

210. *Id.*

211. See Peter Ondrusek, *EC and Investor-State Dispute Settlement: Some Thoughts*, a paper delivered at the BIICL, Investment Treaty Forum: European Law and Investment Treaties: Exploring the Grey Areas, (Dec. 4, 2008).

212. See ICSID Convention, *supra* note 68.

213. See *id.* art. 25 for a list of all the parties to the ICSID Convention.

214. *Id.* art. 67.

less attempt to become a party to an impartial investment dispute forum.²¹⁵ This way, as BITs concluded by EU Member States are gradually phased out, foreign investors will still have access to the procedural mechanisms that make BITs such attractive agreements.

CONCLUSION

This Note has explored the nature of the relationship between BITs concluded by EU Member States and the EU legal order, and the potential impact on this interface now that the Lisbon Treaty has entered into force. It remains to be seen how the challenges of the EU's international investment system will be resolved in the future. Prior to the passage of the Lisbon Treaty, a system of shared competence in the realm of foreign investment led to incompatibility and overlap issues that made it difficult for the EU to act as a united front. At the same time, this BIT network has been in place for over five decades and provides benefits to countries seeking to attract foreign investors, as well as to foreign investors who seek protection against the inherent risks associated with their investments. While the Lisbon Treaty brings FDI under the auspice of the Common Commercial Policy, the simple addition of the term "foreign direct investment" does not indicate how the EU's exclusive competence over FDI will be interpreted and applied, and whether or not it is intended to completely displace the current BIT network.

Because of the need for legal certainty, the EU's current system of BITs should remain intact in the short term, as it provides for investment protection and arbitral dispute mechanisms of which there are no viable equivalents under the Lisbon Treaty. While the EU's exclusive competence over FDI is a logical step in the movement toward a more streamlined, comprehensive multilateral EU trade and investment system, an expedited overhaul of the current legal structure would foster uncertainty and be detrimental to the EU's continued ability to attract FDI and manage foreign-investor expectations. It would be imprudent to immediately do away with the standing BIT system until the EU is able to develop a stable and transparent international investment framework. Therefore, the EU should implement a transition period in which it can gradually adapt to its new, exclusive authority to negotiate and conclude international investment treaties. Dr. Stephen Woolcock states, "The inclusion of FDI in EU competence is an important step towards the creation of a comprehensive EU approach to trade and investment that reflects the nature of the international economy in which trade and investment are

215. *See supra* Part I.B.

inextricably linked.”²¹⁶ The EU must take gradual and deliberate action in order to improve its international investment regime.

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216. Woolcock, *supra* note 170, at 5.

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MARKET ORIENTALISM: REASSESSING AN OUTDATED ANTI-DUMPING POLICY TOWARDS THE PEOPLE'S REPUBLIC OF CHINA

INTRODUCTION

From the perspective of many enterprises operating in the People's Republic of China ("PRC"), U.S. unfair trade law has failed to keep pace with the market reforms of the Chinese economy.¹ This failure has led the United States Department of Commerce ("Commerce") to assume the role of a veritable Janus, simultaneously recognizing and denying the market-oriented features of the PRC's economy, depending on what trade law is being applied.² In this Note I will evaluate Commerce's current anti-dumping law valuation approach to the PRC and propose an alternative PRC anti-dumping policy that balances a pro-market position with the goal of promoting equity and bilateral reciprocity.

Section I of this Note begins with an overview of anti-dumping law as applied to market economy ("ME") countries and non-market economy ("NME") countries, emphasizing the crucial role of valuation methodology in calculating dumping margins.³ After detailing the disadvantages of being classified as an NME for purposes of anti-dumping law, I will explore the current approach of classifying the PRC as an NME for purposes of anti-dumping law, while treating the country as an ME for countervailing duty ("CVD") law purposes.⁴

1. Liu Danyang, Comment on Behalf of Ministry of Commerce of the People's Republic of China, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 7 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/boft-nme-moe-cmt-20071210.pdf> (stating disapproval with Commerce's "delay in crafting rules" to address the "inconsistency" between anti-dumping laws for non-market economies and countervailing duty laws as applied to the People's Republic of China).

2. For a discussion of how Commerce assumes in anti-dumping investigations that non-market-economy countries have distorted their internal markets so that is impossible to measure real prices, but assumes in countervailing duty investigations against the PRC, a non-market economy that the real price of government subsidies is measurable, see discussion *infra*, Section I.D.1.

3. See Sanghan Wang, *Article: U.S. Trade Law Concerning Nonmarket Economies Revisited for Fairness and Consistency*, 1 EMORY INT'L L. Rev. 593, 615-16 (2005) (discussing how the method by which normal value is calculated can lead to "potentially inaccurate determination[s]").

4. See Memorandum from Shauna Lee-Alaia and Lawrence Norton, Office of Policy, Import Administration, to David M. Spooner, Assistant Secretary for Import Administration, Regarding Countervailing Duty Investigation of Coated Free Sheet Paper from

Section II will first discuss Commerce's recent interest in reevaluating the PRC's status as an NME. In pursuit of a possible new approach to an anti-dumping framework for the PRC, Commerce has been soliciting interested parties for comments on a proposed test to identify certain market-oriented enterprises ("MOE") in order to grant them an individualized valuation methodology.⁵ Section II will explore multiple perspectives on whether such a test would be legally permissible, whether there are actually firms operating in the PRC that could be identified as market-oriented, and finally whether such a test would be administratively feasible.

In section III, I take the position that an MOE test would be the most pragmatic way for U.S. trade law to address the fact that many PRC firms are operating under relatively market-oriented conditions. After arguing against the inequitable practice of double counting, section III discusses how a recent case, *GPX Int'l Tire v. United States*, potentially requires Commerce to adopt an MOE approach.⁶ Finally, I attempt to lay the framework for a valuation approach that contains elements of both ME and NME methodology so that U.S. anti-dumping law may work in concert with CVD law to best reflect the current economic reality of the PRC.⁷

People's Republic of China, 10 (Mar. 29, 2007), <http://ia.ita.doc.gov/download/nme-separates/prc-cfsp/china-cfs-georgetown-applicability.pdf> [hereinafter Georgetown Steel Memorandum] (concluding that Commerce is capable of identifying and measuring subsidies bestowed by the PRC government upon Chinese producers).

5. See Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise, 72 Fed. Reg. 29, 302, 29, 302 (proposed May 25, 2007) [hereinafter May 25 Request]; see also Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, 72 Fed. Reg. 60, 649, 60, 649 (proposed Oct. 25, 2007) [hereinafter October 25 Request] (refining the request for comments to focus on legality, identification and administrability).

6. See generally *GPX Int'l Tire Corp. v. United States*, No. 09-103, 645 F. Supp. 2d 1231, 1251 (Ct. Int'l Trade 2009).

7. See Georgetown Steel Memorandum, *supra* note 4, at 4-5 (stating that the PRC's economy is "more flexible" than the Soviet command-style economies in regard to which the NME valuation approach was formulated).

I. UNITED STATES ANTI-DUMPING LAWS AND THE NON-MARKET ECONOMY

A. Overview of Anti-Dumping Investigations

Anti-dumping laws have operated in the U.S. for almost a century⁸ with the purpose of preventing low-priced foreign-manufactured goods from undercutting U.S. competition and damaging domestic manufacturers.⁹ Anti-dumping laws operate by imposing a duty on foreign imports equal to the amount by which the import is considered undervalued, in cases where domestic manufacturers of similar goods (the “domestic industry”) are hurt by such undervaluation.¹⁰ The result of this simple yet elegant arithmetic is a price that is intended to reflect what the value of the imported merchandise would (or indeed, should) be, were the product priced at the “correct” level.¹¹

An anti-dumping investigation is initiated against foreign exporters either by Commerce, or by representatives of the domestic industry.¹² In order to ensure that the majority of the domestic industry supports the investigation, there are certain statutory representation requirements that the petitioners must meet.¹³ Commerce must determine that the petitioners represent 25% of the total domestic industry, 50% of those expressing an opinion on the issue, and that they have met certain evidentiary standards in bringing the complaint.¹⁴ Although the United States originally

8. Daniel M. Lopez, *The Continued Dumping and Subsidy Offset Act of 2000: “Relief” for the U.S. Steel Industry; Trouble for the United States in the WTO*, 23 U. PA. J. INT’L ECON. L. 415, 415 (2002) (stating that anti-dumping laws were first implemented in 1916).

9. See NEVILLE PETERSON, *CUSTOMS LAW & ADMINISTRATION* 1 (2008) (explaining that the anti-dumping statute is intended to provide relief to domestic producers that are injured, or threatened with injury, because of unfairly priced foreign-manufactured goods imported for sale in the US).

10. See Patricia H. Piskorski, *A Dangerous Discretionary “Duty”: U.S. Antidumping Policy Toward China*, 34 HOFSTRA L. REV. 595, 603 (2005) (describing the anti-dumping duty as the average amount by which the fair market value of the product in question exceeds the price that the product is sold for in the US).

11. Lopez, *supra* note 8, at 417–18.

12. See Andrea Miller, *The United States Antidumping Statutes: Can A Trade Agreement With The United States Be Both “Free” And Fair? A Case Study Of Chile*, 54 CATH. U.L. REV. 627, 629 (2005) (discussing how an anti-dumping investigation is initiated).

13. See 19 U.S.C. § 1673a(c)(4)(A) (2006).

14. See *id.*

resisted implementing this threshold requirement,¹⁵ it has since defended the requirement on the grounds that “national authorities have a responsibility to examine the petition for accuracy and adequacy of evidence.”¹⁶

Any interested party may respond to the petitioner’s allegations subsequent to initiation, but Commerce limits its dumping calculation to a selected group of respondents.¹⁷ These mandatory respondents will have “within 45 days after the date on which the petition is filed” to present a response to the allegations.¹⁸ Although the petitioners have generally spent significantly more time preparing their case, they also bear the burden of proof that they, as the domestic industry, are injured or threatened by foreign dumping.¹⁹ Because responsibility for carrying out an anti-dumping investigation is shared by Commerce and the International Trade Commission (“ITC”), the investigation itself is best thought of as a process of multiple determinations rather than as a single event.²⁰ For example, Commerce is responsible for determining sales at less than fair value (“LTFV”), while the ITC is responsible for determining injury.²¹

For the purposes of this Note we will primarily consider Commerce’s role in the anti-dumping investigation. Commerce initially makes several determinations critical to a finding of dumping.²² The initial determination is based on whether the petitioners have satisfied Commerce that the petitioners as a whole makes up a minimum percentage of the domestic market for that product in question (the “representation requirement”).²³ Sixty days after the ITC has determined that there is a “reasonable indi-

15. See Tara Gingerich, *Why The WTO Should Require The Application Of The Evidentiary Threshold Requirement In Antidumping Investigations*, 48 AM. U.L. REV. 135, 158–59 (1998).

16. See *id.* at 164.

17. See Bernd G. Janzen, *International Trade Decisions Of The Federal Circuit: Three Years Of Rigorous Review*, 52 AM. U.L. REV. 1027, 1074 (2003).

18. 19 U.S.C. § 1673b(a)(2)(A)(i) (2006).

19. William D. DeGrandis, *Proving Causation in Dumping Cases*, 20 INT’L L. 563, 563 (1986).

20. See Robert H. Lantz, *The Search For Consistency: Treatment Of Nonmarket Economies In Transition Under United States Antidumping And Countervailing Duty Laws*, 10 AM. U.J. INT’L L. & POL’Y 993, 1000–01 (1995).

21. *Id.* at 1001.

22. See U.S. INT’L TRADE COMM’N, ANTIDUMPING AND COUNTERVAILING DUTY HANDBOOK II-3 (2008), available at http://www.usitc.gov/trade_remedy/documents/handbook.pdf (detailing the various determinations that Commerce must make during the course of an anti-dumping investigation).

23. *Id.* at I-6.

caution” of material injury,²⁴ Commerce makes its preliminary determination of dumping, based on whether there is a “reasonable basis to believe or suspect that the merchandise is being sold, or is likely to be sold, at less than fair value.”²⁵ Within 75 days of the preliminary determination, Commerce will issue its final determination.²⁶ While the preliminary determination included an estimated penalty, at this point Commerce will publish a final amount by which a number called normal value exceeds export price. This number becomes the estimated dumping margin, subject only to the additional requirement that the ITC make an affirmative finding of material injury.²⁷

Following the calculation of the dumping margin, the ITC makes its final determination on whether or not the inflated prices are harming or have the potential to harm the domestic industry.²⁸ The ITC makes this determination by evaluating a large number of economic factors relating to the affect the imports are having (or may have) on the domestic industry.²⁹ This is a key determination because a finding of no-injury terminates the investigation, regardless of Commerce’s earlier determination.³⁰

Despite the misleading nomenclature of the “final determination,” the actual duties are not calculated until the (very important) annual review.³¹ During an annual review, the dumping margin is completely reassessed, potentially resulting in a revised rate that is substantially different than the rate originally assigned.³²

24. STEPHEN D. COHEN ET AL., *FUNDAMENTALS OF U.S. FOREIGN TRADE POLICY* 171 (2003).

25. 19 U.S.C. § 1673b(b)(1)(A) (2006).

26. 19 U.S.C. § 1673d (2006).

27. See Lantz, *supra* note 20, at 1001–02.

28. See *id.* at 1002.

29. See *id.* at 1002–03.

30. See Herbert C. Shelley et al., *A Review Of Recent Decisions Of The United States Court Of Appeals For The Federal Circuit: Area Summaries: The Standard Of Review Applied By The United States Court Of Appeals For The Federal Circuit In International Trade And Customs Cases*, 45 AM. U.L. REV. 1749, 1759 (1996) (stating that Commerce will only publish an anti-dumping order after the ITC has issued an affirmative final determination).

31. See Michael A. Lawrence, *Bias in the International Trade Administration: The Need for Impartial Decision-makers in United States Antidumping Proceedings*, 26 CASE W. RES. J. INT’L L. 1, n.33 (1994).

32. See *id.*

B. Calculating Normal Value

1. The Importance of Normal Value

Normal value is the number calculated by Commerce to represent a fair price for the imported good in question.³³ This number is then held up as a benchmark of sorts against the export price (or the constructed export price, if the first domestic sale is to an affiliated purchaser). It is important to respondents that the normal value be as low as possible, because the dumping margin itself is calculated as the difference between normal value and the export price above.³⁴ This makes an understanding of the valuation process absolutely crucial in order to reduce margins by as much as possible. The task is complicated by the fact that there are at least three methods of calculating normal value in cases involving market economy respondents, and an additional method applicable to respondents from non-market economies.³⁵

While the available methods are analyzed below, it is important to consider that the tension exists between normal value and export price because the duty is payable not as a flat tax or a levy but as an *ad valorem* duty proportional to the value of the merchandise.³⁶ It follows that when the product is being exported in large quantities, a relatively small adjustment to normal value can result in significantly higher or lower costs for the exporting company.

2. Normal Value Calculations for Market Economy Exporters

When the respondent is based in a country that Commerce considers a market economy, Commerce will determine normal value using one of the three methods.³⁷ Commerce's first preference is to use the home-

33. Sungjoon Cho, *Anticompetitive Trade Remedies: How Antidumping Measures Obstruct Market Competition*, 87 N.C.L. REV. 357, 381(2009) (defining normal value as "a normative, fair price, which should have been set in the home (exporting) market without any alleged unfair governmental intervention").

34. See Jarrod M. Goldfeder, *A Review Of Recent Decisions Of The United States Court Of Appeals For The Federal Circuit: Area Summary: 2008 International Trade Decisions Of The Federal Circuit*, 58 AM. U.L. REV. 975, 1020–21 (2009).

35. *Id.* at 1020–22; See also 19 U.S.C. 1677(35)(A) (2006) (defining the dumping margin as "the amount by which the normal value exceeds the export price or constructed export price of the subject merchandise").

36. See Bryan A. Edens, *Substantial Evidence In The Law Of International Trade: Meaningful Judicial Review Of Antidumping Actions Or Perpetuation Of The Yo-Yo Effect?*, 6 CARDOZO PUB. L. POL'Y & ETHICS J. 431, n.62 (2008).

37. See Lantz, *supra* note 20, at 1001.

market method.³⁸ Subject to a series of price adjustments, normal value is calculated at the price that the product is sold in the market of the exporting country for domestic consumption.³⁹

This constructed value method involves cumulating certain inputs, including allowances for profit and other indirect costs.⁴⁰ Under this method, normal value is constructed as a sum of a product's component costs.⁴¹ Commerce will use results of this exceedingly complex calculation⁴² as the price against which the export price (or constructed export price) is compared, in order to determine the dumping margin.⁴³

3. Control of the Valuation Process for Market Economy Exporters

The calculation of normal value remains critically important to the respondents long after the ITC's final determination. Rather than existing as a static number, normal value is generally recalculated annually as part of regular review, which is important.⁴⁴ Furthermore, a change in normal value can affect duties already paid as far back as 18 months, which gives the respondent great incentive to lower the normal value during these annual reviews.⁴⁵ As a result, exercising control over the valuation process is highly valuable to respondents.⁴⁶

38. See Brink Lindsey & Dan Ikenson, *Antidumping 101: The Devilish Details of "Unfair Trade" Law*, CATO INST. TRADE POL'Y ANALYSIS 5 (21 Nov. 2002), <http://www.cato.org/pubs/tpa/tpa-020.pdf>.

39. *Id.* at 6–8 (explaining the price adjustments).

40. 19 U.S.C. § 1677b(e) (2006) (explaining that the "constructed value" is equal to the sum of "the cost of materials and fabrications," plus "the actual amounts incurred . . . by the specific exporter," plus "all other expenses incidental to placing the subject merchandise in condition packed ready for shipment").

41. *Id.*

42. See *Lester Engineering Co. v. United States*, 3 C.I.T. 236, 240 (1982) (asserting that calculating constructed value "involves a complex compilation and analysis of many facts").

43. See Goldfeder, *supra* note 34, at 1020–21.

44. ROBERT FEINSCHREIBER & CHARLES L. CROWLEY, *IMPORT HANDBOOK: A COMPLIANCE AND PLANNING GUIDE* 277–79 (stating that "a new [dumping] rate for each exporter . . . is determined as the weighted average of dumping rates found on all sales reviewed in each [one year] period").

45. *Id.* at 279 (explaining that the Uruguay Round Agreements Act imposed a statutory deadline of 1 year for annual reviews, extendable by 6 months).

46. See Brenda A. Jacobs, Comment on Behalf of Chutex Group, Response to Anti-dumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 4–5 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/chutex-nme-moe-cmt-20070625.pdf> [hereinafter Chutex June 25 Comment] (arguing that because of the unpredictable nature of the valuation process, NME producers are unable to identify the necessary pricing adjustments in

When the home or third country market valuation method is used, a respondent can exercise control over the normal value by adjusting its prices in those markets, potentially affecting a lower dumping margin.⁴⁷ Even more significantly, respondents that are able to predict their calculated normal value with a high level of accuracy are able to adjust their selling price in the U.S. to bring their export price up to the proper value level and reduce or eliminate the dumping margin.⁴⁸

C. Anti-Dumping Investigations Against Nonmarket Economy Exporters

1. Overview

Exports from countries on Commerce's list of NMEs are subject to a different valuation process than exports from market-economy countries.⁴⁹ If Commerce determines that a country "does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise" then it has the discretion to designate that country as an NME.⁵⁰ While the anti-dumping timeline and means of initiating the investigation are the same, the process of calculating normal value is markedly different.⁵¹

Commerce is vested with substantial power to determine which countries are market-oriented for the sake of unfair trade laws.⁵² In determining whether to consider a country market-oriented, Commerce will look at several statutory factors, including but not limited to the extent of government ownership or control of the means of production and also the extent of government control over the allocation of resources and over the price and output decisions of enterprises.⁵³

order to fairly trade their goods with the United States, and asking Commerce to use actual prices and costs when appropriate).

47. David A. Gantz, *A Post-Uruguay Round Introduction To International Trade Law In The United States*, 12 ARIZ. J. INT'L & COMP. LAW 7, 74 (1995).

48. See Chutex May 25 Comment, *supra* note 46, at 5.

49. See Joseph A. Laroski, Jr., *NMES: A Love Story Nonmarket and Market Economy Status Under U.S. Antidumping Law*, 30 LAW & POL'Y INT'L BUS. 369, 375 (1999).

50. *Id.* at 381-82 (quoting 19 U.S.C. § 1677(18)(A) (1994)).

51. *Id.* at 375-76.

52. *Id.* at 381-82; see also 19 U.S.C. § 1677(18)(A) (2006) (defining a "nonmarket economy country" as "any foreign country that [Commerce] determines does not operate on market principles").

53. See 19 U.S.C. § 1677(18)(B) (2006). The list also includes the extent to which the currency of the foreign country is convertible into the currency of other countries; the extent to which wage rates in the foreign country are determined by free bargaining between labor and management; the extent to which joint ventures or other investments by

While normal value in NME cases is calculated differently from any of the three methods used in ME cases, the methodology is conceptually most similar to the constructed value method, in that Commerce seeks to cumulate the exporters costs to determine normal value.⁵⁴ The essential difference between the two methodologies is that under the constructed-value method, the costs will be calculated based on the price actually paid, but under the NME method the amount paid by the exporter generally⁵⁵ has no bearing on the final dumping calculation.⁵⁶ Instead, Commerce determines the component cost of inputs in a third country, and applies the resulting numbers as if they were the actual costs (“factors of production”) of the respective NME enterprise.⁵⁷

The NME valuation process is generally unfavorable to the exporter, compared to the valuation processes used for market-economy exporters, for two major reasons.⁵⁸ First, the NME valuation method normally results in a higher dumping margin than its ME counterparts.⁵⁹ Second, the

firms of other foreign countries are permitted in the foreign country; and such other factors as the administering authority considers appropriate. *Id.*

54. See U.S. Dep’t of Commerce, Int’l Trade Administration, Import Administration, Antidumping (anti-dumping) / Countervailing Duty (CVD) Petition Counseling and Analysis Unit, Glossary, <http://ia.ita.doc.gov/pcp/pcp-index.html> (defining constructed value as the sum of the “cost of materials and fabrication of the subject merchandise . . . selling, general, and administrative expenses and profit,” and similarly defining the factors of production approach as the sum of the hours of labor; the quantities of raw material; the amounts of energy; and the representative capital costs, although the costs are determined based on their “value . . . in a market economy country”).

55. This rule is subject to an exception. See text accompanying notes *infra*, p 14.

56. See 19 U.S.C. §1677b(c) (2006). Commerce is required to calculate the normal value of a product from an NME exporter by using surrogate values, called “factors of production,” derived from the cost of producing a similar product in an economically comparable ME country, *id.* at §1677b(c)(4). These surrogate values, rather than actual costs, are used as the NME exporter’s factors of production, which are then summed to ascertain normal value, *id.* at §1677b(c)(1).

57. 19 U.S.C. §1677b(c)(2) (2006). If Commerce finds that the available information is inadequate to determine normal value, it may use the market price of comparable merchandise produced by an ME country.

58. Lantz, *supra* note 20, at 1004–05 (asserting that the use of NME valuation methodology generally results in dumping margins that are higher than if the methods used for ME exporters had been applied, and explaining that the surrogate country approach has been criticized for being “unpredictable and arbitrary”).

59. For a thorough analysis of the higher rates typical of NME anti-dumping methodology, see Bruce M. Mitchell & Ned H. Marshak, Comment on Behalf of the Government of the People’s Republic of China, Ministry of Commerce, Response to Antidumping Methodologies in Proceedings Involving Non-Market Economy Countries: Surrogate Country Selection and Separate Rates; Request for Comment, at 6 (April 20, 2007), <http://ia.ita.doc.gov/download/nme-surrogate-20070321/prc-mofcom-cmts-042007.pdf> [hereinafter PRCMOC Comment] (demonstrating that over a period of 3 years the China-

nature of the NME method makes it difficult for exporters to predict how the normal value will change during the annual reviews; as a result such exporters are unable to set their prices to the correct levels.⁶⁰

While it is widely accepted that the NME valuation method results in higher dumping margins than its market-economy equivalent,⁶¹ the unique methodology is premised on the idea that NME countries have distorted their internal markets to such an extent that it is impossible to determine the “real” price paid for goods and services.⁶² As a result, the ME valuation methods which rely on said “real prices” are necessarily inapplicable.

2. NME Valuation and the Factors of Production

The surrogate country valuation process acts by imposing certain costs, known as the factors of production.⁶³ The process can be illustrated by conceptualizing a good produced in a non-market economy as a sum of its parts, each with a blank price tag. The price tag is then filled in using published prices from the surrogate country or countries, at which point the prices are cumulated to find normal value, similar to the constructed value method.⁶⁴

wide rate was, on average, “13 times greater than the average market economy ‘all other’ rate”) (emphasis added); *see also* Bruce M. Mitchell & Ned H. Marshak, Comment on Behalf of the Government of the People’s Republic of China, Bureau of Fair Trade for Imports & Exports, Response to Separate Rates Practice in Antidumping Proceedings Involving Non-Market Economy Countries; Request for Comment, at 5–8 (June 1, 2004), <http://ia.ita.doc.gov/download/nme-sep-rates/comments/boft-nme-sep-rates-cmt.pdf> (presenting multiple examples of how the average PRC rate is significantly higher than the average “all other” rate in ME countries for similar merchandise).

60. *See* Chutex June 25 Comment, *supra* note 46, at 5.

61. The view that surrogate-country methodology leads to higher dumping margins appears to be widely adopted by foreign exporters and even acknowledged by the U.S. government. *See, e.g.*, U.S. Gov’t Accountability Office, Report No. GAO-06-231, *U.S. Chinese Relations: Eliminating Nonmarket Methodology Would Lower Anti-Dumping Duties for Some Chinese Companies* (2006), available at <http://www.gao.gov/htext/d06231.html>; EMBASSY OF THE PEOPLE’S REPUBLIC OF CHINA IN THE UNITED STATES OF AMERICA, REPORT: US TRADE RULES UNFAIR (2005), available at <http://www.china-embassy.org/eng/zmgx/1/t191208.htm>.

62. PETERSON, *supra* note 9, at 99.

63. *Id.* at 65.

64. *Id.* The factors that Commerce considers when calculating normal value for an NME country include hours of labor required; quantities of raw minerals consumed; amount of energy and other utilities consumed; and representative capital costs. These factors are similar to the factors used in the constructed value approach, discussed *supra* note 40.

For better or for worse, this disconnect between actual cost and surrogate cost is absolute.⁶⁵ Regardless of what kind of market the component materials were purchased from, whether or not the wages paid to the workers were competitive or not, and no matter the price paid for utilities to run the factories, Commerce attaches no significance to the expenditures required to produce the exported goods.⁶⁶ Instead, Commerce assigns values to these factors of production equal to their “cost” in the surrogate country.⁶⁷

One significant exception to this rule is if the NME respondent purchased one of its factors of production directly from an ME producer, and paid in the currency of that ME country.⁶⁸ In this case, Commerce will use the actual price paid instead of the surrogate value for this factor of production, even in cases where only a portion of the factor is purchased according to the requirements.⁶⁹

3. Surrogate Country and Data Selection

Selection of a surrogate country (like many processes within the NME anti-dumping framework) is controversial, heavily criticized and often difficult to justify.⁷⁰ Commerce is guided by the conditions that the surrogate country be “at a level of economic development comparable to that of the [NME] economy country” and also a “significant producer of the subject merchandise.”⁷¹ These provisions notwithstanding, Commerce’s efforts to find a suitable surrogate country are often frustrated by the lack of publicly available data or the unwillingness of the selected

65. Subject to the exception explained *infra* Part 4.

66. 19 U.S.C. §1677b(c)(1) (2006). When merchandise is exported from a non-market economy country and the available information does not permit the value of the merchandise to be determined pursuant to market economy valuation schemes, normal value is to be determined instead using the surrogate country factors of production approach, rather than using actual costs pursuant to the market economy approach.

67. *Id.*

68. *See* 19 C.F.R. § 351.408(c)(1) (2005).

69. *Id.* (“In those instances where a portion of the factor is purchased from a market economy supplier and the remainder from a nonmarket economy supplier, the Secretary normally will value the factor using the price paid to the market economy supplier”).

70. *See* Peter D. Ehrenhaft & Charlotte G. Meriwether, *The Trade Agreements Act of 1979: Small Aid for Trade?*, 58 TUL. L. REV. 1107, 1128 (1984).

71. 19 U.S.C. § 1677b(c)(4)(A)-(B) (2006). Advocates for exporters would not have us forget that the statute predicates selecting an appropriate surrogate country on the condition that Commerce finds that the available information does not permit Commerce to determine normal value pursuant to the market economy valuation methods. 19 U.S.C. § 1677b(c)(1)(B).

country to cooperate with the investigation, leading to the selection of seemingly bizarre match-ups.⁷²

Although Commerce recently expressed its interest in reevaluating its methodology for selecting a surrogate country,⁷³ the current practice is to prepare a list of several countries that Commerce finds to be potentially suitable as surrogates, and then solicit recommendations from interested parties on which country is most suitable.⁷⁴ Nonetheless, Commerce ultimately has wide discretion in choosing the surrogate country.⁷⁵

With regard to the actual data that Commerce elects to use in determining the factors of production, the statute provides that that such data chosen from the surrogate country be “the best available information.”⁷⁶ If the adjective “best” begs the question “best for what purpose?” it is clear that Commerce would surely prefer to leave the answer to this question in the realm of bureaucratic discretion. However, it is becoming increasingly clear that Commerce is to gather this information for the purpose of calculating the dumping margin “as accurately as possible.”⁷⁷ While this anchor creates a certain tension in the selection of acceptable surrogate country data, Commerce still retains a substantial amount of proverbial slack in settling on a data set.⁷⁸

72. See Ehrenhaft & Meriwether, *supra* note 70, at note 66 (discussing an investigation wherein India, Commerce’s first choice, refused to cooperate with the investigation, leading Commerce to choose Thailand as a surrogate for the PRC).

73. See generally May 25 Request, 72 Fed. Reg. 29, 302 (requesting comment on reevaluating its anti-dumping NME methodology for the PRC); October 25 Request, 72 Fed. Reg. 60, 649 (requesting further comment).

74. See Antidumping Methodologies in Proceedings Involving Non-Market Economy Countries: Surrogate Country Selection and Separate Rates, 72 FR 13, 246, 13, 246–47 (Proposed March 21, 2007) [hereinafter Surrogate Proposal] (explaining Commerce’s process of “inviting comments” regarding surrogate countries from interest parties). For a criticism of this process, see PRCMOC Comment, *supra* note 59, at 3.

75. See Surrogate Proposal, *supra* note 74, at 13, 246 (“The Tariff Act...provides broad discretion in the selection of surrogate market economy countries.”).

76. 19 U.S.C. § 1677b(c)(1) (2006).

77. *Allied Pac. Food (Dalian) Co. v. United States*, 587 F. Supp. 2d 1330, 1342 (Ct. Intl. Trade 2008) (citing *Parkdale Int’l v. United States*, 475 F.3d 1375, 1380 (Fed. Cir. 2007)) (finding that Commerce failed to prove that its chosen data set was more reliable than other data offered by the respondent); see also *Shakeproof Assembly Components v. United States*, 268 F.3d 1376, 1382 (Fed. Cir. 2001) (reflecting that the purpose of the statutory provisions outlined in 19 U.S.C. §1677(b)(c)(1) determine margins accurately).

78. See *Allied Pac. Food*, *supra* note 77, at 1342 (asserting that while Commerce’s choice is to be guided by the purpose of calculating duties as broadly as possible, Commerce has been granted wide discretion in what it considers the best available information).

4. Consequences of Surrogate Country Valuation

Respondents from NME countries argue vociferously against the use of surrogate country factors of production in determining normal value.⁷⁹ NME exporters subject to this methodology argue that both surrogate country and data sets are selected in an arbitrary and even capricious manner.⁸⁰ Unsurprisingly, criticism of the methodology reflects the widely held belief that using surrogate country values of production leads to higher normal value calculations, and thus higher penalties, than comparable anti-dumping actions against ME exporters.⁸¹

Commerce assumes that “all companies within the NME country are essentially operating units of a single, government-wide entity and should receive a single antidumping rate.”⁸² As a result, a firm with high input costs (and perhaps an equivalently-priced product) is going to receive a much higher dollar-penalty than a firm operating in a low-cost environment.⁸³

Although Commerce “presumes that all companies within the NME country are subject to government control,” it does allow certain firms the opportunity to receive individually calculated normal values (“sepa-

79. See Meikun Liu, Comment on Behalf of China Chamber of Commerce for Import & Export of Machinery and Electronic Products, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 6 (June 17, 2007), <http://ia.ita.doc.gov/download/nme-moe/ccme-nme-moe-cmt-20070625.pdf> [hereinafter CCCIEM June 17 Comment] (arguing that Chinese respondents should receive market-economy valuation in dumping investigations).

80. See, e.g., Sungjoon Cho, *A Dual Catastrophe of Protectionism*, 25 NW. J. INT'L L. & BUS. 315, 328–32 (2005); Karen Halverson, *China's WTO Accession: Economic, Legal and Political Implications*, 27 B.C. INT'L & COMP. L. REV. 319, 329–30 (2004).

81. See PRCMOC Comment, *supra* note 59, at 6.

82. IMPORT ADMINISTRATION, UNITED STATES DEPARTMENT OF COMMERCE, IMPORT ADMINISTRATION ANTIDUMPING MANUAL, Chapter 10, at 7 (Jan. 22, 1998), available at <http://ia.ita.doc.gov/admanual/index.html> (last updated Oct. 13, 2009) [hereinafter COMMERCE ANTIDUMPING MANUAL]. In accordance with Commerce's disclaimer, this citation to the Manual is intended to illustrate the reasoning behind the practice of assigning a single rate, and is not intended to establish that this is the practice currently adopted by Commerce. For a citation to satisfy the latter purpose, see *Certain Tissue Paper Products and Certain Crepe Paper Products From the People's Republic of China: Notice of Preliminary Determinations of Sales at Less Than Fair Value, Affirmative Preliminary Determination of Critical Circumstances and Postponement of Final Determination for Certain Tissue Paper Products*, 69 Fed. Reg. 56, 407, 56, 412 (2004) [hereinafter *Tissue Determination*].

83. See *Tissue Determination*, Fed. Reg. 56, 407 at 56, 412. (“it is the Department's policy to assign all exporters of merchandise subject to investigation in an NME country this single [percentage] rate”).

rate rate status”) by proving an absence of governmental control.⁸⁴ Because of the high administrative burden of conducting a separate rate status analysis, Commerce tends to limit the number of entities that qualify, although its discretion is not unlimited.⁸⁵

The NME exporter is further disadvantaged by the relatively arbitrary and unpredictable nature of using factors of production to determine normal value. The implications of this unpredictability are best illustrated through comparison to the ME exporters. In ME cases, Commerce uses relatively predictable, consistent methods to calculate normal value, methods that closely track either the producer’s sale price or its input cost.⁸⁶ This is important because it allows an ME respondent to either lower the price of its inputs, or “correctly price its goods in the U.S. market, thereby avoiding an anti-dumping duty.”⁸⁷

Because the NME respondent is unable to predict which data set Commerce is going to use to calculate the factors of production for any given review, it is effectively constrained against calculating a “correct” price for its merchandise.⁸⁸ Furthermore, because Commerce is using surrogate country inputs, it is “impossible for an NME producer to price its goods in the US market to avoid the imposition of antidumping duties.”⁸⁹ This lack of control over the valuation process is a source of frustration to many NME respondents subject to anti-dumping duties, espe-

84. U.S. Dep’t of Commerce, Import Administration Policy Bulletin 05.1, *Separate Rates Practice and Application of Combination Rates in Antidumping Investigations Involving Non-Market Economy Countries* 1 (Apr. 5, 2005), available at <http://ia.ita.doc.gov/policy/bull05-1.pdf> (laying out the dual requirements of absence of *de Jure* (in law) control and *de facto* (in fact) control [hereinafter Separate Rates Policy Bulletin]).

85. *Compare* Longkou Haimeng Mach. Co. v. United States, 581 F. Supp. 2d 1344, 1351–52 (Ct. Int’l Trade 2008) (holding that Commerce’s decision not to calculate company-specific dumping margin for plaintiff, a voluntary respondent, was in accordance with law. In this case Commerce’s decision not to grant mandatory respondent status to the plaintiff was based on part on the high administrative burden the analysis would require), *with* Zhejiang Native Produce & Animal By-Products Imp. & Exp. Corp. v. United States, 637 F. Supp. 2d 1260, 1264 (Ct. Int’l Trade 2009) (holding that Commerce’s decision not to select voluntary respondent Zhejian for review was not in accordance with law. Distinguished *Longkou* by stating that the plaintiffs in that case had “conceded that Commerce had the authority to limit the number of mandatory respondents,” while in this case the plaintiffs alleged that Commerce had no such authority, given the small number of total respondents).

86. Laroski, *supra* note 49, at 395 (arguing that “market economy status adds accuracy to antidumping investigations and adds predictability”).

87. *Id.*

88. *Id.*

89. Charlene Barshefsky, *Non-Market Economies in Transition and the US Antidumping Law: Remarks on the Need for Reevaluation*, 8 B.U. INT’L L.J. 373, 375 (1990).

cially when Commerce argues that the respondent should have known it was dumping.⁹⁰

D. The PRC's Status under US Unfair-Trade Laws

1. NME Status and the Market-Oriented Industry Test

The PRC's accession to the World Trade Organization ("WTO") was completed on December 11, 2001.⁹¹ Following extensive negotiations, the PRC gained full membership, but the permanent WTO members forced the PRC to make several concessions in order to achieve this end.⁹² Concerned that the PRC's abundance of cheap labor would make it impossible for certain low-skill domestic industries to compete with Chinese imports, the US and other developed countries insisted on certain protectionist measures.⁹³ One such concession was that the US and other WTO member countries would be able to treat the PRC as an NME until 2016.⁹⁴

The immediate consequence of permitting member states to classify the PRC as an NME was that imposing surrogate-country valuation methods on Chinese exporters became officially permitted in certain situations.⁹⁵ A brief summary of NME valuation under the GATT rules is valuable at this point to illustrate how the PRC Accession Protocol interacted with the rules that existed prior to the PRC Accession Protocol.

An explanatory note to the 1947 GATT Agreement, which preceded the WTO, provided that valuation methods that did not utilize domestic prices may be necessary when the exporting country has "a complete or substantially complete monopoly of its trade and where all domestic

90. See *Zhejiang Native Produce & Animal By-Products Imp. & Exp. Corp. v. United States*, 432 F.3d 1363, 1368 (Fed. Cir. 2005) (reh'g denied 2006 U.S. App. LEXIS 4544) (agreeing with defendant respondent's argument that it did not or should not have known it was dumping, despite Commerce's assertion to the contrary).

91. Tracy Elizabeth Dardick, *The US-China Safeguard Provision, the GATT, and Thinking Long Term*, 6 CHI. J. INT'L L. 467, 474 (2005) (discussing the importance of the valuation process in anti-dumping investigations).

92. *Id.* at 472.

93. *Id.* at 473-74.

94. *Id.* at 472.

95. See World Trade Org., *Protocol on the Accession of the People's Republic of China*, pt. I, § 15(a)(ii), WT/L/432 (Nov. 23, 2001) (on file with author) ("The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail"), available at <http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN002123.pdf> [hereinafter Accession Agreement].

prices are fixed by the state.”⁹⁶ Although this seemingly strict “monopoly” requirement would appear to refer exclusively to Soviet-style command economies, in practice it has not been applied quite so strictly.⁹⁷ This note was retained in the 1994 GATT Agreement (which led to the creation of the WTO),⁹⁸ which explicitly provided that surrogate country valuation would be appropriate when actual costs are unemployable “because of the particular market situation [in the exporting country].”⁹⁹

Because the PRC’s economy is somewhere between a classic command-economy and a purely market-based economy,¹⁰⁰ it is unclear whether WTO members would have legally been able to subject the PRC to the surrogate-country valuation method under the 1947 and 1994 GATT rules. However, it is clear that the PRC Accession Protocol sets out guidelines for an NME status determination that differs from the traditional GATT protocol. The reference to a state “monopoly” did not survive.¹⁰¹ Instead, a member country is permitted to impose surrogate country valuation on Chinese respondents, unless such respondent can prove that the entire industry for that product operates under market-economy conditions (“MOI Test”).¹⁰²

Although the revised GATT rules were finalized in 1994, Commerce had already employed a Market Oriented Industry (“MOI”) Test as far back as 1992.¹⁰³ In order to escape surrogate-country valuation using the MOI test, the respondent in an anti-dumping investigation must prove

96. General Agreement on Tariffs and Trade, Annex I: Notes & Supplementary Provisions, Art. VI, ¶ 1(2) (1947), available at http://www.wto.org/english/docs_e/legal_e/gatt47_03_e.htm#annexi [hereinafter GATT Annex 1]

97. See Gary N. Horlick & Shannon S. Shuman, *Nonmarket Economy Trade and U.S. Antidumping/Countervailing Duty Laws*, 18 INT’L LAW. 807, 807 n.57, 858 (1984).

98. See Marcia Don Harpaz, *China and the WTO: New Kid on the Developing Bloc?*, 36 n.139 (Hebrew Univ. of Jerusalem Faculty of Law, Research Paper No. 2-07, 2007), available at www.ssrn.com/abstractid=961768.

99. Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994, pt. 1, art. 2, Determination of Dumping (1994), available at http://www.wto.org/english/docs_e/legal_e/19-adp_01_e.htm.

100. See Daniel H. Johnson, Comment, *East Seats West: China’s Accession to the World Trade Organization and the Rise of a Potent Threat to the North Carolina Furniture Industry*, 29 N.C.J. INT’L L. & COM. REG. 83, 92–93 (2003).

101. See generally Accession Agreement, *supra* note 95 (omitting reference to the GATT protocol or the “monopoly” requirement laid out in GATT Annex 1, *supra* note 96).

102. *Id.* at pt. I, § 15(a).

103. See David Codevilla, Comment, *Discouraging the Practice of What We Preach: Saarlust I, Inland Steel and the Implementation of the Uruguay Round of GATT 1994*, 3 GEO. MASON INDEP. L. REV. 435, 466 n.190 (1995).

virtually no government involvement in industry prices or production; that the industry is marked by private or collective ownership that behaves as one in an ME country; and that producers pay market-determined prices for all major inputs and almost all minor inputs.¹⁰⁴

According to Laroski, “the strict market-oriented industry test used by [Commerce] virtually guarantees that a market oriented industry will not be found.”¹⁰⁵ As of this date, no respondent has been successful in its attempts to convince Commerce that its industry is market-oriented under the terms of the test, and it appears unlikely that any industry will be able to qualify in the near future.¹⁰⁶

2. The “Double Standard” of Anti-Dumping & CVD Penalties

While this Note focuses primarily on anti-dumping valuation issues, it is important to briefly discuss CVD law, another unfair trade mechanism. In *Georgetown Steel Corp. v. United States*, the court explained that the purpose of CVD law is “to offset the unfair competitive advantage that foreign producers would otherwise enjoy from export subsidies paid by their governments.”¹⁰⁷ CVDs are relevant to the discussion of anti-dumping NME valuation as applied to the PRC for two interrelated reasons. First, Commerce’s recent decision to employ CVD law against the PRC, an NME, apparently spurred the decision to reevaluate the valuation method used against Chinese respondents in anti-dumping cases. More recently, the Court of International Trade expressed its own dissatisfaction with the status quo approach, and ordered Commerce to either drop CVD penalties against the PRC or rethink its anti-dumping approach to take CVDs into account.¹⁰⁸

In 2007 Commerce reversed its policy of not applying CVDs against NMEs, in a case involving imports of paper from the PRC.¹⁰⁹ In that case, the respondents argued that Commerce was precluded from applying CVDs to NME countries by virtue of *Georgetown Steel*, in which the Court of Appeals upheld the administrative decision to refrain from ap-

104. See May 25 Request, 72 Fed. Reg. 29, 302 at 29, 302–03.

105. Laroski, *supra* note 49, at 396.

106. See May 25 Request, 72 Fed. Reg. 29, 302 at 29, 303.

107. *Georgetown Steel Corp. v. United States*, 801 F.2d 1308, 1315 (Fed. Cir. 1986) (citing *Zenith Radio Corp. v. United States*, 437 U.S. 443, 455–56 (1978)).

108. See GPX *supra* note 6. This case is discussed in detail in Section III.A.2, *infra*.

109. See Press Release, Dep’t of Commerce Office of Pub. Affairs, Commerce Applies Anti-Subsidy Law to China (March 30, 2007) (on file with author) available at http://www.commerce.gov/NewsRoom/PressReleases_FactSheets/PROD01_002950 [hereinafter Commerce Press Release].

plying CVDs to the PRC.¹¹⁰ However, Commerce maintained that it had imputed authority to apply CVD law to the PRC.¹¹¹

Prior to 2007, commentators, courts and assumedly the PRC had long believed that NME status guaranteed that CVD duties would not be imposed, which was consistent with Commerce statements made in the Federal Register.¹¹² During this period Commerce maintained that the centrally controlled aspect of NME economies made government subsidies immeasurable for purposes of calculating CVDs.¹¹³ In explaining the change in policy, Commerce stated that it had become possible to identify and measure government subsidies due to increasingly market-oriented nature of the PRC's economy.¹¹⁴

This was the first time that the US had imposed CVDs on an NME,¹¹⁵ but recent development notwithstanding, it appears to have become the rule rather than the exception.¹¹⁶ Imposing CVDs on NME countries is not explicitly precluded by WTO regulations.¹¹⁷ However, since the poli-

110. See Memorandum from Stephen J. Claeys, Deputy Director, Import Administration, to David M. Spooner, Assistant Secretary for Import Administration, regarding Issues and Decision for the Final Determination in the Countervailing Duty Investigation of Coated Free Sheet from the People's Republic of China, at 16–17 (Oct. 17, 2007), <http://ia.ita.doc.gov/frn/summary/PRC/E7-21046-1.pdf> [hereinafter Coated Free Sheet Final Determination] (“The [respondent] argues that [Commerce] does not have the authority to apply the CVD law to China as long as the Department continues to designate China as a nonmarket economy, . . . In support, [petitioner] points to . . . [Georgetown Steel]”).

111. *Id.* at 19–20.

112. See Countervailing Duties, 63 Fed. Reg. 65, 348, 65, 360 (Dep't Commerce Nov. 25, 1998).

113. See Carbon Steel Wire Rod from Czechoslovakia: Final Negative Countervailing Duty Determination, 49 Fed. Reg. 19, 370, 19, 371–19, 372 (Dep't Commerce May 7, 1984).

114. See Georgetown Steel Memorandum, *supra* note 4, at 10.

115. See Commerce Press Release, *supra* note 109 (“This is the first time countervailing duties will be imposed on imports from a non-market economy.”). However, for a discussion on the first CVD investigation against an NME, see Harris, *infra* note 257.

116. See, e.g., Kathleen Canon, *U.S. PC Strand Industry Files Antidumping and Countervailing Duty Cases Against China*, REUTERS, May 27, 2009, at <http://www.reuters.com/article/pressRelease/idUS195758+27-May-2009+PRN20090527> (announcing the domestic producers of steel wire filed anti-dumping and CVD petitions against the same PRC respondent); Department of Commerce, Int'l Trade Comm., Fact Sheet, available at <http://ia.ita.doc.gov/download/factsheets/factsheet-prc-drill-pipe-init-012110.pdf>; but cf. *GPX*, *supra* note 6, at 3 (holding that the application of both CVDs and NME anti-dumping penalties in their current form to PRC producers was impermissible).

117. See Loren Yager, Director, International Affairs and Trade, U.S. Government Accountability Office GAO-06-608T, Testimony Before the U.S.-China Economic and Security Review Commission, at 2 (April 4, 2006).

cy-shift, the Chinese government has been lobbying heavily for so-called equal treatment: either its exporters receive the benefit of ME valuation methods under anti-dumping laws, or CVD laws not apply.¹¹⁸

Currently, Chinese exporters may be subject to unfavorable status under both CVD and anti-dumping laws.¹¹⁹ On one hand, the Chinese economy has liberalized to the point where Commerce believes government subsidies have become measurable and thus subject to CVD analyses.¹²⁰ At the same time, Commerce does not believe the Chinese economy has developed to the point where ME valuation is appropriate.¹²¹ Further, no individual industry can establish that it is operating entirely under free-market principles in order to pass the MOI test and receive the benefit of the ME valuation method.¹²² At this point in time the PRC is the only country to receive NME status per anti-dumping laws and ME status per CVD policy.¹²³

In September 2009, the Court of International Trade effectively mandated that Commerce do something about its failure to address its application of anti-dumping procedures against the PRC in light of the market liberalization impliedly recognized by the decision to apply CVDs to Chinese exporters.¹²⁴ The reasoning behind this holding—that NME anti-dumping valuation plus CVD duties effectively amount to “double counting”¹²⁵—speaks to both the need for, and the legality of, a new val-

118. See William H. Barringer, Comment on Behalf of China Chamber of Commerce of Minerals, Metals and Chemical Imports and Exporters, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 7–8 (June 25, 2009), <http://ia.ita.doc.gov/download/nme-moe/cccmc-nme-moe-cmt-20070625.pdf> [hereinafter CCCMMC June 25 Comment]. Although demonstrating frustration for being penalized under both anti-dumping and CVD law, Chinese respondents are generally more inclined to advocate for abolition of NME status than to argue for elimination of CVD duties, *id.*

119. Subject to the discussion of *GPX*, *infra* Section III.A.2.

120. See Coated Free Sheet Paper From the People’s Republic of China: Amended Preliminary Affirmative Countervailing Duty Determination, 72 Fed. Reg. 17, 484, 17, 486 (Dep’t Commerce Apr. 9, 2007).

121. See Georgetown Steel Memorandum, *supra* note 4, at 7.

122. See May 25 Request, 72 Fed. Reg. 29, 302 at 29, 303.

123. See Polyethylene Retail Carrier Bags From the Socialist Republic of Vietnam: Initiation of Countervailing Duty Investigation and Request for Public Comment on the Application of the Countervailing Duty Law to Imports From the Socialist Republic of Vietnam, 74 FR 19064, 19067 (Dep’t of Commerce April 27, 2009).

124. See *GPX*, 645 F. Supp. 2d at 1288–89; see also Yager, *supra* note 117, at 2 (“[a]bsent a clear congressional grant of authority, [applying CVDs to an NME] could be challenged in court, with uncertain results”).

125. *GPX*, 745 F. Supp. 2d at 1235.

uation approach for anti-dumping investigations against Chinese countries, and will be discussed more fully in section III of this Note.

II. AN ECONOMY IN TRANSITION: THE STATE OF THE PRC'S MARKETS AND A SEARCH FOR A NEW VALUATION APPROACH

A. The Transitional State of the PRC's Economy

Cognizant of the competitive disadvantage its exporters suffer due to NME classification, the Government of the PRC supported a request made by Chinese respondents in an anti-dumping case that Commerce review the PRC's status as an NME country.¹²⁶ In response, Commerce drafted two memoranda in which it discussed in detail whether the PRC could be considered an ME country.¹²⁷

In the Georgetown Steel Memorandum, which effectively summarized the two memoranda,¹²⁸ Commerce found that the PRC had implemented significant economic reforms since the early 1990's, and that its economy was far more "flexible" than the soviet-style economies for which the NME valuation methods were formulated.¹²⁹ In contrast to those economies, the PRC has eliminated price controls on most products; allows employers to set wages; permits a certain degree of individual entrepreneurship; and extends foreign trading rights to Foreign-Invested Enterprises.¹³⁰ Commerce summarized the PRC's economy as "one in which constrained market mechanisms operate alongside (and sometimes, in spite of) government plans."¹³¹

Unfortunately for the respondent in that case, and for Chinese exporters in general, Commerce found that those alluded-to government plans

126. See Georgetown Steel Memorandum, *supra* note 4, at 2.

127. See generally Memorandum from Shauna Lee-Alaia et al., Office of Policy, Import Administration, to David M. Spooner, Assistant Sec'y, Import Administration, The People's Republic of China (PRC) Status as a Non-Market Economy (NME) (May 15, 2006), <http://ia.ita.doc.gov/download/prc-nme-status/prc-nme-status-memo.pdf> [hereinafter May 15 Memorandum] (evaluating whether the PRC's economy had graduated to ME status); Memorandum from Shauna Lee-Alaia ET AL., Office of Policy, Import Administration, to David M. Spooner, Assistant Sec'y, Import Administration Antidumping Duty Investigation of Certain Lined Paper Products from the People's Republic of China ("China")- China's status as a non-market economy ("NME") (Aug. 30, 2006), http://www.docinweb.com/Lined_Paper_Products_from_the_People%27s_Republic_of_China_61356#download_link [hereinafter August 30 Memorandum] (evaluating in great detail whether China's economy had graduated to ME status).

128. Georgetown Steel Memorandum, *supra* note 4, at 3 n.1.

129. *Id.* at 4.

130. *Id.* at 5-7.

131. *Id.* at 9.

in fact constrained the Chinese market to a legally determinative extent.¹³² In particular, the May 15 Memorandum stated that the Chinese government continued to exert a great deal of control over the banking sector, which was particularly significant given that one of the factors for an NME determination is the extent of government control over the allocation of resources.¹³³ The August 30 Memorandum additionally highlighted the extent of government control over currency value,¹³⁴ labor mobility,¹³⁵ and the undeveloped state of property rights¹³⁶ as evidence that the PRC was not yet a ME under its interpretation of the Tariff Act requirements.

Based on these findings, Commerce reached the conclusion that due to the “limited extent to which market forces and institutional reform have taken root in critical sectors of the [PRC’s] economy . . . the [PRC] should therefore continue to be considered an NME country for purposes of U.S. antidumping law.”¹³⁷ In answer to the PRC’s request that it be allowed to use ME country valuation methods in anti-dumping investigations, Commerce stated, “market forces in the [PRC] are not yet sufficiently developed to permit the use of prices and costs in that country for purposes of the Department’s dumping analysis.”¹³⁸

B. A Reconsideration of NME Valuation Methods for Chinese Respondents

1. Commerce’s Requests for Comment

The astute reader will have noticed the adverbial form of the word “yet,” used above, referring to the (in)appropriateness of ME valuation

132. Coated Free Sheet Final Determination, *supra* note 110, at 19–20.

133. May 15 Memorandum, *supra* note 127, at 3. Given the investment-driven nature of the PRC’s economy, the May 15 Memorandum attached extra significance to government control of the financial sector.

134. See August 30 Memorandum, *supra* note 127, at 13 (concluding that although the renminbi was not yet market-based, it was not “completely insulated from market forces”). Although the PRC is currently pegging the value of the renminbi to that of the dollar, see Michael Pettis, *What the [PRC] Cannot Do With Its Reserves* (Feb. 22, 2010), <http://mpep.com/2010/02/what-the-pboc-cannot-do-with-its-reserves>, I posit that this imbalance is best addressed by the executive branch of government, and that the legislative and judicial branches should respectfully defer.

135. *Id.* at 22 (“[R]estrictions on labor mobility serve to inhibit and guide workforce flows and seriously distort the supply side of the labor market”).

136. *Id.* at 46 (concluding that property rights in the PRC “remain poorly defined and weakly enforced”).

137. May 15 Memorandum, *supra* note 127, at 8–9.

138. August 30 Memorandum, *supra* note 127, at 82.

methods for Chinese exports in anti-dumping investigations. In the negative, the adverbial “yet” signifies that the speaker is expecting something to happen.¹³⁹ The literalist may protest that there is no error, as the valuation method is expected to change in 2016.¹⁴⁰ However, Commerce has recently demonstrated a more immediate willingness to re-evaluate the valuation procedures for Chinese companies in anti-dumping investigations, although it has not yet implemented any changes.

In May of 2007 Commerce began to publicly solicit for suggestions on modifying its approach to calculating normal value for individual Chinese respondents.¹⁴¹ Acknowledging the Georgetown Steel Memorandum, the May 25th request stated:

The evolution of the PRC's economy together with the features and characteristics of the PRC's present-day economy...suggest that modification of some aspects of the Department's current NME antidumping policy and practice with regard to the PRC may be warranted, such as the conditions under which the Department might grant an individual respondent in the PRC *market-economy treatment* in some or all respects.¹⁴²

Although commentators such as Lantz had been advocating an approach that focused on individual enterprises since the 1990's,¹⁴³ this was the first time Commerce had raised the possibility of an MOE analysis.¹⁴⁴ The incentive for proposing the MOE test now apparently stemmed in part from Commerce's admission that no Chinese industry had met the high standard required to pass the MOI test¹⁴⁵ and also in part from the

139. RAYMOND MURPHY, ENGLISH GRAMMAR IN USE: A SELF-STUDY REFERENCE AND PRACTICE BOOK FOR INTERMEDIATE STUDENTS OF ENGLISH 222 (2004). True purveyors of grammatical nuance may have also noticed the continual use of the word “continue,” this time in reference to the PRC's nominal status as an NME. One may assume an equivalent connotation.

140. 2016 is the date at which the PRC will become an ME under the terms of the Accession Agreement. See Accession Agreement, *supra* note 95, at pt. I, § 15(d).

141. See May 25 Request, 72 Fed. Reg. 29, 302 at 29, 302.

142. *Id.* at 29, 303 (emphasis added).

143. Lantz, *supra* note 20, at 1049 (arguing that such an individualized approach would be “superior,” and also stating rather prophetically that such a test would forestall the undesirable possibility that an NME respondent would be subject to both NME valuation for Ad purposes and ME liability for CVD purposes).

144. The short-lived “bubbles-of-capitalism” approach attempted briefly to address this type of enterprise, but was ultimately never utilized. This approach will be discussed in Section III.B.1, *infra*.

145. May 25 Request, 72 Fed. Reg. 29, 302 at 29, 302.

fact that in the PRC's economy had evolved to the point where government subsidies could be "identified and measured."¹⁴⁶

In its May 25th Request, Commerce asked interested parties to respond to two questions. Initially, how should Commerce identify individual Chinese respondents that are operating under market conditions, if at all? In posing this question, the May 25th Request emphasized an identification of the particular "conditions" under which the ME treatment might be warranted.¹⁴⁷ Then, once identified, to what extent should Commerce rely on the MOE's own costs to determine normal value?¹⁴⁸ Regarding this second question, Commerce was particularly concerned with costs that were "inextricably linked" to the factors that the Georgetown Steel Memorandum identified as still being subject to Chinese government control.¹⁴⁹

After receiving initial responses, Commerce published a second request for comment.¹⁵⁰ The October 25th request posed new questions in response to certain arguments made in the initial responses, arguments addressed in detail in part C of this section. First, does Commerce have the legal authority to administer an MOE test?¹⁵¹ Second, would an MOE test be administratively feasible, particularly considering the interconnectedness of prices within an economy?¹⁵² And finally, Commerce asked again for comment addressing the extent to which an MOE's own prices and costs could be utilized, specifically those costs most exposed to "macroeconomic NME distortions."¹⁵³

For the purposes of this Note, I will attempt to summarize the positions argued in the responses in regard to three questions. First, is an MOE test legal? That is, does Commerce have the statutory authority to adopt an MOE test, and would such a test be compatible with our WTO obliga-

146. *Id.* While CVDs were not explicitly mentioned in the May 25th Request, Commerce referred repeatedly to the Georgetown Steel Memorandum, which had posited the applicability of CVDs as a direct consequence of that fact that government benefits could be identified and measured.

147. *Id.* at 29, 303.

148. A valuation method that took an MOE's own costs into consideration would likely resemble the ME Constructed Value method, although this term is not used explicitly in the May 25th Request. *See generally* May 25 Request, 72 Fed. Reg. 29, 302.

149. *See* May 25 Request, 72 Fed. Reg. 29, 302 at 29, 303 (the "inextricably linked" inputs identified were labor, land and capital).

150. *See generally* October 25 Request, 72 Fed. Reg. 60, 649 (asking for further comment on the proposed MOE test).

151. *Id.* at 60, 650.

152. *Id.*

153. *Id.* The inputs that were given as "inextricably linked" were the same as the ones mentioned in the May 25 Request, 72 Fed. Reg. 29, 302, namely, labor, land and capital.

tions. As you will see, many of the respondents argue that not only is an MOE test legal, but in fact it is necessary. Second, assuming that an MOE test is legal, which companies qualify for it, and how would those companies be identified? Finally, after identifying an MOE, the question becomes how to calculate normal value, that is, for what inputs may Commerce depart from traditional NME valuation methods, and on what alternate methods should it rely?

2. Responses to Commerce's Request for Comment: A Summary

a. Legality of a Market-Oriented Enterprise Test

Commerce received almost 40 responses to the May 25th request¹⁵⁴ and almost 30 for the October 25th request,¹⁵⁵ although there was a fair amount of overlap in terms of participants.¹⁵⁶ Arguments around legality generally centered around 19 U.S.C. 1677 and 1677b (the "Tariff Act"), as well as the accession act granting the PRC admission to the WTO (the "Accession Act").

The responses in favor of an MOE test ("Responses in Favor") were adamant in their assertion that the Tariff Act language did not create a barrier to the MOE test. One noteworthy response made the point that the "two-step statutory analysis [of 19 U.S.C. 1677b(c)(1)] anticipates that the Department may find it appropriate to use its standard methodology for calculating normal value even in proceedings involving an NME country."¹⁵⁷ For readers possessing neither a photographic memory nor encyclopedic knowledge of trade law, 19 U.S.C. 1677b(c)(1) outlines two requirements that must be in order to impose NME valuation methods in anti-dumping investigations: first, that the merchandise subject to the anti-dumping investigation be exported from an NME, and second,

154. A complete list of the May 25th responses is available at <http://ia.ita.doc.gov/download/nme-moe/nme-moe-cmt-20070625-index.html>.

155. A complete list of the October 25th responses is available at <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/nme-moe-cmt-20071210-index.html>.

156. Of the 29 Second-Round Responses received, 13 had also been First-Round Responses. See <http://ia.ita.doc.gov/download/nme-moe/nme-moe-cmt-20070625-index.html>.

157. Brenda A. Jacobs, Comment on Behalf of Chutex Group, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 2 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/chutex-nme-moe-cmt-20071210.pdf> [hereinafter Chutex December 10 Comment].

that the available information does not permit standard ME methods of valuation must be met.¹⁵⁸

The first prong of the above test is rather straightforward. However, it is the second prong that the Responses in Favor are fixated upon, however painfully. As the Chutex December 10 Comment clearly enunciates, “the mere fact that an antidumping proceeding involves an NME is insufficient reason for the Department to deviate from the standard [ME] methodology for calculating normal value.”¹⁵⁹ This implicitly implies that the state of the PRC’s economy does indeed allow the application of ME methods to determine the normal value of merchandise. In fact, this interpretation extends an MOE test, which would hypothetically account for this situation, beyond permissible and into the rigid realm of necessary, considering that Commerce would actually be precluded from using NME methodology if the available information made certain ME methods applicable.

In case its statutory interpretation is in doubt, the Chutex December 10 Comment pointed to the legislative history of the 1988 trade act that amended the antidumping statute.¹⁶⁰ Read in part, the history stipulates that “[i]f information submitted by a non-market economy country to the Department permits foreign market value to be determined accurately using the normal [ME] methodology, then the committee expects such methodology to be used by the department.”¹⁶¹

Statutory provisions aside, various responses pointed out that Commerce enjoys an interpretive flexibility that allows it to deviate from the industry-wide surrogate value method.¹⁶² Put less formally, Commerce already tweaks the NME valuation approach to account for certain market-oriented forces by allowing certain respondents the opportunity to gain separate rate status by showing a lack of government control, and also by valuing certain inputs purchased directly from market-economy

158. See 19 U.S.C. 1677b(c)(1) (2006).

159. Chutex December 10 Comment, *supra* note 157, at 2.

160. *Id.* at 3.

161. *Id.* at 3–4 (citing S. Rep. No. 100-71, 100th Cong., 1st Sess., 108 (1987)).

162. *Id.* at 4–5; see also Douglas J. Heffner & Rick Johnson, Comment on Behalf of J.C. Penney, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 4 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/jcpenny-nme-moe-cmt-20071210.pdf> [hereinafter J.C. Penney December 10 Comment] (pointing out that the MOI test itself would not be legal under an interpretation of [19 U.S.C. 1677b] that precluded ME methodology from being applied in an NME setting).

countries at market price.¹⁶³ Because these practices are currently accepted as legal interpretations of statutory authority, it seems unlikely that an MOE test would be impermissible.

The responses that advocated against an MOE test (the “Responses Against”) tended to emphasize both the PRC WTO Accession Agreement and also 19 U.S.C. §1677b(c)(1). Citing the Tariff Act, the American Furniture June 25th Comment argues that 19 U.S.C. §1677b(c)(1) precludes an MOE test by defining NMEs as countries where ME methodologies are inapplicable, therefore “when the exporting country is designated a [NME], the Department must use the [NME] methodology.”¹⁶⁴ However, while such circular logic is questionable, a closer reading of the statute reveals that this argument effectively jumps from the term “Nonmarket economy countries” to the factors of production approach at the end of the sentence, effectively skipping the two-prong test discussed above.¹⁶⁵

A stronger argument is that neither the Accession Agreement nor the Tariff Act contemplates individual entities receiving special status. A comment arguing that the language in Accession Agreement precludes an MOE test points out that “while the [Accession Agreement] provides for determinations as to whether Chinese *industries* warrant market economy treatment, there is no such provision [that this would be done for individual companies].”¹⁶⁶ Similarly, the ICL June 25th Comment ar-

163. See Harry Lee, Comment on Behalf of Textile Counsel of Hong Kong, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 3–4 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/tchk-nme-moe-cmt-20071210.pdf> [hereinafter Textile Counsel December 10 Comment] (“Other practices adopted by [Commerce] reinforce the principle that [Commerce] may deviate from its alternative NME methodology where warranted”).

164. See Joseph W. Dorn, et al., Comment on Behalf of American Furniture Manufacturers Committee for Legal Trade et al., Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 2–3 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/king-spalding-nme-moe-cmt-20070625.pdf> [hereinafter American Furniture June 25 Comment] The exact statutory language is, “the valuation of the factors of production shall be based on the best available information regarding the values of such factors in a market economy country or countries considered to be appropriate by the administering authority,” 19 U.S.C. 1677b(c)(1) (2006).

165. See 19 U.S.C. 1677b(c) (2006).

166. Robert E. Lighthizer et al., Comment on Behalf of United States Steel Corporation, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 2 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/us-steel-nme-moe-cmt-20070625.pdf> [hereinafter U.S. Steel June 25 Comment].

gued that the NME methodology outlined by the Tariff Act at 19 U.S.C. 1677b, “applies to exports from ‘a nonmarket economy,’ not to exports of a particular enterprise.”¹⁶⁷

While there is nothing factually wrong with these arguments, they do not address the fact that Commerce already applies special rules to individual respondents, as several of the Responses in Favor were quick to point out.¹⁶⁸

b. Identifying a Market-Oriented Enterprise

Most of the Responses in Favor shared one prominent stipulation regarding identification: the identification portion of the test should not be impossible to pass.¹⁶⁹ These concerns arose from the fact that “no industry has met the MOI standard in the fifteen years since this test was introduced by the Department.”¹⁷⁰

Although virtually all of the Responses in Favor cited specific criteria that Commerce could use to help it identify whether an individual enterprise was sufficiently market-oriented, the responses trifurcated on whether the identification criteria should be modeled more on the MOI test, on the Separate-Rates Test, or on the NME test.¹⁷¹

167. James R. Cannon, Jr., Comment on Behalf of ICL Performance Products, LP and Innophos, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 4 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/icl-innophos-nme-moe-cmt-20070625.pdf> [hereinafter ICL June 25 Comment] (citing 19 U.S.C. 1677b(c)).

168. See Textile Counsel December 10 Comment, *supra* note 163, at 3–4.

169. See Brenda Jacobs, Comment on Behalf of Textile Counsel of Hong Kong, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 6–7 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/tchk-nme-moe-cmt-20070625.pdf> [hereinafter Textile Counsel June 25 Comment] (suggesting that the MOE test employ criteria “that may be realistically met by companies that have embraced market principles,” and “avoid the problems that have plagued application of the MOI test”).

170. *Id.* at 6.

171. Compare Chutex December 10th Comment, *supra* note 157, at 7–8 (arguing that unlike the NME test, the Separate-Rate Test was created with individual enterprises in mind, and thus would reduce the administrative costs of implementing an MOE test based on its design), with Wang Xuehua & Bao Xiaobo, Comment on Behalf of Huanzhong & Partners, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 3 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/bhp-nme-moe-cmt-20071210.pdf> [hereinafter Huanzhong December 10 Comment] (arguing that some of the factors listed in U.S.C. 1677(18)(B) that constitute the NME test “appear to be more suitable for individual companies rather than for a country”).

Despite the failure of the MOI test, several of the Responses in Favor urged Commerce to borrow certain aspects of the MOI test to identify individual companies that may be considered market oriented.¹⁷² In addition to the general requirements of the MOI test, these responses suggested that Commerce consider whether the firm utilizes generally accepted accounting principles, adheres to regularized depreciation and payment systems, and are not protected from bankruptcy or afforded debt relief from the government.¹⁷³

In fact, such a test would be similar to one already utilized by the European Union.¹⁷⁴ According to the Jurisno June 20 Comment, the European Community Regulations identify 5 criteria for granting ME treatment to individual respondents.¹⁷⁵ These criteria include whether pricing and related decisions are made without State interference; whether accounting records are in line with international accounting standards; whether the production costs and financial situations are not subject to significant distortions, whether the firms are subject to reliable bankruptcy and property laws; and exchange rate conversions being carried out at the market rate.¹⁷⁶

Another group of Responses in Favor urged Commerce to identify MOEs using criteria already employed in the separate-rate test.¹⁷⁷ One response explained, “the separate rate test serves as the appropriate boilerplate for developing an MOE test because the purpose of the separate rate test is the same as the test for determining an MOE – i.e., determin-

172. See, e.g., Eric J. Jiang & Aimin Sun, Comment on Behalf of Jurisno Law group, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 6 (June 20, 2007), <http://ia.ita.doc.gov/download/nme-moe/jurisino-nme-moe-cmt-20070625.pdf> [hereinafter Jurisno June 20 Comment] (suggesting that Commerce initially base its MOE test on the conditions developed for the MOI test, and also consider the European Union approach); Textile Counsel June 25 Comment, *supra* note 169, at 7 (suggesting that the MOI criteria be applied to an MOE test “in a more practical manner”).

173. Jurisno June 20 Comment, *supra* note 172, at 3.

174. *Id.*

175. *Id.* at 3.

176. *Id.* at 3 (citing Council Regulation (EC) No 905/98 of 27 April 1998 amending Regulation (EC) No 384/96 on Protection Against Dumped Imports From Countries Not Members of the European Community).

177. Douglas J. Heffner & Rick Johnson, Comment on Behalf of J.C. Penney, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 3–4 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/jcpenney-nme-moe-cmt-20070625.pdf> [hereinafter J.C. Penney June 25 Comment]. For a comprehensive list of separate-rate test factors, see Separate Rates Policy Bulletin, *supra* note 84, at 2.

ing absence of government control.”¹⁷⁸ In principal such a test would “expand the focus of the analysis from just the export operations to the respondent’s entire operations—both manufacturing and export activities.”¹⁷⁹

Conceptually similar to the separate-rate test approach was the mutually compatible suggestion that Commerce establish a shifting burden of proof depending on the classification of the respondent. As one response put it, “a hierarchy could be constructed under which state owned companies are required to answer certain questions . . . not required of privately owned companies.”¹⁸⁰ Analogously, SOEs could be presumed ineligible for MOE treatment, while wholly-foreign-investment enterprises (“WFIE”) would be granted MOE status *prima-facie*, with private Chinese-owned companies falling somewhere in the middle.¹⁸¹

Finally, the Huanzhong December 10 Comment argued that the factors used for the determination of the market-economy status of a country “could be adapted for individual companies.”¹⁸² In particular, they argue that it would be feasible to determine on an individual basis whether the company set wage rates or not and whether the government or the company controlled the production means or made decisions regarding output.¹⁸³

Less subtle than the above suggestions were the responses made on behalf of various Chinese Chambers of Commerce. In forceful, immoderate terms, these responses argued, “that an absolute majority of Chinese enterprises are operate under market-economy environment [sic],”¹⁸⁴ and

178. Philippe M. Bruno, Comment on Behalf of Baosteel Group Corp., et al., Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 3–4 (June 25, 2007), <http://ia.ita.doc.gov/download/nme-moe/baosteel-nme-moe-cmt-20070625.pdf> [hereinafter Baosteel June 25 Comment].

179. *Id.* at 5.

180. CCCMMC June 25 Comment, *supra* note 118, at 17–18.

181. See Richard Malish et al., Comment on Behalf of Cheng Meng Furniture, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 7–9 (June 21, 2007), <http://ia.ita.doc.gov/download/nme-moe/cmfnme-moe-cmt-20070625.pdf> [hereinafter Cheng Meng June 25 Comment] (arguing that Commerce should “distinguish between” state-owned enterprises and privately owned companies for purposes of an MOE test).

182. Huanzhong December 10 Comment, *supra* note 171, at 3.

183. *Id.*

184. Wang Hangjiang, Comment on Behalf of China Chamber of Commerce for Import & Export of Machinery & Electric Products, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 2 (December 10, 2007), <http://ia.ita.doc.gov/download/>

“currently, the vast majority of Chinese industries have met the . . . MOE criteria.”¹⁸⁵ Responding specifically to administrative feasibility, the Chamber of Commerce responses argue across the board that most private-owned firms operating completely under “a fair and liberal market economy,”¹⁸⁶ with the implication that identification of those firms should be fairly straightforward.

Many of the Responses Against made the equally hard-line assertion that “*economy-wide* distortions in the PRC . . . affect all Chinese respondents,” and that “accordingly, it would be inappropriate for the Department to find that any Chinese respondent is entitled to [MOE] treatment.”¹⁸⁷ Thus according to this argument, the problem with identifying NMEs is the fact that none exist.

A better argument was that determining whether Chinese enterprises are market-oriented would be administratively unfeasible.¹⁸⁸ Based on the premise that non-market distortions permeate the Chinese economy, “any attempt to demonstrate how an individual Chinese company could be shown to be so insulated [against non-market distortions] would be extremely complicated and excessively time-consuming.”¹⁸⁹

On a similar note, the ICL December 10 Comment raised the question of where Commerce would obtain its data to make an MOE determination. It stated, “the crux of the problem is not whether market-based prices to [sic] exist, but whether it possible [sic] to identify such prices. More specifically, is it possible to analyze whether market-based price [sic]

load/nme-moe/comments-20071210/cccla-nme-moe-cmt-20071210.pdf [hereinafter CCCIEM December 10 Comment].

185. China Chamber of Commerce of Metals, Minerals, Chemical Importers & Exporters, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 3 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/cccmc-nme-moe-cmt-20071210.pdf> [hereinafter CCCMMC December 10 Comment].

186. China Chamber of Commerce for Import & Export of Textiles, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 2 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/ccct-nme-moe-cmt-20071210.pdf> [hereinafter CCCIET December 10 Comment].

187. U.S. Steel June 25 Comment, *supra* note 166, at 8.

188. See David A. Hartquist, Comment on Behalf of Committee to Support U.S. Trade Laws, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 7 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/csustl-nme-moe-cmt-20071210.pdf> [hereinafter Committee December 10 Comment].

189. *Id.* at 8.

exist from the books and records of individual enterprises in the market?”¹⁹⁰

The issue of whether the petitioner or respondent should bear the burden of proof was particularly contentious, with several Responses in Favor arguing for a presumption of MOE status unless the petitioner can show evidence to the contrary.¹⁹¹ On the other hand, Responses Against argued that if MOE status were presumed, the burden and expense of disproving MOE status would be excessive both to petitioners and also Commerce.¹⁹²

c. Administering MOE Valuation

Assuming that an MOE test is legal and that individual MOEs can be identified, the more difficult question then becomes how to calculate normal value for the newly-dubbed MOE’s exports. The strongest proposals put forward by the Responses in Favor advocated for a hybrid approach that combined aspects of NME methodology, and ME, as well as several innovative concepts not currently in use.

For example, the Cheng Meng June 25 Comment advocated using ME valuation methods in situations involving foreign investment enterprises (“FIE”) and private Chinese companies, but using surrogate prices when the input in question is subject to price controls, guidance prices, etc.¹⁹³ Such a method would use home-market sales when possible, but likely disallow sales made to State Owned Enterprises (“SOE”), which them-

190. *Id.*

191. *See, e.g.*, Bureau of Fair Trade for Imports and Exports of the Ministry of Commerce of the People’s Republic of China, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 7 (June 15, 2007), <http://ia.ita.doc.gov/download/nme-moe/boft-nme-moe-cmt-20070625.pdf> [hereinafter BOFTA June 15 Comment] (arguing for a presumption of MOE status for Chinese enterprises, and urging that the burden of proving otherwise be put on the petitioner); Ou Meng, Comment on Behalf of China Chamber of Commerce of Import and Export of Foodstuffs Native Produce & Animal By-Products, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 2 (June 21, 2007), <http://ia.ita.doc.gov/download/nme-moe/cfna-nme-moe-cmt-20070625.pdf> [hereinafter CCCIEF June 25 Comment] (urging Commerce to apply MOE treatment to all Chinese respondents).

192. *See* Committee December 10 Comment, *supra* note 188, at 6–7 (arguing that the multi-layered analysis necessary to disprove a respondent’s assertion of NME status would be “well-nigh impossible”).

193. Cheng Meng June 25 Comment, *supra* note 181, at 12 (recommending a surrogate valuation method or “de minimis” rule when an input is subject to Chinese government interference).

selves would be prima facie barred from MOE status.¹⁹⁴ Although the Responses in Favor generally preferred a home-market method (unsurprisingly), if the constructed value method were used, they preferred that the test dictate the use of actual price paid for imported inputs¹⁹⁵ and also allow use of the actual price paid if the input was purchased from an FIE or privately owned company.¹⁹⁶

The strongest argument seemed to be for an MOE method modeled after the ME Constructed Value methodology. This is in large part due to the fact that some inputs, such as those purchased from SOEs, would have to be valued separately, and the Constructed Value method is best suited to take multiple inputs into account. An approach modeled on the Constructed Value method would also address one of the primary concerns of MOE valuation: that of a home-market method that would use the price of the product sold in the PRC as the normal value benchmark.¹⁹⁷

This concern is predicated on the possibility that government distortions in the home market could distort demand, with the result that the home-market test would generate a deceptively low normal value.¹⁹⁸ The implication for purposes of administrability was that in order to account for these potential distortions, Commerce would be forced to undertake the exhaustive task of examining the upstream and downstream markets for subject merchandise, rather than limiting its analysis to the individual seller.¹⁹⁹ However, an MOE test employing constructed value analyses

194. *Id.* at 9 n.12.

195. This would be consistent with Commerce's current practice of using price paid for ME inputs. *See*, 19 C.F.R. § 351.408(c)(1) (2005).

196. *See* Cheng Meng June 25 Comment, *supra* note 181, at 11 (hypothesizing that a potential MOE test would use the actual price paid for inputs purchased from foreign-investment enterprises).

197. *See* James R. Cannon, Jr., Comment on Behalf of ICL Performance Products, LP and Innophos, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 3–4 (December 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/icl-innophos-nme-moe-cmt-20071210.pdf> [hereinafter ICL December 10 Comment] (addressing the possibility of home-market price manipulation by stating “the questionnaire would have to be expanded to address whether home market prices are set in a free market for the subject merchandise”).

198. *Id.*

199. *See* J. Christopher Wood, Comment on Behalf of Occidental Chemical Corp., Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 6–7 (November 26, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/oxychem-clearon-nme-moe-cmt-20071210.pdf> [hereinafter OxyChem November 26 Comment] (“[T]he Department would be required to expand the scope of its analysis to determine whether

would be not only more feasible from a legal and administrative perspective, but could also help to alleviate these concerns.²⁰⁰

The Responses in Favor were mixed on the important issue of how to address individual inputs that were clearly not market-oriented. Some responses, such as the Baosteel June 25 Comment, were apparently so confident that the majority of (its own) inputs would be market oriented, that they suggested, “if any price is found not to be market-driven, the department may rely on the surrogate methodology.”²⁰¹ On the other hand, some responses rejected any use of surrogate-country methodology, instead urging that Commerce only apply ME methodology to potential MOEs.²⁰²

The Chutex December 10 Comment cautioned against simply reverting to traditional NME anti-dumping methods for MOE inputs that were determined to be non-market-driven. It stated, “in the . . . case where it may be appropriate to limit an MOE finding, the Department has the tools to make such limitation feasible by not accepting a particular input cost as market-based.”²⁰³

One of these suggested tools was an “inflator” for costs that could not be divorced from government control, such as labor, land and capital costs identified by the Georgetown Steel Memo.²⁰⁴ The “inflator” would increase these distorted costs by an ad valorem percentage equal to the distortion effect.²⁰⁵ According to the Chutex December 10 Comment, this

suppliers of inputs to the producer were similarly market-oriented and whether purchasers in the non-market economy of the producer’s output operated according to market principles”).

200. While Responses Against argued that government intervention could affect the prices of inputs, necessitating a more complex analysis even for an MOE methodology more akin to constructed value, *id.* at 6, generally the arguments focused on likelihood of intervention in home-market demand. *See* U.S. Steel June 25 Comment, *supra* note 166, at 6–7 (questioning whether it is possible that all of a Chinese firm’s customers would be operating under market conditions). Whether or not the firm’s home-market customers were market oriented would only necessarily be factored in under a home-market approach, *see* Lindsey & Ikenson, *supra* note 38, at 6–8 (discussing the factors that are considered under the home-market approach).

201. Baosteel June 25 Comment, *supra* note 178, at 7.

202. *See* CCCMMC June 25 Comment, *supra* note 118, at 22 (arguing that, “in such a case [that inputs were purchased from a SOE] the Department would resort to a third-country market (if such a market were viable) or constructed value, as opposed to using the NME methodology”). It is unclear where this approach expects Commerce to find values for those inputs purchased from an SOE under a constructed value analysis.

203. Chutex December 10 Comment, *supra* note 157, at 12.

204. *Id.* at 13.

205. *Id.* (stating that this “inflator” approach would be similar to adjustments proposed with respect to energy costs for companies from the Russian Federation in 2005).

approach would “lend[] stability and predictability to the Department’s calculations” and also be easier to administer than a mix-and-match surrogate value approach.²⁰⁶

This inflator approach would make sense, especially considering the understandable concerns that “a Market-Oriented Enterprise Test would require consideration of direct and indirect state influence in the competitive environment in which an individual firm operates.”²⁰⁷ Echoing the Georgetown Steel Memorandum, the OxyChem November 26 Comment cited land, labor, and in particular, capital allocation, as the three most problematic areas in this regard.²⁰⁸ The inflator approach discussed above would be an elegant and equitable solution to these pervasively distorted factors.

One proffered guideline for utilizing individual inputs was the oft-repeated prohibition against allowing inputs paid to SOEs into the proverbial cauldron.²⁰⁹ The OxyChem November 26 Comment argued, “any assessment of market-oriented enterprises should exclude state-owned enterprises in a non-market economy.”²¹⁰ The underlying resistance to SOEs stems from the perception that “when [SOEs] receive economics benefits from the government, their price and output decisions are influenced by those benefits and are thereby distorted. These distortions create false price signals that impact the competitive decisions of all firms within the industry.”²¹¹

Merely excluding inputs purchased from SOEs while allowing ME valuation methods for the rest of the inputs would be unsatisfactory to the many Responses Against that point to the difficulty of uncoupling inputs that are operating under market principals from inputs that are affected by the greater NME economy. Indeed, the primary factor identified by the Responses Against as an impediment to an administratively

206. *Id.*

207. OxyChem November 26 Comment, *supra* note 199, at 5.

208. *Id.* at 4–6; *see also* ICL December 10 Comment, *supra* note 197, at 9 (arguing that “the banking system does not operate in a genuinely open market,” and that “the government continues to preserve its ability to direct the economy”).

209. *See generally* Cheng Meng June 25 Comment, *supra* note 181, at 11 (arguing for the exclusion of inputs subject to government price controls). This principal as applied would most likely exclude many SOEs, in particular those “pillar” SOEs discussed in Section III.C.2, *infra*.

210. Oxychem November 26 Comment, *supra* note 199, at 7.

211. Terence P. Stewart & Gert De Prest, Comment on Behalf of Stewart and Stewart, Response to Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise; Request for Comment, at 21 (Dec. 10, 2007), <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/stewart-stewart-nme-moe-cmt-20071210.pdf> [hereinafter Stewart December 10 Response].

feasible MOE test was the difficulty of determining whether a given Chinese price was market-based or not.²¹² U.S. Steel June 25 Comment pointed out that, “even if a Chinese producer were to try to operate its own business on market principles, it is extremely unlikely that all of its myriad *suppliers* and *customers* would also be doing so.”²¹³ The American Furniture June 25 Comment made a similar point: “[I]n order for an entity to operate as a market-oriented enterprise within an industry marked by non-market conditions, it would have to source its inputs . . . outside of the industry’s supply chain.”²¹⁴

Responding to the idea that Commerce could impose a system that would use actual Chinese costs for certain inputs, but use surrogate values for the three problematic inputs identified above, ICL December 10 Comment stated that this would create a “hodge-podge of unrelated factor values.”²¹⁵ Elaborating on this argument, the ICL December 10 Comment asserted that all of the actual Chinese costs would inevitably be affected by the allocation of land, labor, and capital.²¹⁶ Furthermore, it stated, “the surrogate overhead rate is divorced from its context in a particular market,” creating an “arbitrary[,] not accurate” result.²¹⁷

III. AN EQUITABLE APPROACH: LOGISTICS AND LEGALITY OF A WORKABLE MARKET-ORIENTED ENTERPRISE TEST

In this final section I first argue that the current NME anti-dumping approach for the PRC is inadequate for its purpose, of dubious legality, and therefore needs to be supplemented by an MOE test that would address these deficiencies. I follow up this assertion by laying out the framework for a workable MOE test conceptually grounded in a previous test called the “Bubbles of Capitalism,” while employing several distinct features. Next, I answer the question posed by Commerce regarding legality, arguing that an MOE test is not only legal, but also required if

212. See ICL December 10 Comment, *supra* note 197, at 5 (highlighting the scope of the analysis necessary to determine whether a given price was distorted).

213. U.S. Steel June 25 Comment, *supra* note 166, at 6.

214. American Furniture June 25 Comment, *supra* note 164, at 4. Although certainly valid, following this line of argument ultimately leads to the current MOI test, which has proven impossible to pass up to this point. From a policy perspective it is unfortunate that domestic producers and others who weighed in against the administrability of MOE valuation were so united in their opposition to constructive feedback.

215. ICL December 10 Comment, *supra* note 197, at 9.

216. See *id.* at 9–10. For example, when a Chinese manufacturer purchases a raw material from another Chinese manufacturer, the cost of that raw material would be affected by the same problematic distortions (e.g. capital, land, and labor) as the final product, and so on down the line, creating a cycle of distortion.

217. *Id.* at 10.

Commerce continues to apply CVD law to Chinese companies. Finally, I address the remaining issues of identification and administrability, in the context of the proposed test.

A. A Market Oriented Enterprise Test Should be Adopted

1. The Failure of the Status Quo

While the current antiquated NME valuation method is itself probably inappropriate for use against the majority of Chinese respondents, the more fundamental problem with the current approach is the double imposition of both CVD and anti-dumping remedies. To rectify this problem, an MOE test would provide an equitable opportunity not afforded by the MOI test for certain Chinese respondents in anti-dumping investigations to have the normal value of their products calculated fairly and consistently without the problem of double remedies.

It is significant that less than two months after Commerce changed its policy of not applying CVD law to NME countries, the agency published its first request for comment on a possible MOE approach.²¹⁸ In the May 25 Request, Commerce stated that it was considering an MOE approach in light of its determination that CVD laws were applicable to Chinese imports.²¹⁹ The timing of the request, along with the references to measurable state subsidies (required for a CVD investigation),²²⁰ argues that the impetus for an MOE test was directly related to the decision to impose CVD laws to imports from the PRC.

Commerce has long recognized that double remedies are generally not permitted by its regulations and has thus attempted to avoid imposing

218. The preliminary decision to apply CVD law to imports from the PRC was announced on March 30, 2007, *see* Commerce Press Release, *supra* note 109. The first request for comment was published in the federal registrar on May 25, 2007, *see* May 25 Request, 72 Fed. Reg. 29, 302.

219. *See* May 25 Request, 72 Fed. Reg. 29, 302 at 29, 302 (stating that it was requesting comment on the conditions for an MOE test “given the Department’s analysis in the March 29, 2007 Georgetown Steel Memorandum,” which served as a basis for its decision to apply CVD law).

220. *Id.* (“[I]t is possible to determine whether the state has bestowed a benefit upon a Chinese producer (i.e., a subsidy can be *identified* and *measured*)” (emphasis added)). It is important to note that this is a reference to the CVD analysis, rather than an admission that state subsidizations can be measured in the context of an MOE test, which is a comparison some Responses in Favor have drawn, *see* Huanzhong December 10 Comment, *supra* note 171, at 5 (“[I]f the subsidy can be ‘identified’ and ‘measured’ for the purpose of applying the anti-subsidy duty, the subsidy can also be identified and measured to make adjustments to the normal value in the anti-dumping proceeding.”).

them.²²¹ In *Certain Cut-To-Length Carbon Steel Plate From Germany: Final Results of Antidumping Duty Administrative Review*, Commerce refused to allow CVD to affect its calculation of normal value in an anti-dumping case in order to avoid counting the same benefit twice.²²² Similarly, in *Wheatland Tube Co. v. United States*, the Court held that Commerce's decision to deviate from its usual practices in order to avoid imposing a "double remedy" in a 201 Investigation was reasonable.²²³ Significantly, GATT Article VI(5) also states, "No product of the territory of any Member imported into the territory of any other Member shall be subject to both anti-dumping and countervailing duties to compensate for the same situation of dumping or export subsidization."²²⁴

The AAFA addressed this situation of double remedies in its December 10 Comment. It stated:

[I]f a countervailing duty is applied to offset an upstream subsidy on a particular input in a countervailing duty proceeding involving the same product from [the PRC], an anti-dumping calculation based on anything higher than the respondent's actual costs for that input would inevitably result in [double] remedies that are disproportionate with the subsidies granted.²²⁵

This argument makes sense: if a surrogate value approach results in a factor of production that is higher than a producer's cost, the difference represents a benefit to the company.

The surrogate-country valuation method produces higher dumping margins than the home market or constructed value methods, effectively acting as a penalty for enjoying the benefits of a quasi-state controlled economy like the PRC's. These benefits, while certainly worthy of a penalty to offset the inequitable advantage over competing American companies, are best addressed by CVD law.

221. See *Certain Cut-To-Length Carbon Steel Plate From Germany: Final Results of Antidumping Duty Administrative Review*, 62 Fed. Reg. 18390, 18, 395 (Dep't of Commerce, April 15, 1997) (stating that double counting was "unjustifiable").

222. *Id.*

223. *Wheatland Tube Co. v. United States*, 495 F.3d 1355, 1363 (Fed. Cir. 2007). A 201 Investigation is an unfair trade action similar in effect to an anti-dumping investigation, *see id.*

224. General Agreement on Tariffs and Trade, Article VI: Anti-dumping and Countervailing Duties, ¶ 5, 1947, available at http://www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm#articleVI.

225. Letter from Kevin M. Burke, Chief Executive Officer and President, American Apparel and Footwear Association, to David M. Spooner, Assistant Secretary for Import Administration of U.S. Dept of Commerce, at 3 (December 10, 2007), available at <http://ia.ita.doc.gov/download/nme-moe/comments-20071210/aafa-nme-moe-cmt-20071210.pdf> [hereinafter AAFA December 10 Comment].

It is the position of this Note that applying both CVD law and NME anti-dumping law to Chinese imports is essentially granting double-remedies, and Commerce is acting consistently with its past approach of avoiding this situation by attempting to formulate an MOE test. Commerce has made it clear that this is against its policy, and as the case below explains, the courts have held that Commerce must modify its approach in the future to avoid the double remedy phenomenon.

2. The GPX Int'l Tire Corp. Mandate

On September 18 the Court of International Trade addressed the problem of double remedies in its *GPX Int'l Tire Corp.* decision.²²⁶ This case arose from a challenge to Commerce's decision to apply both CVD law and NME anti-dumping methodology to imports of pneumatic off-road tires from the PRC. Agreeing with the respondent that "the application of both the CVD and anti-dumping law using the NME methodology results in a double counting of duties,"²²⁷ the court ordered Commerce to decide between foregoing the imposition of CVDs on Chinese imports and adapting its NME methodology, presumably by creating a workable MOE test.²²⁸

The Court's rationale for requiring Commerce to choose between CVD and a new NME anti-dumping method was similar to the reasoning above. The Court agreed that CVD law and NME valuation in anti-dumping cases addressed many of the same practices. Specifically, it stated that, "the NME anti-dumping statute was designed to account for government intervention in an NME country's economy, including resulting price distortion."²²⁹ Referring to the similarity between the former statute and the CVD statute, the Court stated, "the anti-dumping and CVD law when applied to NME countries both work to correct government distortion of market prices."²³⁰

Significantly, the Court seized upon Commerce's failure to implement a workable test for MOE treatment, finding the decision to address the plaintiff's request for MOE status to be "arbitrary and capricious."²³¹ Even more significantly (especially for the purposes of this Note), the Court essentially mandated that Commerce consider a Chinese respon-

226. See 645 F. Supp. 2d 1231, 1241 (Ct. Int'l Trade 2009) (holding that the current NME anti-dumping framework combined with the application of CVDs constituted a double remedy).

227. *Id.* at 20.

228. *Id.* at 28–29.

229. *Id.* at 17–18.

230. *Id.* at 19.

231. *Id.* at 30.

dent's request for MOE status in order to comply with the statutory requirement to "establish[] antidumping margins as accurately as possible."²³² Because this part of the decision was contextually separated from discussion of the CVD investigation, it leaves open the possibility that Commerce must at least consider granting MOE status to Chinese respondents even in situations where CVD law was not being applied.²³³

The *GPX* court concluded that Commerce would have to choose between not applying CVDs to NMEs and constructing a new NME anti-dumping methodology.²³⁴ Leaving the choice in the agency's hands, the court stated, "Commerce must determine how best to harmonize these two statutes and account for the fact that the statute provides no direction as to how to calculate both NME ADs and CVDs at the same time."²³⁵ At the least, the decision was an endorsement of the MOE test. Moreover, assuming that Commerce decides not to rescind application of CVD law to the PRC, the decision is clearly a mandate to implement an MOE or similar test.

On April 26, 2010, Commerce released a redetermination in response to a remand order issued by the *GPX* court ("Redetermination").²³⁶ In the Redetermination, Commerce defended its decision to apply CVD law to the PRC.²³⁷ It also stated that it has "no procedure or policy governing any category of NME companies as MOEs, [nor] criteria that could be used to qualify any respondent company as an MOE."²³⁸

The lack of framework notwithstanding, Commerce did agree to consider the request for MOE status from Starbright, one of the tire-importer respondents. Without "official" factors to work from, Commerce analyzed the three factors identified as indicatory of MOE status by Star-

232. *Id.* at 32–33 (citing *Shakeproof Assembly Components v. United States*, 268 F.3d 1376, 1382).

233. *Id.* at 35 ("It is impossible to tell if Commerce was not required to apply MOE status to [respondent] because Commerce simply refused to address the issue. As stated previously, however, if the CVD statute is being imposed in an NME country situation, Commerce *must modify its application of the NME anti-dumping statute*, which it did not do") (emphasis added).

234. *Id.* at 35–36.

235. *Id.* at 35.

236. Results of Redetermination Pursuant to Remand, *GPX Int'l Tire Corp. v. United States*, Consol. Court No. 08-00285 (Ct. Int'l Trade 2009) (stating that Commerce does not have any MOE procedures in place to address the problem of double counting, and stating Commerce's intent to address this issue temporarily by offsetting the CVD penalties against the anti-dumping penalties).

237. *Id.* at 7–8. Based on the *GPX* holding, discussed *supra* p. 48–49, a decision to continue to apply CVD law to the PRC would require Commerce to address the problem of double-counting, most likely via an MOE test.

238. *Id.* at 12.

bright itself: its complete ownership by a U.S. company; its focus upon external markets; and its belief that any distortions to manufacturing costs would be addressed by CVD law.²³⁹

Regarding the “foreign ownership” argument, Commerce stated that while foreign ownership can be relevant to the separate rate analysis,²⁴⁰ it wanted Starbright to explain how American-style “market principles and managerial systems” affected production costs, which Commerce argued was relevant to an analysis of whether “available information permits the calculation of normal value.”²⁴¹ This implicit reference to the second requirement laid out in 19 U.S.C. § 1677b(c)(1) marks an acknowledgment by Commerce that it is considering an MOE test justified, at least in part, on that section of the Tariff Act.²⁴²

In responding to Starbright’s “external market focus” requirement, Commerce again referenced the “available information” section of the Tariff Act.²⁴³ It argued that an emphasis on sales to external market “does not speak to domestic production” and does not defeat the conclusion that government distortions “render[] price comparisons and the calculation of production costs invalid under [ME] methodologies.”²⁴⁴ Finally, Commerce dismissed the argument that the presence of a “companion CVD case” should serve as grounds to grant MOE status as “unsupported by record evidence.”²⁴⁵

Although the arguments advanced by Starbright were perhaps lacking the persuasive power of several of the more well-considered Arguments in Favor [of an MOE test], Commerce rejected any real analysis of whether Starbright could be considered to operate under market-oriented conditions, and instead opted for a less thoughtful approach.²⁴⁶ To address the problem of double remedies, Commerce decided to offset the *GPX* respondents’ CVD duty against their calculated dumping margin.²⁴⁷ This exceptionally straightforward methodology is neither accurate nor satisfactory, nor is it logical. It is not accurate because it does not distin-

239. *Id.* at 15.

240. For a discussion of the separate rate analysis, see *supra* Section 1.C.4.

241. *Id.* at 16.

242. For a discussion of the two prong test laid out in 18 U.S.C. § 1677b(c)(1), see *supra* note 66.

243. Results, *supra* note 236, at 17.

244. *Id.*

245. *Id.*

246. While Commerce’s rather dismissive analysis of Starbright’s MOE status certainly was consistent with Commerce’s admitted failure to generate any of its own MOE criteria, at least Starbright gets points for trying. Commerce’s response was a template, so to speak, for paying mere lip-service to a court’s mandate.

247. Results, *supra* note 236, at 3.

guish between duty attributable to government subsidies and duty attributable to under-priced goods. It is surely unsatisfactory to the domestic industry because it neuters CVD law to the point where the only case where it is beneficial to bring a CVD case against a PRC respondent would be when the CVD actually exceeds the dumping margin, drastically disincentivizing the domestic industry from bringing CVD investigations. Finally, per Commerce's own admission, it is not logical that anti-dumping law and CVD law were not meant to be mutually exclusive.²⁴⁸

Ultimately, the Redetermination is illustrative of the fact that Commerce has yet to develop a clear MOE policy. Furthermore, the inadequacy of the offsetting solution suggests that Commerce will continue to resist setting out a framework until it has exhausted its judicial remedies in regards to the *GPX* decision.²⁴⁹

3. A Market Oriented Enterprise Test is Good Foreign Policy

I argue that creating a reliable, efficient, and predictable MOE test would be beneficial even if avoiding double counting and the *GPX* decision are not yet driving Commerce's policy. First, a test that is reliable and predictable would undercut many of the problems with the current surrogate-value approach. Second, it would help modernize our trade laws to reflect the economic realities of the Chinese economy. Finally, it would create an effective policy lever with which to engage the PRC and encourage the development of independent institutions in that country.

As discussed above in Section I, the current surrogate country method lacks the predictability and consistency of the ME valuation methods.²⁵⁰ The main reason the method is so unpredictable is the wide range of acceptable surrogate-country data sets, combined with the fact that the data set so employed may be changed from year to year. Eliminating reliance on surrogate-country data for most inputs and employing a simple and consistent inflator for those inputs that are subject to unspecific distortions not addressed by CVD law would increase overall efficiency by decreasing burdensome and unpredictable litigation for both Chinese respondents as well as the domestic industry.

Additionally, the current policy of applying NME valuation across-the-board in anti-dumping cases means that imports from a U.S.-owned and

248. *See id.* at 7–8 (noting that it “does not agree that the [Tariff Act] necessitates the ‘coordination’ of concurrent [anti-dumping] and [CVDs]”).

249. *See Order, GPX Int'l Tire Corp. v. United States*, Consol. Court No. 08-00285 (Ct. Int'l Trade 2009) (on file with author) (stating that “it is important to get this case in a position for appeal” and also questioning whether Commerce's redetermination has adequately complied with the remand order).

250. Laroski, *supra* note 49, at 395.

managed company operating in the PRC faces the same constraints as products created by a Chinese SOE. NME valuation methods were first propagated against Soviet command-style economies that did not allow or severely restricted foreign capital investment and ownership.²⁵¹ In contrast, today the PRC ranks among the top destinations for foreign direct investment in the world.²⁵² Although the Chinese government continues to exert significant control over SOEs,²⁵³ private enterprises in the PRC have “significant discretion” over major business decisions, according to Commerce.²⁵⁴ Consequently, it does not make sense to subject foreign-owned enterprises to the same valuation methods as SOEs, especially considering the context in which such methods were created.

Finally, implementing an MOE test would create particularized incentives for market-based reform in the Chinese economy. In compliance with its WTO Accession requirements, the PRC has begun to privatize some of its SOEs, largely through the securities markets.²⁵⁵ An MOE test that penalized firms for purchasing too many inputs from SOEs would further incentivize the privatization of these enterprises, as well as discourage the banking practices that artificially help to stabilize them.²⁵⁶

B. Logistics of a Proposed MOE Test

1. An Old Approach New Again: “Bubbles of Capitalism”

Before Commerce formulated the current MOI test, it briefly employed an unusually named “Bubbles of Capitalism” (“Bubbles”) test that calculated normal value for an individual respondent by using actual input price for inputs that were determined to be market driven, while using

251. See generally W. Gary Vause, *Perestroika and Market Socialism: The Effects of Communism's Slow Thaw on East-West Economic Relations*, 9 NW. J. INT'L L. & BUS. 213 (1988).

252. See *Stock of Direct Foreign Investment – At Home*, CENTRAL INTELLIGENCE AGENCY, THE WORLD FACTBOOK, <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2198rank.html> (last visited Dec. 20, 2009) (showing the PRC ranked among the top ten countries receiving direct foreign investment).

253. See Georgetown Steel Memorandum, *supra* note 4, at 8 (describing various control levers at the disposal of the Chinese government over SOEs).

254. *Id.* at 7.

255. Jiangyu Wang, *Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market*, 5 ASIAN-PACIFIC L. & POL'Y J. 1, 47–48 (2004) (discussing the role of securities markets in advancing economic reform in the PRC).

256. Georgetown Steel Memorandum, *supra* note 4, at 9 (discussing how the PRC's misuse of its banking sector control has perpetuated unsustainable corporate practices among certain SOEs and irresponsible lending within the banking sector).

surrogate figures for those that were not.²⁵⁷ This input-by-input approach, along with several modifications discussed in the next section, would serve as a solid foundation for a workable MOE test.

When it implemented the Bubbles approach, Commerce stated, “there is nothing to be gained in terms of accuracy, fairness, or predictability in using surrogate values when market-determined values exists in the NME country.”²⁵⁸ Commerce applied the Bubbles test by analyzing the extent to which each input was controlled by the state.²⁵⁹ Even though Commerce would only grant complete ME valuation if every input was market-based, it decided that the anti-dumping statute directed it to use actual price for each individual input that passed the test.²⁶⁰

While rather unfortunately named, the Bubbles test produced more positive findings of market orientation in its two applications than the MOI test has in fifteen years.²⁶¹ When Commerce applied this test to its initial anti-dumping action against *Chrome-plated Lug Nuts from the PRC*, it found that two of the major inputs purchased domestically overcame the presumption of state control, and thus, those prices could be used in the factor of production formula instead of a surrogate-country value.²⁶² In support of its new approach, Commerce went so far as to state in *Oscillating Fans* that, “[re]quiring the use of surrogate values in a situation where actual market-based prices incurred by a particular firm are available would be contrary to the statutory purpose.”²⁶³

Commentators remarked that this Bubbles approach (sometimes more benignly referred to as “mix and match”) “mitigated the worst faults of

257. Luke P. Bellocchi, *The Effects of and Trends In Executive Policy and Court Of International Trade (CIT) Decisions Concerning Antidumping and the Non-Market Economy (NME) of the People's Republic of China*, 10 N.Y. INT'L L. REV. 177, 208 (Winter, 1997) (“[Commerce] would use those inputs from the home country that were determined to be market driven, while using surrogate figures for the rest”).

258. Final Determination of Sales at Less Than Fair Value: Chrome-Plated Lug Nuts From the People's Republic of China, 56 Fed. Reg. 46, 153, 46, 154 (Dep't of Commerce 1991) [hereinafter *Lug Nuts*].

259. See *id.* at 46, 155 (“We have determined whether particular inputs are market-driven by analyzing the extent to which each factor input is state-controlled”).

260. See *id.* (stating that the price for certain inputs may be appropriate when “market forces” are at work).

261. This, of course, is due to the fact that while the Bubbles approach identified market-oriented inputs, see *id.* at 46, 155, the MOI test has yet to identify a single market-oriented industry, see May 25 Request, 72 Fed. Reg. 29, 302 at 29, 303.

262. See *Lug Nuts*, 56 Fed. Reg. 46, 153, at 46, 155 (finding that “the presumption of state control” had been “overcome” for the inputs of steel and chemicals”).

263. Final Determinations of Sales at Less Than Fair Value: Oscillating Fans and Ceiling Fans From the People's Republic of China, 56 Fed. Reg. 55, 271, 55, 275 (Dep't Comm.1991).

the factors-of-production methodology” and “enhanced the accuracy, fairness, and predictability of the dumping determination.”²⁶⁴ In retrospect, the major criticism of this approach was that it potentially exposed market-oriented sectors of an NME country to CVD actions while leaving the non-market driven sectors insulated.²⁶⁵ Significantly, under Commerce’s current approach of applying CVDs to the PRC this would no longer be a concern.

Unfortunately, Commerce’s enthusiasm for bubbles popped rather unexpectedly when it decided to end the test less than six months after a CVD case was initiated against a Chinese respondent.²⁶⁶ In addition to the problem with the CVDs, Commerce also decided that the Bubbles of Capitalism approach failed to account for “indirect effects of nonmarket economy distortions”²⁶⁷ and that ultimately, “the scope of inquiry was too narrow.”²⁶⁸ I address the concerns of indirect distortions and scope in the following section.

2. Modifications to the Bubbles Approach

This Note proposes an MOE test that combines the Bubbles approach of an input-by-input analysis, with a basket system to address CVD overlap, while using the “inflator” approach posited in the December 10 Chutex Response to address indirect NME distortions. This approach would best address the problems identified with the Bubbles test, while preserving a role for CVD law to function alongside a modified anti-dumping NME approach for the PRC.²⁶⁹

264. Robert L. Harris, Note, *Goin' Down the Road Feeling Bad: U.S. Trade Laws' Discriminatory Treatment of the East European Economies in Transition to Capitalism*, 31 COLUM. J. TRANSNAT'L L. 403, 429 (1993); see also Jeffrey P. Bialos et al., *Trading with Central and Eastern Europe: The Application of the U.S. Unfair Trade Laws to Economies in Transition*, 7 INT'L L. PRACTICUM 69, 73 (1994) (“By allowing the use of actual prices for particular market-driven inputs, Commerce was trying to improve the accuracy and fairness of the less-than-fair value calculation.”).

265. See Harris, *supra* note 264, at 435 (“[a] nation in transition from communism to capitalism [becomes] highly vulnerable to CVD liability.”).

266. See *id.* at 436. Harris, I must confess, was not responsible for the pun.

267. David W. Richardson & Robert E. Neilsen, *Recent Development in the Treatment of Nonmarket Economies Under the anti-dumping/CVD Laws*, 789 PLI/CORP 149, 159 (Oct. 1–2, 1992).

268. Amendment to Final Determination of Sales at Less Than Fair Value and Amendment to Antidumping Duty Order: Chrome-Plated Lug Nuts From the People’s Republic of China, 57 Fed. Reg. 15, 052, 15, 053 (Dep’t of Commerce, 1992) [hereinafter *Lug Nuts Amendment*].

269. While the Dec. 10 Chutex Response, *supra* note 157, did not discuss the inflator concept in great detail, it referred to Magnesium Metal from the Russian Federation: Notice of Final Determination of Sales at Less Than Fair Value, 70 Fed. Reg. 9041, 9043

My proposed MOE test would work by examining the component inputs of a given product and breaking them down into individual price tags, similar to the constructed value approach. For inputs that Commerce determined to be produced and exchanged under market conditions, the respondent would be allowed to use the cost paid in the local currency, identical to the approach used by the Bubbles test.

To address the problem of double remedies and NME distortion, non market-based inputs (i.e. those affected by NME distortions) would be divided into two baskets. One basket would contain all distortions currently accounted for by CVD law. For example, because CVD duties account for direct government spending on energy subsidies, all energy inputs that were so subsidized would go into the CVD basket. In contrast to the Bubbles approach, respondents would be able to use their actual costs for the distorted inputs that land in the CVD basket, which would satisfy the need to avoid double-remedies.²⁷⁰ Because CVD duties were not applied to NME countries when the Bubbles approach was formulated, this would be a needed modification of the original Bubbles framework.

The inputs in the second basket, those that suffer from NME distortions not addressed under CVD law, would be subject to the application of an inflator. This inflator would impose a tariff proportional to the average benefit conferred. For example, if the benefit from a particular distorted input was not taken into account under CVD law, an inflator, or markup may be applied to the corresponding input.²⁷¹ The basket approach is further discussed in the section on administrability below.

Such a test would eliminate the administrative and legal burden, not to mention the uncertainty and inaccuracy, of surrogate values. It would also comply with the policy and *GPX* mandate to avoid double-counting CVD and anti-dumping duties. Finally, with the addition of certain requirements discussed below, it would be more reflective of the modern state of the Chinese economy.

(Dep't Commerce Feb. 24, 2005), in which Commerce responded to petitioners argument that an inflator should be applied to a Russian mining company's energy costs to reflect non-market economy style distortions. In that case, Commerce abstained from applying an inflator, but it did reserve for itself the legal authority to do so, stating, "the Department has the discretion to calculate the costs of production by some other reasonable means," *id.*

270. The benefit received from the subsidy could be recovered under a parallel or subsequent CVD investigation.

271. For example, if Commerce were to find that wages were artificially suppressed in the particular region of the PRC where a certain good was produced, it could apply an inflator to the labor input equal to the percent those wages were suppressed in comparison to unsuppressed Chinese wages.

C. Response to Commerce's Request for Comment

1. Legality

When Commerce published its October 25 Request, there were two implicit threshold questions regarding the legality of an MOE test: first, whether Commerce has the power to calculate normal value using actual costs in an NME context, and second, whether it has the power to apply this analysis to individual firms.²⁷² I argue that both of these questions should be answered in the affirmative.

Commerce answered the first question in the affirmative itself when it published notice that it was rescinding its Bubbles test in favor of the MOI test. At that time it defended the legality of an input-based approach by stating, "section 773(c)(1)(B) allows the Department to calculate foreign market value using normal foreign market value methodologies despite the fact that the economy of the subject country, on a macro basis, is nonmarket in nature."²⁷³

In defending its decision under the Bubbles approach, Commerce noted it was not legally authorized to employ the factors of production methodology unless it found that the available information "did not permit" it to determine normal value using ME country methodologies.²⁷⁴ When Commerce refined its Bubbles test to evaluate each individual input under the above analysis, it stated that such an approach was in line with Congressional intent by, "not using NME prices to determine FMV, while at the same time recognizing that an NME country that is undergoing a transition to a market-oriented economy may contain sectors within its overall economic structure where market forces have already come into play."²⁷⁵

The courts have generally deferred to Commerce's interpretations of unfair trade law statutes.²⁷⁶ In *Sigma Corp. v. United States*, the court noted that Commerce has "broad authority to interpret the antidumping statute and devise procedures to carry out the statutory mandate."²⁷⁷ In fact, Commerce has already exhibited this authority to interpret the antidumping statute by formulating the MOI test. One can also interpret the

272. See October 25 Request, 72 Fed. Reg. 60, 649 at 60, 650 (discussing the legal arguments regarding the MOE test).

273. See Lug Nuts Amendment, 57 Fed. Reg. 15, 052, at 15, 054-55.

274. *Id.* at 15, 054. This interpretation is consistent with the argument raised in the Chutex December 10 Comment, *supra* note 157, at 2.

275. Lug Nuts, 56 Fed. Reg. 46, 153, at 46, 155.

276. Although *GPX*, 645 F. Supp. 2d, is a rather notable exception, for the more common approbation see *Sigma*, *infra* note 277, at 1405.

277. *Sigma Corp. v. United States*, 117 F.3d 1401, 1405 (Fed. Cir. 1997).

current exception that enables an NME enterprise to use actual costs for purchases from an ME country as another example of how Commerce has modified its valuation approach in the past without interference from the courts.

In fact, the court tacitly affirmed the legality of using market prices for individual inputs in *Consolidated Int'l Automotive v. United States*.²⁷⁸ In that case, the Court of International Trade upheld Commerce's authority to implement the Bubbles approach.²⁷⁹ Addressing Commerce's decision to re-formulate its valuation approach for NME respondents, the court stated, "Commerce has presented an acceptable basis both in law and fact for its actions."²⁸⁰

To address the second question of whether it is legal for Commerce to single out individual respondents for special treatment, I would concur with the argument presented by the Textile Counsel December 10 Comment, that other practices such as the ME currency exceptions (as well as the separate rates test) "reinforce the principle that the Department may deviate from its . . . NME methodology."²⁸¹

The approach recommended by this Note does not expand Commerce's authority to single out individual respondents beyond the liberal powers they currently possess. Also, because the approach borrows heavily from the Bubbles approach approved in *Consolidated*, while also responding to concerns about double remedies raised by the Court of International Trade, the proposed approach satisfies the threshold questions of legality. Most importantly, this approach attempts to satisfy the requirement to calculate anti-dumping margins "as accurately as possible," which is ultimately the goal of any valuation approach, and certainly the goal of calculating normal value.²⁸²

2. Identifying MOEs

As discussed above, many of the Responses Against argued that it would be impossible to identify an MOE due to the profusion of NME distortions throughout the PRC's economy.²⁸³ The MOE approach recommended by this Note addresses this concern by adopting a presump-

278. *Consolidated Int'l Automotive v. United States* 16 C.I.T. 692, 696-97 (Ct. Int'l Trade 1992) (holding that Commerce's Bubbles approach was not unjustified).

279. *See id.* at 696-97 (stating that a change of methodology "does not make Commerce's original [Bubbles] approach unjustified").

280. *Id.* at 696.

281. Textile Counsel December 10 Comment, *supra* note 163, at 3-4.

282. *Allied Pac. Food*, *supra* note 77, at 1342.

283. *See U.S. Steel June 25 Comment*, *supra* note 166, at 7 (arguing that the market distortions are of such severity that the existence of an MOE is inconceivable).

tion of MOE status for all non-SOEs. For SOEs that are partially privatized and not operating in one of the “pillar” industries toward which the PRC is consolidating its state control, a test similar to the separate-rate test would be a fair way to identify the SOEs that are only nominally state owned, as opposed to the SOEs that are permeated by NME distortions to the extent that MOE status would not apply, as discussed below.

Using a separate-rate test analysis to identify SOEs that may be market oriented would facilitate MOE identification by employing a method that Commerce is familiar with and currently uses effectively.²⁸⁴ The identification issue is further simplified by the assumption that all non-SOEs are market-oriented to the extent that their inputs are determined under market conditions. Shifting the benefit of MOE status away from automatic market economy valuation and towards an input-by-input approach makes identification as an MOE less contentious. Rather, the emphasis shifts to the individual inputs employed by the MOE, making it more important for an enterprise to employ market-oriented inputs than to achieve nominal MOE status.

3. Administering an MOE Test

a. Application of the Test to State-Owned Enterprises

While the Chinese government has been making efforts to implement market-style reforms to SOEs for years, SOEs are still largely directed by the hand of the state.²⁸⁵ As a result, the SOEs, especially the banks, continue to serve as significant barriers to comprehensive market reform.²⁸⁶ Because of the pervasiveness of NME distortions regarding SOEs, the MOE test should contain a disqualification threshold for manufacturers that receive a threshold level of their inputs from SOEs.

The government of the PRC began the process of de-centralizing its SOEs in 1978, one year before signing the historic Sino-U.S. Trade Agreement.²⁸⁷ Yuma Wei writes that in 1993, “the introduction of modern corporate governance mechanisms was emphasized, and trials of corporatization and privatization were carried out in selected sectors and enterprises.”²⁸⁸ More recently, the PRC has focused on consolidating the

284. See Separate Rates Policy Bulletin, *supra* note 84, at 1 (discussing the separate rates test).

285. See August 30 Memorandum, *supra* note 127, at 73 (discussing the role of the banks as regional barriers).

286. *Id.*

287. See Vause, *supra* note 251, at 223–24.

288. Yuwa Wei, *An Overview of Corporate Governance In China*, 30 Syracuse J. INT'L L. & COM. 23, 37 (2003).

largest SOEs that operate in “pillar industries,” while continuing to privatize SOEs operating in other areas of the economy.²⁸⁹

Despite the fact that many SOEs now operate as quasi-private entities, those SOEs operating in the “pillar industries” remain “excessively burdened by a range of social obligations,” which results in significant government intervention, especially in the banking sector.²⁹⁰ While identifying SOEs is a straightforward task,²⁹¹ it is more difficult to measure the extent of government interference.²⁹² Commerce found that “the government no longer sustains such SOEs through the traditional means of direct resource allocations or the setting of prices (which are now largely freely set), but instead through a complex web of regulatory restrictions, control over the allocation of land-use rights, and the continued dominance accorded to the state-owned banking sector.”²⁹³

Whether or not subsidization of SOEs can be measured by CVD law is subject to a specificity requirement, yet in a 2008 determination, Commerce found certain subsidies to SOEs to be so measurable.²⁹⁴ Rather than apply a CVD-style specificity test to each situation where a Chinese respondent does business with a non-FIE SOE, creating an administrative workload that would be both duplicative and inefficient, it would be more efficient to disallow MOE status to respondents that purchase a significant amount of their inputs from SOEs.

Commerce already employs “threshold” rules in several anti-dumping situations, such as representation requirements.²⁹⁵ Furthermore, “bright line” tests such as threshold requirements promote predictability, effi-

289. *Id.* at 38. Under this policy, SOEs remain dominant in certain high-tech sectors: non-renewable natural resource sectors; public utility and infrastructure sectors; and national security sectors.

290. *Id.* at 39–40 (arguing that the antiquated system in which SOEs played a quasi-government role by providing a variety of social services now makes it difficult for many of these enterprises to fully privatize).

291. In fact, the Chinese government maintains a (somewhat outdated) list of Chinese SOEs online. See GOV.cn, A-Z Index of China’s State Enterprises, http://www.gov.cn/misc/2005-10/21/content_80894.htm (last visited Apr. 04, 2009).

292. Georgetown Memorandum, *supra* note 4, at 3 (discussing the “complex web” of regulatory restrictions, etc., that the government uses to manipulate the Chinese economy).

293. *Id.*

294. Certain New Pneumatic Off-the-Road Tires From the People’s Republic of China: Final Affirmative Countervailing Duty Determination and Final Negative Determination of Critical Circumstances, 73 Fed. Reg. 40480, 40485 (Dep’t of Commerce, 2008) (deciding that an income tax exemption to an SOE was countervailable).

295. See 19 U.S.C. § 1673a(c)(4)(A) (2006).

ciency, and uniformity.²⁹⁶ Finally, because the so-called “pillar industries” in the PRC often correspond to powerful U.S. industries most wary of an MOE test, the SOE threshold requirement would serve as an effective bar to MOE status for enterprises in these “pillar industries” that sufficiently enjoy the benefits of operating in these industries, which could potentially lowering resistance to a new approach from domestic U.S. producers who operate in the same industries.²⁹⁷

b. Administering the Test for Privately Held Companies

A presumption of MOE status is simple to implement from an administrative perspective. After making the initial determination, Commerce would need to develop a method to identify individual inputs that are market oriented. While Commerce briefly employed an input-by-input test under its Bubbles approach, it cited the difficulty of identifying inputs that were free of NME distortions as one of the reasons for abandoning the test.²⁹⁸ The approach recommended here addresses this administrative problem by only allowing a respondent to use actual price-paid under two circumstances: either the input is clearly market oriented, or the input is accounted for under CVD law. The upstream, non-explicit distortions referenced in the Lug Nuts Amendment,²⁹⁹ and also in the Georgetown Steel Memorandum,³⁰⁰ are addressed using the inflator.

In the situations where it is extremely clear that the input is market oriented (e.g., a manufactured input purchased from a wholly-foreign owned enterprise operating outside of the SOE “pillars,” or an input purchased from an ME supplier), the actual price paid would be utilized. In the case of inputs, such as labor, that are found to be distorted, applying a

296. See Cassandra Jones Harvard, *Goin' Round in Circles . . . and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV. 737, 792 (2008) (discussing the importance of predictability, efficiency and uniformity from a regulatory perspective).

297. At least six of the June 25 Responses Against were filed on behalf of the Steel Industry. In the PRC, the Steel industry is considered the archetypical SOE. See Import Administration, *Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies Market-Oriented Enterprise*, <http://ia.ita.doc.gov/download/nme-moe/nme-moe-cmt-20070625-index.html> (last visited December 21, 2009); Thomas Brizendine & Charles Oliver, *China's Steel Sector in Transition*, THE CHINA BUS. REV. (Jan.–Feb. 2001), available at <http://chinabusinessreview.net/public/0101/oliver.html>.

298. See Lug Nuts Amendment, 57 Fed. Reg. 15, 052, at 15, 053 (discussing how the absence of “explicit government involvement” is not enough to warrant a finding of market orientation) (emphasis added).

299. *Id.*

300. Georgetown Steel Memorandum, *supra* note 4, at 5 (discussing the “broader, distorted economic environment”).

pre-determined inflator (perhaps one that considered factors such as geography, industry, etc.) would require some up-front determinations, but ultimately would also be a straightforward and predictable process.

Finally, identifying inputs covered by CVD law in order to exempt those inputs from the inflator adjustment is administratively possible due to Commerce's extensive experience determining what is and what is not measurable as a CVD, as well as its recent determination that subsidies in the PRC have become measurable in general.³⁰¹ The fact that Commerce has decided to apply CVD law to respondents in the PRC is in itself evidence that identifying CVD benefits is administratively feasible, and therefore removing those inputs affected by such benefits should be feasible as well.

D. CONCLUSION

In conclusion, the proposed MOE approach would provide for predictable, consistent, and accurate valuation. Commerce has the authority to implement it based on court approval of the Bubbles approach as well as tacit approval for its separate rate-status test. An MOE test is not only legal, but also necessary to correct double remedy problems if Commerce continues to apply CVD law to Chinese respondents.³⁰² Applying a presumption of MOE status on most Chinese enterprises and a separate-rate style test on the rest would simplify the identification process, and as shown, the combination approach proposed is administratively feasible.

Valuation methodology lies at the heart of our unfair trade laws, because it determines whether and to what extent certain goods will be penalized upon entering this country. Whatever valuation method we adopt should be tailored to the economic reality of the country wherein and individual enterprise by which the good was produced. A method that balances a pro-market position with our international commitments will succeed in encouraging reciprocity that will ultimately lead to growth in the long-term.

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301. *Id.* at 10 (concluding that it is possible to decide if a benefit bestowed upon a Chinese producer is identifiable and measurable).

302. *GPX*, 645 F. Supp. 2d 1231, 1234–35 (“If Commerce is to apply CVD remedies where it also utilizes NME anti-dumping methodology, Commerce must adopt additional policies and procedures for its NME anti-dumping and CVD methodologies.”).

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OWNING GLOBAL KNOWLEDGE: THE RISE OF OPEN INNOVATION AND THE FUTURE OF PATENT LAW

INTRODUCTION

Most people are familiar with the story of the genius inventor, toiling away for years in a basement laboratory to one day emerge with the perfect solution to age old problems. Whether lighting our homes, cutting grass, or allowing instant telecommuting, innovation has propelled our societies forward and become one of the driving forces of economic success. The classic model of patent protection emerged to encourage the inventive process by rewarding the inventor with the exclusive right to profit from public dissemination of the invention.¹

However, the narrative of the lone inventor has faded over the years as technological advances, especially the internet, have resulted in dramatic changes to the innovative landscape.² The knowledge sharing potential in today's globalizing world has created an ever increasing demand for fast, accessible, and far reaching innovation.³ Further, innovation is now frequently an interdisciplinary, networked process from creation to distribution, a process that often proves impossible for the lone inventor.⁴ Even companies—the drivers of innovation activities today—have adapted traditional in-house research and development (“R&D”) models to access the knowledge necessary to make technologically complex products,⁵ to

1. EUROPEAN PATENT OFFICE, EUROPEAN PATENT ORGANISATION, SCENARIOS FOR THE FUTURE 9 (2007), available at <http://www.epo.org/topics/patent-system/scenarios-for-the-future.html>.

2. Katherine J. Strandburg, *Accommodating User Innovation in the International Intellectual Property Regime: A Global Administrative Law Approach*, 2009 ACTA JURIDICA 283, 283; Keith Sawyer, *The Collaborative Nature of Innovation*, 30 WASH. U. J.L. & POL'Y 293, 308 (2009).

3. José Cláudia Terra, *Collaboration in R&R: The Emerging Frontiers of Innovation*, TERRAFORUM CONSULTORES 2, <http://biblioteca.terraforum.com.br/Paginas/CollaborationinRDTheEmergingFrontiersofInnovation.aspx> (last visited May 18, 2010); see also ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OPEN INNOVATION IN GLOBAL NETWORKS 15 (2008) [hereinafter OECD]; Koen De Backer, Vladimir Lopez-Bassols & Catalina Martinez, *Open Innovation in a Global Perspective—What do Existing Data Tell Us?* 7 (Org. for Econ. Coop. & Dev., STI Working Paper 2008/4, 2008), available at <http://www.oecdilibrary.org/oecd/content/workingpaper/230073468188>.

4. OECD, *supra* note 3, at 15; John Dubiansky, *The Role of Patents in Fostering Open Innovation*, 11 VA. J.L. & TECH 7, 3 (2006) (“Ideas are created from the recombination of elements from various firms and in various industries.”); De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7.

5. See EUROPEAN PATENT OFFICE, *supra* note 1, at 17, 88; Mark A. Lemley & Carl Shapiro, *Patent Holdup and Royalty Stacking*, 85 TEX. L. REV. 1991, 1992 (2007); Sawy-

share exorbitant development costs,⁶ to mitigate risk,⁷ and to compete on the forefront of global intellectual property markets.⁸

The future of innovation is an “open,” collaborative, global approach to R&D.⁹ To promote successful development of this trend, international patent reform must account for the changing modes of innovation and the new role of intellectual property in business strategies.¹⁰ Moreover, instead of focusing solely on patent harmonization, the conversation must shift to reevaluate the underlying goals of patent law. Rather than focusing on the ardent protection of ideas, the patent regime should work to facilitate the flow of knowledge and to police a growing international intellectual property market.

“Open innovation,” coined in 2003, is a new way of thinking about technology production and innovation that assumes that companies benefit most when they utilize ideas and paths to market that are both internal and external.¹¹ The key to the theory of open innovation is that firms open their doors to the free flow of ideas, allowing capitalization of technologies wherever most expedient, thus increasing the competitiveness of all market players.¹² Firms employ a growing division and specialization of innovation labor in a kind of reciprocal outsourcing model.¹³ These strategies hinge on the most efficient use of intellectual property—whether that entails finding needed technology to complete internal R&D, selling unused intellectual property, or collaborating on freely distributed knowledge.¹⁴ One well-known example of open innovation is “open source,” a popular means of producing software for which the source code is freely accessible as long as users comply with license terms which usually forbid restrictive redistribution or inclusion in a

er, *supra* note 2, at 303–04; Gene Slowinski & Matthew W. Sagal, *Allocating Patent Rights in Collaborative Research Agreements*, RES. TECH. MGMT, Jan.–Feb. 2006, at 51.

6. See EUROPEAN PATENT OFFICE, *supra* note 1, at 18.

7. OECD, *supra* note 3, at 41; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7.

8. Cf. OECD, *supra* note 3, at 27 (“Changes in the marketplace—globalisation among them—require companies to be open to external ideas that supplement internal R&D in order to remain competitive.”).

⁹ Sawyer, *supra* note 2, at 312.

¹⁰ Cf. *id.* at 318.

11. HENRY CHESBROUGH, OPEN INNOVATION: THE NEW IMPERATIVE FOR CREATING AND PROFITING FROM TECHNOLOGY xxiv (2003).

12. See generally *id.*

13. See HENRY CHESBROUGH, OPEN BUSINESS MODELS: HOW TO THRIVE IN THE NEW INNOVATION LANDSCAPE 1–2, 56–57 (2006).

14. See generally CHESBROUGH, *supra* note 11.

commercially sold product which locks access to the original code.¹⁵ Thus, in practice, open innovation takes various forms that span a continuum of collective and proprietary intellectual property creation and use.

This Note explores the open innovation model with International Business Machines Corporation (“IBM”) as its example. IBM is one of the world’s largest information technology companies to begin employing open innovation strategies after a “near death experience” induced a strategic shift in its innovation trajectory.¹⁶ In 1992, IBM recorded the largest quarterly and annual losses in U.S. corporate history.¹⁷ This wake-up call resulted in a complete strategic overhaul with a particular emphasis on open innovation.¹⁸ While IBM is not the first, or only, company to expand R&D outside its four walls, the range and global reach of its innovation programs¹⁹ and its highly visible position in the marketplace make it a natural case study.²⁰

There is skepticism as to whether IBM can make this business model work as there are significant concerns regarding the issue of global intellectual property rights.²¹ Without doubt, IBM must employ significant efforts to coordinate and manage its extensive patent portfolio, especially with the magnitude of its open innovation programs and the accompanying variations on intellectual property ownership.²² Regardless of the agility of IBM’s attorneys to navigate complex intergovernmental patent systems, the question remains whether the world’s various patent systems can support IBM. Under the governance of international patent law, which is based on a fixed standard of mass market, seller-based innova-

15. Joel West & Scott Gallagher, *Challenges of Open Innovation: the Paradox of Firm Investment in Open-Source Software*, 36 R&D MANAGEMENT 319, 322 (2006); Sawyer, *supra* note 2, at 321.

16. CHESBROUGH, *supra* note 11, at 101; Video: Address of David Yuan, Vice President of Corporate Communications, IBM, at the Collaborative Innovation Summit, held by Business Innovation Factory-4 (Oct. 15–16, 2008), available at <http://www.businessinnovationfactory.com/iss/video/bif4-david-yaun>.

17. CHESBROUGH, *supra* note 11, at 101 (reporting a loss of \$4.96 billion after taxes).

18. *Id.* at 102.

19. Steve Hamm, *Big Blue’s Global Lab*, BUS. WK., Sept. 7, 2009, at 40, 42 (“The depth of [the] collaboration, the number of partners, the staff involved, and its global reach set IBM apart.”).

20. This Note makes no endorsement or criticism of IBM or its practices. Rather, the singular focus on IBM programs as illustrations of open innovation is purely for the purpose of consistency.

21. Hamm, *supra* note 19, at 42.

22. See generally, Athena Ma, *IBM Patent Leadership: Balances Proprietary and Collaborative Innovation*, CHINA IP, Jan.–Feb. 2008, at 24, available at <http://www.chinaipmagazine.com/en/journal-show.asp?id=250>.

tion,²³ open innovation may flounder in its more audacious goals of patent liberalization and collaborative development. Further, the disparate nature of global patent law and the increase of value placed on intellectual property assets have resulted in various obstacles to the functioning global patent regime.

As more multinational and transnational companies are beginning to employ open innovation models, issues arise on a global scale. The creation of the World Trade Organization (“WTO”) “deepened the deregulatory logic of economic globalization” and linked intellectual property rights to global trade, leading to territorial expansion.²⁴ The Agreement on Trade Related Aspects of Intellectual Property Rights, (“TRIPs”) incorporated into the WTO, helped to streamline global intellectual property rights. Patent law, however, is still largely territorial in nature—there is no single global patent registry, and the multiplicity of applications necessitates country-by-country monitoring and enforcement. This international state of patent law leads to significant costs and uncertainties for global ventures employing open innovation strategies.

While business models have evolved and adapted to a newly integrated world, patent law continues to reflect a defensive, sales-oriented, proprietary model²⁵ which may be incongruous with open innovation.²⁶ Despite this lag in patent law rationale, businesses have shifted their operations and are taking an offensive approach to patents, which are now the means by which knowledge is shared and built rather than controlled.²⁷ Additionally, the value of global businesses is increasingly measured with intangible assets protected and utilized by intellectual property, rather than physical assets.²⁸ “Patent registration is now no longer an expensive way to placate engineers—it is a primary means to generate value.”²⁹

This Note posits that for the continued development and growth of open innovation, international patent law harmonization must take on new dimensions. Due consideration must be given to the expanded role that intellectual property assets play in today’s global business strategies and the ways in which patent law can better facilitate the active man-

23. Strandburg, *supra* note 2, at 285.

24. EUROPEAN PATENT OFFICE, *supra* note 1, at 9, 22.

25. Strandburg, *supra* note 2, at 284.

26. *Cf.* Sawyer, *supra* note 2, at 297 (“[T]he current IP regime is based almost entirely on the linear model of innovation. If that model is inaccurate, then the IP regime currently is designed to work with an inaccurate conception of the innovation process.”).

27. EUROPEAN PATENT OFFICE, *supra* note 1, at 9; *see* OECD, *supra* note 3, at 103.

28. EUROPEAN PATENT OFFICE, *supra* note 1, at 17.

29. *Id.*

agement of these rights. However, this is not enough; the underlying goals of the patent regime must be reevaluated. Rather than a defensive exclusion of others, intellectual property rights should serve to further knowledge production, ease the sharing of ideas, and promote and police an ever growing international intellectual property market.

Part I of this Note explores the evolution of open innovation, its components, its globalization, and its interaction with intellectual property. Part II explains the international agreements and domestic laws that constitute international patent law in order to show that despite the move toward harmonization, patent law remains stuck in the past. Part III discusses the main themes of current patent reform and the implications for open innovation. Part IV argues that efforts toward harmonization are in fact misdirected because the only way to fully support the changing global landscape is a complete paradigm shift in the underlying logic of patent rights.

I. OPEN INNOVATION

In an age of globalization, competition comes from all corners of the world, knowledge is increasingly multidisciplinary and widespread, investment in R&D is on the rise, and product lifecycles are shortening.³⁰ With such fierce and dispersed competition, and equally diverse and demanding consumers, innovation is an important means to secure market share and build a sustainable business.³¹ Companies have thus been faced with a “sink or swim” situation;³² they have been forced to adapt to these challenges by innovating the *way* they innovate. One response has been the adoption of “open” models of innovation—companies search outside their firm for complementary assets, expertise, and research, in order to swiftly access new and different technologies and capitalize on their own unused intellectual property.³³ These R&D activities are also increasingly global, as firms explore new markets and local knowledge bases.³⁴ Open innovation is a targeted response to today’s interconnected world as it

30. OECD, *supra* note 3, at 15; Terra, *supra* note 3, at 2; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7.

31. OECD, *supra* note 3, at 15.

32. Cf. OECD, *supra* note 3, at 27 (stating “[c]hanges in the marketplace—globalisation among them—require companies to be open to external ideas that supplement internal R&D in order to remain competitive”).

33. OECD, *supra* note 3, at 15; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7.

34. OECD, *supra* note 3, at 15

results in faster, more efficient innovation by employing intellectual property assets as the catalysts of knowledge production.³⁵

A. *The Rise of Open Innovation*

Innovation methods are constantly changing and adapting to new circumstances.³⁶ The iconic “lone inventor” was indeed a prominent figure in nineteenth century American innovation and, consequently, the patent market of the time.³⁷ Fast forward to an industrialized world and the rise of the multinational enterprise (“MNE”) and witness R&D models that are completely internal, in-house, and closed to outsiders.³⁸ This “closed innovation” system relies on the assumption that “*successful innovation requires control*.”³⁹ This creates a “virtuous circle”—companies invest in internal R&D, make discoveries, use these discoveries to create new products and services, reap profits, and reinvest in further R&D, all of which leads to additional breakthroughs.⁴⁰ The intellectual property generated from internal R&D is usually guarded closely to prevent unwanted imitation.⁴¹ In order to compete in this system, firms must have significant resources and the ability to commit to lengthy research programs.⁴² Hence, giant corporate research laboratories such as Bell Labs and the Palo Alto Research Center (“PARC”) dominated the innovation scene of that time and contributed to the creation of global industry leaders such as AT&T, IBM, and Xerox.⁴³ Indeed, from 1945 to 1980, IBM was *the* central player in the computer industry, “built on internal innovation [and] proprietary control over the architecture and all its key elements . . .”⁴⁴

During the last years of the twentieth century, changes in the global landscape eroded the logic of closed innovation.⁴⁵ The growing availability and mobility of skilled workers led to a diffusion of knowledge and a

35. EUROPEAN PATENT OFFICE, *supra* note 1, at 9.

36. ERIC VON HIPPEL, *THE SOURCES OF INNOVATION* 3–5 (1988).

37. JAMES BESSEN & MICHAEL J. MEURER, *PATENT FAILURE: HOW JUDGES, BUREAUCRATS, AND LAWYERS PUT INNOVATION AT RISK* 169 (2008) (citing B. ZORINA KAHN, *THE DEMOCRATIZATION OF INVENTION: PATENTS AND COPYRIGHTS IN AMERICAN ECONOMIC DEVELOPMENT, 1790–1920* (2005)); see Sawyer, *supra* note 2, at 322.

38. CHESBROUGH, *supra* note 11, at xix; OECD, *supra* note 3, at 18, 25.

39. CHESBROUGH, *supra* note 11, at xx.

40. *Id.* at xx–xxi.

41. *Id.* at xxi.

42. *Id.* at xix.

43. See *id.* at xviii–xix.

44. *Id.* at 93, 96.

45. *Id.* at xxii.

fluid labor market which further dispersed technical know-how.⁴⁶ With large numbers of skilled graduates entering the job market, more companies could tap into their talent without the traditionally insurmountable costs of R&D.⁴⁷ Additionally, increased labor mobility resulted in further diffusion of knowledge as employees of R&D giants left their jobs to pursue careers with suppliers, customers, or start-ups who paid a premium for their training and experience. IBM felt the blow of this development, for example, when one of its engineers left the company and shared his knowledge of disk-drive technology with two competitors, contributing to the erosion of IBM's disk-drive dominance.⁴⁸

The leakage of intellectual property rights that once "sat on the shelf" also contributed to the erosion of closed innovation.⁴⁹ In a closed system, innovation that does not fit the company's needs or business strategy remains unused, "on the shelf," collecting dust.⁵⁰ However, with the increase of firms utilizing R&D, disillusioned employees sought out alternative means to utilize their unused discoveries.⁵¹ These ideas were brought to market without the original company that funded the creative R&D.⁵² Thus, despite the in-house control of closed innovation knowledge production, leakage of unused ideas led to an increase in external suppliers of specialized, technical components.⁵³ This proliferation of suppliers undermined the logic of closed innovation by providing previously inaccessible knowledge and technology to a broader market.⁵⁴ Closed innovators found themselves faced with increased competition and pressure from those that already utilize various sources of knowledge.⁵⁵

Open innovation signals a paradigm shift that encourages innovators to integrate external ideas and technology into their own internal R&D, as well as to control the flow of unused ideas and direct them to the most efficient users on the outside.⁵⁶ Companies cannot ignore the diffusion of knowledge production. Data shows that small firms—those with less

46. *Id.* at 34.

47. *Id.*

48. *Id.* at 35.

49. *Id.* at 40.

50. OECD, *supra* note 3, at 18.

51. CHESBROUGH, *supra* note 11, at 38.

52. *Id.*

53. *Id.* at 39.

54. *Id.*

55. *Id.* at 40.

56. CHESBROUGH, *supra* note 13, at xiii; ECONOMIST INTELLIGENCE UNIT, THE ECONOMIST, SHARING THE IDEA: THE EMERGENCE OF GLOBAL INNOVATION NETWORKS 10 (2007) [hereinafter EIU].

than a thousand employees—account for a growing proportion of R&D spending.⁵⁷ Further, universities conducting research around the world are more in tune today with industry needs⁵⁸ and produce more qualified graduates ready to work than ever before.⁵⁹ These facts suggest that the playing field for innovation is leveling and that there are fewer economies of scale in R&D than there once were.⁶⁰ Additionally, technological advances, such as the internet, make dispersed knowledge easier to access and less costly.⁶¹ The days of highly centralized corporate R&D laboratories and knowledge monopolies are gone and companies can no longer disregard the contribution of smaller, less traditional innovators.⁶²

Adaptive companies have developed the tools to leverage multiple paths to market for their technology by accepting a new logic of innovation that leverages and exploits existing internal and external knowledge.⁶³ “Companies’ solid boundaries are being transformed into a semi-permeable membrane that enables innovation to move more easily between the external environment and the companies’ internal innovation process.”⁶⁴ Cooperation is an essential means of knowledge-sourcing⁶⁵ and the partnerships that are created in these collaborations are “as important as the ownership of the actual knowledge.”⁶⁶ Of course, utilizing external knowledge is not an entirely new phenomenon; however, it takes place much more rapidly today and is distinguished by the systematic integration of the strategy into the overall business model.⁶⁷

57. CHESBROUGH, *supra* note 13, at 22–23 (detailing statistics from the National Science Foundation showing that small firms accounted for almost 25% of total industry spending).

58. CHESBROUGH, *supra* note 11, at 41.

59. EIU, *supra* note 57, at 7 (reporting that “India produces 1 million English-speaking graduates a year and, by 2008, it will have more technology graduates than the population of the UK”).

60. CHESBROUGH, *supra* note 13, at 23 & n.2.

61. CHESBROUGH, *supra* note 11, at 44.

62. *Id.* at 45–49. Chesbrough also notes that larger companies used to be skeptical of the quality of R&D from smaller firms. However, reports from the larger laboratories suggest that the competition for hiring researchers out of top Ph.D. programs comes not from other lab giants but from small start-ups and universities.

63. *Id.* at 51.

64. OECD, *supra* note 3, at 18.

65. De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7.

66. OECD, *supra* note 3, at 25.

67. *Id.* at 24; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7.

B. Modes of Open Innovation

The open innovation business model is essentially a division of innovation labor.⁶⁸ Value is created by leveraging more ideas, some of which originate externally, and value is captured more effectively by using key assets both inside and outside the business.⁶⁹ In other words, companies look both “outside-in” and “inside-out” in this dynamic innovation model.⁷⁰ Ultimately, this setup makes it possible for ideas to reach the market more quickly and efficiently than when one company is responsible for the idea from start to finish.⁷¹

Companies employ open innovation strategies in a variety of ways. Modes of “outside-in” innovation include: the purchase or licensing of technology; joint ventures; joint development; collaboration within and across industries; equity in outside projects; and pooled R&D.⁷² IBM employs many of these techniques, forming strategic collaborative partnerships, called “collaboratories,” with universities, customers, and other firms to combine resources and skills.⁷³ For example, in 2008, an IBM laboratory in California teamed up with Yale University to research algorithms aimed at helping analyze medical images and videos for the purpose of cardiac disease analysis.⁷⁴ IBM also uses online brainstorming sessions, called “Innovation Jams” to assess the value of external projects.⁷⁵ In 2006, one Innovation Jam brought together over 150,000 people from 104 countries and 67 companies.⁷⁶ Some 46,000 ideas were posted by participants and, in the end, IBM pledged \$100 million to collaboratively pursue ten new businesses generated through the exercise.⁷⁷ The portfolio included initiatives such as real time translation services, 3D internet and a banking system capable of reaching remote locations in emerging market countries.⁷⁸

68. See CHESBROUGH, *supra* note 13, at 1–2, 56–57

69. *Id.* at 2.

70. OECD, *supra* note 3, at 18.

71. EIU, *supra* note 57, at 10.

72. OECD, *supra* note 3, at 37; WEST & GALLAGHER, *supra* note 15, at 323.

73. *Research and Development*, IBM, http://www.ibm.com/ie/emerging_business_centre/research.html (last visited Apr. 21, 2010).

74. *Collaborative Research Initiatives*, IBM, <http://www.ibm.com/developerworks/university/collaborativeresearch/projects.html> (last visited Apr. 21, 2010).

75. OECD, *supra* note 3, at 101.

76. Press Release, IBM, IBM Invests \$100 Million in Collaborative Innovation Ideas (Nov. 14, 2006), available at <http://www-03.ibm.com/press/us/en/pressrelease/20605.wss> [hereinafter IBM Press Release]

77. *Id.*

78. *Id.*

The outbound—or, “inside-out”—innovation strategy is a newer development that allows for the exploitation of in-house knowledge that has yet to be commercialized.⁷⁹ Modes of “inside-out” innovation also include licensing, joint ventures, and venture capital, as well as internal corporate venturing, and divesting—or, “spinning out”—unused technologies.⁸⁰ IBM licenses a considerable amount of technology and also sells internally-developed technology components to its competitors.⁸¹ These tactics work to make the technology more cost-effective, especially when fierce competition bars IBM from controlling or maintaining a competitive edge in any one branch of technology.⁸² Another radical innovation strategy is IBM’s internal corporate venturing through an internal website they call the “Thinkplace.”⁸³ Acting like an internal market, employees post ideas and proposals and their colleagues vote on them.⁸⁴ The highest rated ideas move on to the next stage where a manager sponsors and takes ownership of each idea’s development.⁸⁵ Three to four employees from around the world form a team and allocate one day a week to work on the project.⁸⁶ In this way, IBM invests and capitalizes on its employees and encourages cross-border collaboration.

C. Globalized Open Innovation

Globalization has collapsed the world of R&D, dramatically expanding the number of potential partners in the development of global innovation networks.⁸⁷ Firms forge these networks by building their own R&D facilities abroad and by collaborating with local partners and suppliers in foreign countries.⁸⁸ Locations for R&D investment are often based on a country’s technological infrastructure as well as the firm’s abilities to grasp trends in local markets, to benefit from local knowledge and skilled personnel, to access technology and spillover from other R&D activities, to support local manufacturing facilities, and to form strategic alliances with universities or government institutions.⁸⁹ In this regard, emerging

79. De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 8.

80. OECD, *supra* note 3, at 38, 40.

81. CHESBROUGH, *supra* note 11, at 109.

82. *See id.* at 108.

83. OECD, *supra* note 3, at 97

84. *Id.*

85. *Id.*

86. *Id.*

87. De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 8; *see* OECD, *supra* note 3, at 33.

88. De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 8.

89. OECD, *supra* note 3, at 30–32; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 8.

countries are increasingly attractive because of low costs and, where the education system is strong, a large number of trained researchers.⁹⁰ Lower costs are attractive for any business, but the allure isn't only about the bottom line; there is also the potential for smaller companies—those that would not otherwise have the necessary resources or level of investment—to enter the globalized market.⁹¹

Despite this potential leveling of the playing field between MNEs and small firms, research shows that at least 98% of the 700 firms with the largest R&D expenditures are MNEs. These 700 firms account for close to half of the world's total R&D expenditure and more than two thirds of the world's business R&D.⁹² Recent evidence shows that these top spenders are increasing their investments outside their home countries.⁹³ IBM is one of the top twenty firms in R&D expenditures⁹⁴ and it has truly internationalized its R&D strategy. Since 1995, it has operated a wholly owned R&D facility in China⁹⁵ and currently has collaboratories underway in China, India, Ireland, Saudi Arabia, Switzerland, and Taiwan.⁹⁶ Furthermore, IBM is working with Taiwan's publicly funded Industrial Technology Research Institute, its Institute for Information Industry, and several universities to research and develop healthcare services and devices geared toward preventive medicine and wellness.⁹⁷

90. OECD, *supra* note 3, at 31. This phenomenon is interesting on a social level as well. In what is basically a reverse "brain drain," large companies invest resources and train local talent in their capacity as local employees. Thus, the brightest minds continue to boost their local economies and foster further growth in their countries. This is in stark contrast to the common concern that MNEs hire local talent to work for their companies outside of their home country (usually in a developed country) where they earn money for the company and, ultimately, the developed nation. Alternatively, concerns have been voiced that the emergence of India and China as seats of research and talent will lead to further outsourcing by companies and now in a field of relatively high skill jobs. The potential for this to erode national R&D infrastructures is unsettling to those on this side of the debate. Thus, the open innovation trend has interesting implications for global social policy.

91. *Id.* at 33.

92. U.N. Conference on Trade and Dev. [UNCTAD], *World Investment Report 2005: Transnational Corporations and the Internationalization of R&D*, 119, U.N. Doc. UNCTAD/WIR/2005 (Oct. 29, 2005).

93. Organisation for Economic Co-operation and Development [OECD], *The Internationalisation of Business R&D: Evidence, Impacts and Implications*, at 21 (2008).

94. UNCTAD, *supra* note 92, at 120.

95. *Id.* at 119.

96. Hamm, *supra* note 19, at 41.

97. See Dan Nystedt, *Taiwan to Host IBM's First Joint Healthcare IT Research Unit*, PCWORLD (Dec. 21, 2009), <http://www.pcworld.com/article/185193/taiwan>; Press Release, IBM, IBM Research Collaborates with Leading Taiwanese Institutions to Deliver Wellness-Centric Healthcare via Cloud Computing (Dec. 21, 2009), *available at*

Taiwan is experienced in technology-driven health care services, and this project explores the potential role of mobile devices, analytics, and cloud computing in preventative medicine and illness management.⁹⁸ Ultimately, the goal is to pioneer smarter solutions, test drive them in Taiwan, and then work together to export them to the rest of the world.⁹⁹

D. Open Innovation and Intellectual Property

The type and extent of open innovation strategy pursued in foreign countries often reflects the country's national intellectual property regime.¹⁰⁰ In fact, intellectual property is at the heart of open innovation as technologies or ideas being accessed, licensed, or sold are embodiments of intellectual property. "[T]he open innovation paradigm . . . is as much a change in the use, management, and employment of [intellectual property] as it is in technical and research driven generation of [intellectual property]."¹⁰¹ With open innovation strategies, companies take a proactive approach to intellectual property, usually in the form of patents, as an integral part of their technology strategy and capital creation.¹⁰² Patents are strategically utilized not only to leverage a firm's own product development, but also to profit off others' uses of its ideas.¹⁰³ Thus, firms shop for patents that compliment their own innovations and also offer unused technologies for more efficient allocation.

A clear example of intellectual property rights at the heart of an open innovation strategy is that of pooled R&D. "[F]irms donate [intellectual property] to the open-source project while exploiting the common benefits of all contributors to facilitate the sale of related products."¹⁰⁴ For instance, IBM has donated 300 of its software patents to the public domain for anyone working on open source projects.¹⁰⁵ Further, IBM employees are often tasked with contributing to open source software.¹⁰⁶ These activities may seem counterintuitive for value creation; however,

<http://www-03.ibm.com/press/us/en/pressrelease/29086.wss>; Yeshim Deniz, *IBM to Deliver Healthcare Through Cloud Computing*, AJAX WORLD MAG. (Dec. 21, 2009), <http://ca.sys-con.com/node/1227658>.

98. *Id.*

99. *Id.*

100. OECD, *supra* note 3, at 42.

101. WEST & GALLAGHER, *supra* note 15, at 320.

102. CHESBROUGH, *supra* note 11, at 56, 155.

103. *Id.*

104. WEST & GALLAGHER, *supra* note 15, at 323.

105. OECD, *supra* note 3, at 104. IBM will retain the patents, but has agreed not to seek royalties or place restrictions on their use, as long as they are used in open source projects.

106. CHESBROUGH, *supra* note 13, at 45.

the donated intellectual property creates demand for related products and services sold by IBM and fosters industry advancement and goodwill.¹⁰⁷

In open source situations, the intellectual property created is nonproprietary and, therefore, the arrangement of each party's rights is less complex than in situations such as partnerships and collaborations.¹⁰⁸ The obvious question that all partnerships encounter is how to properly allocate the benefits of the partnership.¹⁰⁹ IBM customizes each partnership agreement,¹¹⁰ producing a range of results from publicly shared and royalty free outputs to sponsored research where the output is intended to be owned by one or both of the partners.¹¹¹ However, one survey reports that of 300 senior executives, 60% of them indicated that intellectual property theft is the biggest risk in collaborating on innovation with international partners.¹¹²

Collaborative partnerships may require significant transfers of existing intellectual property and the "know-how" or the specialized practical skills necessary to utilize these shared technologies.¹¹³ Companies face an increased risk of leakage of proprietary knowledge, involuntary spillovers, and potential loss of control.¹¹⁴ Further, intellectual property has been described as "sticky" because exposure to the technology and know-how pollutes the firm, resulting in an "embedding problem."¹¹⁵ Once an employee learns about the intellectual property, the knowledge sticks with the employee and he or she unwittingly uses it in the future.¹¹⁶ The concern over this dissipation of know-how once prevented foreign partnerships.¹¹⁷ Now, studies indicate that companies act strategically in choosing where to operate abroad, taking account of national intellectual

107. See WEST & GALLAGHER, *supra* note 15, at 325.

108. See Sawyer, *supra* note 2, at 317 ("It can become difficult even to identify what the proper componential decomposition of a new innovation is. These realities provide many challenges for IP, including how to determine what proportion of ownership rights the creator of each individual idea should receive.").

109. See OECD, *supra* note 3, at 42. Successful partnerships will discuss these issues prior to starting the collaboration, otherwise serious breakdown often occurs. With today's IP regime, though, the winner might always be the partner with the best contract lawyer and the savviest understanding of the complex web of international patent laws.

110. IBM, *supra* note 74

111. *Id.*

112. EIU, *supra* note 57, at 2, 14.

113. OECD, *supra* note 3, at 34; see also Eric von Hippel, *Cooperation Between Rivals: Informal Know-How Trading*, 16 RES. POL'Y 291, 292 (1987).

114. OECD, *supra* note 3, at 41.

115. GENE SLOWINSKI & MATTHEW W. SAGAL, *THE STRONGEST LINK: FORGING A PROFITABLE AND ENDURING CORPORATE ALLIANCE* 154-55 (2003).

116. *Id.*

117. OECD, *supra* note 3, at 42.

property regimes to determine what types of R&D to carry out.¹¹⁸ For example, in emerging countries where intellectual property rights are weak,¹¹⁹ a company will focus R&D on technologies that require complementary assets unavailable in the host country.¹²⁰ Additionally, firms employ various tactics to foster the trust and confidence necessary to facilitate a free flow of knowledge within the partnership. Nondisclosure, confidentiality, and exclusivity agreements are often central in this endeavor.¹²¹

II. INTERNATIONAL INTELLECTUAL PROPERTY

Legal contracts between partners are a common business practice. However, in the context of open innovation these contracts take on a central role as a means of facilitating the active use of intellectual property assets.¹²² Businesses have adapted to meet the challenges of globalization and increased competition by utilizing patents in ways other than for the mere protection of ideas.¹²³ Meanwhile, patent law around the world remains static and rooted in a singular logic. It aims to curb a perceived market failure by rewarding inventors with a period of exclusivity in order to incentivize further innovation.¹²⁴ However, this system is unlikely to anticipate or be able to react to problems that arise from the offensive use of intellectual property assets.¹²⁵

Individual nations maintain their own national patent systems. There is no global patent law, per se; instead, international patent law is com-

118. *Id.*

119. Some may argue that these countries deserve access to the technologies used in the partnership for development purposes. Others will counter that the companies owning the proprietary knowledge are not required to allow “free-riders,” even if we are talking about a least developed country. Regardless of the “right answer” to this question, bringing advanced technology into a country for the first time can only have positive repercussions for those exposed to it due to the “leaky” and “sticky” nature of IP.

120. OECD, *supra* note 3, at 42.

121. *Id.* at 103.

122. *Id.*

123. CHESBROUGH, *supra* note 13, at 81.

124. R. VAN WENDEL DE JOODE, J.A. DE BRUIJN & M.J.G. VAN EETEN, PROTECTING THE VIRTUAL COMMONS: SELF-ORGANIZING OPEN SOURCE AND FREE SOFTWARE COMMUNITIES AND INNOVATIVE INTELLECTUAL PROPERTY REGIMES 52 (2003); Sawyer, *supra* note 2, at 321. Admittedly, this is traditionally thought of as the U.S. perspective with other countries focusing on labor or natural law theories. However, TRIPs harmonization of national laws has arguably established this utilitarian philosophy as the mainstay of international patent law. Doris Estelle Long, “Democratizing” Globalization: Practicing the Policies of Cultural Inclusion, 10 CARDOZO J. INT’L & COMP. L. 217, 243 (2002).

125. *Cf.* Sawyer, *supra* note 2, at 318 (“Many features of the current IP regime reward behavior that blocks the natural flow of innovation in collaborative webs . . .”).

posed of various agreements that link these territorial laws together. These agreements have successfully harmonized domestic laws more and more over the years; however, important areas are still in discord and the overall rationale behind patent law remains static. In order to understand how patent law must change, it is important to know the foundation upon which the existing laws are built.

The formal law of patents as we know it today began in the late fifteenth century in Venice as “an instrument designed to attract engineers to the Republic.”¹²⁶ Interestingly, this statute did not grant a monopoly to the patentee but instead ensured royalties for compulsory licenses, a more public policy oriented rationale.¹²⁷ The notion of intellectual property as private property was popularized in America and eventually enshrined in The International Convention for the Protection of Industrial Property (the “Paris Convention”) in 1883.¹²⁸ Though the Paris Convention grants individuals from any member state equal protection under the laws of any other member state,¹²⁹ a look at the distinct patent laws of individual states suggests that the underlying purpose of patent rights remains in dispute.¹³⁰

The Paris Convention is the “bedrock of the international patent system.”¹³¹ It commits its members to three key principles. First, members must treat foreign inventors from member states no worse than domestic

126. GRAEME B. DINWOODIE ET AL., INTERNATIONAL INTELLECTUAL PROPERTY LAW AND POLICY 415 (2d ed. 2008).

127. *Id.*

128. Convention of Paris for the Protection of Industrial Property, Mar. 20, 1883, *revised* Oct. 31, 1958, 13 U.S.T. 1, 828 U.N.T.S. 107 [hereinafter Paris Convention]. Please note that the Paris Convention underwent revision several times since its inception on Mar. 20, 1883: Brussels on Dec. 14, 1900; Washington on Nov. 6, 1925; London on Jun. 2, 1934; Lisbon on Oct. 31, 1985; and Stockholm on July 14, 1967. *Id.*; see also DINWOODIE ET AL., *supra* note 126, at 421–24.

129. DINWOODIE ET AL., *supra* note 126, at 424.

130. Note, for example, that U.S. law grants patents to the first-to-invent, with contest procedures to ensure the correct individual receives the patent and a tenancy-in-common grant for joint inventors. On the other hand, all other foreign systems award patents to the first-to-file, valuing the sharing of the invention over the protection of the “true” inventor. Compare 35 U.S.C. §§ 102, 262 (2006), with Tokkyohō [Patent Act], Act No. 121 of 1959, art. 29(2) (amended 2006).

131. DINWOODIE ET AL., *supra* note 126, at 426; see also John R Thomas, *Multinational Patent Acquisition and Enforcement: Public Policy Challenges and Opportunities for Innovative Firms*, in PATENTS: ISSUES AND LEGAL DEVELOPMENTS 143, 159 (John V. Martin ed., 2002) (referring to the Convention as “the foundation patent harmonization treaty”); Robert R. Willis, *International Patent Law: Should United States and Foreign Patent Laws Be Uniform? An Analysis of the Benefits, Problems, and Barriers*, 10 N.C.J.L. & TECH. 283, 288 (2009) (calling the Paris Convention the “foremost international intellectual property regime”).

inventors, and must provide them the same protections and the same access to legal remedies (this is the “national treatment” provision).¹³² Second, national patent rights are independent of one another,¹³³ thus, each country must enforce them individually within the distinct patent law regimes.¹³⁴ Third, a patent seeker who files in a member country must be given 12 months to file in another member country without prejudice regarding information that enters the public domain.¹³⁵ Known as the “international priority principle,” this provision is significant considering that many nations still have strict laws that any disclosure of an invention prior to the filing of a patent defeats the patentability of the invention.¹³⁶ Thus, the priority provision allows the patent seeker to preserve the first filing date while arranging for filing abroad.¹³⁷

Though the Paris Convention was a giant step toward alignment of national patent systems, the agreement fell short of any real substantive harmonization, and it failed to streamline the patent application procedures and provide effective enforcement mechanisms. The latter issue was addressed in the 1970 Patent Cooperation Treaty (“PCT”), which allows a single “international patent application” to be submitted to the national offices of designated member countries.¹³⁸ This simplifies the application process and reduces costs. It is important to note, however, that the international application does not result in a single, global patent but rather commences national applications in jurisdictions that are members of the PCT.¹³⁹ Ultimately, it is still the decision of the national patent authority whether to issue a patent and to protect the rights conferred.¹⁴⁰

132. Paris Convention, *supra* note 128, art. 2.

133. *Id.* art. 4bis.

134. Thomas, *supra* note 131, at 143, 159.

135. Paris Convention, *supra* note 128, art. 4.

136. *See, e.g.*, Convention on the Grant of European Patents (European Patent Convention), art. 54(2), *concluded* Oct. 5, 1973, 1065 U.N.T.S. 254 (as amended in 2000) [European Patent Convention] (“The state of the art shall be held to comprise everything made available to the public by means of a written or oral description, by use, or in any other way, before the date of filing of the European patent application.”); Tokkyohō [Patent Act], Act No. 121 of 1959, arts. 29(1), 30 (amended 2006) (disqualifying any invention that was made publicly known more than six months prior to filing the patent in Japan).

137. Thomas, *supra* note 131, at 143, 160.

138. Patent Co-operation Treaty, *done* Jun. 19, 1970, 28 U.S.T. 7645, 1160 U.N.T.S. 231; *see also* Thomas, *supra* note 131, at 143, 160–61 (citing ABBOTT, FREDRICK ET AL., THE INTERNATIONAL INTELLECTUAL PROPERTY SYSTEM: COMMENTARY AND MATERIALS 646 (1999)).

139. *See* Thomas, *supra* note 131, at 143, 161; Willis, *supra* note 131, at 291.

140. DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL TRADE LAW 211 (2008).

The desire for substantive harmonization of patent laws was finally addressed in TRIPs under the WTO framework.¹⁴¹ This agreement, adopted by more than 153 members,¹⁴² is the primary authority on international patent law, as it directly incorporates the Paris Convention¹⁴³ and also provides minimum substantive standards, enforcement provisions, and a dispute settlement mechanism.¹⁴⁴ Though this agreement mandates that members bring their national laws into harmonized compliance, there is still considerable flexibility built into the agreement,¹⁴⁵ and a variety of issues remain the province of national law.

The TRIPs substantive standards provide that, at a minimum, members must give patent rights for inventions in all fields of technology as long as they are new, involve an inventive step, and are useful.¹⁴⁶ With a few exceptions to patentability,¹⁴⁷ this standard clearly indicates the outer parameters for which patents will be granted in exchange for disclosure.¹⁴⁸ TRIPs enshrines the traditional utilitarian, market failure logic by mandating—with a few exceptions¹⁴⁹—the right to exclude others from “making, using, offering for sale, selling[,] or importing” the patented subject for at least 20 years.¹⁵⁰ TRIPs also requires members to provide minimum enforcement mechanisms domestically¹⁵¹ and provides access

141. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, 1869 U.N.T.S. 299, 33 I.L.M. 1197 (2004) [hereinafter TRIPs].

142. See generally World Trade Organization, Members and Observers, available at http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm (last visited Oct. 18, 2009) (listing members as of July 23, 2008).

143. TRIPs, *supra* note 141, art. 2.

144. Thomas, *supra* note 131, at 144, 163.

145. For example, Article 7 specifies that IP rights should be “conducive to social and economic welfare.” Article 8 allows for the protection of public health and the promotion of public interest in sectors of vital importance to their socio-economic and technological development.” Article 30 provides for “limited exceptions to the exclusive rights conferred by a patent.” And Article 66 allows grace periods for least-developed countries to comply with the standards. TRIPs, *supra* note 141.

146. TRIPs, *supra* note 141, art. 27.

147. *Id.* art. 27(2), (3) (providing exceptions to patentability for diagnostic, therapeutic, and surgical methods for treating humans or animals; for biological processes for growing plants or breeding animals; and for interests such as avoiding serious prejudice to the environment or protecting public order, morality, or human, animal, or plant life).

148. *Id.* art. 29 (“[A]n applicant for a patent shall disclose the invention in a manner sufficiently clear and complete for the invention to be carried out by a person skilled in the art.”).

149. *Id.* art. 30.

150. *Id.* arts. 28, 33; see Long, *supra* note 124, at 243.

151. TRIPs, *supra* note 141, art. 41, 44–46.

to the Dispute Settlement Body¹⁵² of the WTO, where the flex of other trade measures can pressure compliance with intellectual property laws.¹⁵³

All in all, the Paris Convention, the PCT, and TRIPs together provide the first steps towards a harmonized patent system. However, the international community continues to debate the future of patent law and the World Intellectual Property Organization (“WIPO”) is a forum in which members frequently grapple with such issues. Created in 1967, this specialized agency of the United Nations has as its mandate to “promote the protection of intellectual property throughout the world.”¹⁵⁴ In this role, the WIPO acts as the administrator of several intellectual property agreements including the Paris Convention and the PCT.¹⁵⁵ Additionally, TRIPs provides for an ongoing relationship with WIPO; for instance, WIPO members act as consultants regarding the implementation of TRIPs provisions.¹⁵⁶ WIPO also develops intellectual property policy and serves as a forum for discussion of potential improvements to international intellectual property rights. It is in this vein that WIPO’s Standing Committee on the Law of Patents has been addressing issues of harmonization.¹⁵⁷ Nevertheless, to acquire, manage, and enforce patent rights throughout the world is a complex and costly endeavor.¹⁵⁸ Even firms with the means to successfully achieve these ends may find the system inefficient in or incapable of supporting their global innovation.¹⁵⁹

152. *Id.* art 64.

153. *Cf.* CHOW & SCHOENBAUM, *supra* note 140, at 200 (explaining that a members protection of intellectual property rights plays a role in either encouraging or discouraging trade with other members); DINWOODIE ET AL., *supra* note 126, at 777 (describing the ability of members to retaliate against countries that refuse to comply with the agreement through the suspension of other trade concessions or obligations).

154. *What is WIPO*, WORLD INTELLECTUAL PROP. ORG., http://www.wipo.int/about-wipo/en/what_is_wipo.html (last visited Apr. 21, 2010).

155. *Id.*

156. TRIPs, *supra* note 141, art 68.

157. World Intellectual Prop. Org., Substantive Patent Law Harmonization, <http://www.wipo.int/patent-law/en/harmonization.htm> (last visited Apr. 21, 2010).

158. Thomas, *supra* note 131, at 143–144.

159. *Cf.* WENDY H. SCHACHT & JOHN R. THOMAS, CONGRESSIONAL RESEARCH SERVICE, PATENT REFORM IN THE 111TH CONGRESS: INNOVATION ISSUES 7 (2009) (“[P]atent protection in a single jurisdiction is an inefficient method to protect the interest of both domestic and international inventors.”); Sawyer, *supra* note 2, at 318 (“Current policy favors linear, centralized innovation, and blocks the natural rhythm of the collaborative web.”).

III. PATENT HARMONIZATION THROUGH THE LENS OF OPEN INNOVATION

It has been stated that “[t]he continued need for harmonization remains prevalent due to the globalization of commerce, the reduction of trade barriers, and the need for stability and predictability in international patent protection.”¹⁶⁰ However, despite the forces driving the international buzz over harmonization,¹⁶¹ the conversation largely fails to consider the implications of globalized commerce for patent reform. Open innovation, as one such trend in global business, should be considered both for the insight it can provide on patent reform, as well as for the impact that proposed harmonization can have on the stability and predictability of patent law in use. Harmonization debates generally focus on broader issues such as patent quality, costs, and scope of patentability with a specific focus on differences in patent priority, grace periods, and enforcement.¹⁶² These issues must be reexamined through the lens of open innovation.

A. Patent Priority

The United States is the only patent-issuing nation in the world to maintain a first-to-invent priority system.¹⁶³ In the event that more than one application is filed in the U.S. claiming the same invention, the patent is awarded to the applicant who can establish the earliest “date of conception, and reduction to practice of the invention,” as well as reasonable diligence to patent.¹⁶⁴ Outside the U.S., the first-to-file priority system grants the patent to the first applicant, regardless of whether he was actually the original inventor.¹⁶⁵ On the most basic level, the co-existence of these two systems could result in the award of patent rights

160. Ryan M. Corbett, Note, *Harmonization of US and Foreign Patent Law and H.R. 2795: The Patent Reform Act of 2005*, 18 FLA. J. INT’L L. 717, 722–23 (2006).

161. See generally Patent Reform Act of 2009, H.R. 1260, S. 515, S. 610, 111th Cong. (2009) (bills in both houses proposing significant changes to initiate some level of harmonization); EUROPEAN PATENT OFFICE, *supra* note 1, at 1 (explaining that “European patents are granted on the basis of harmonised law codified in the European Patent Convention” and exploring the potential for future international patent regimes); World Intellectual Prop. Org., *supra* note 157 (providing background on the international body’s work toward harmonization).

162. See Thomas, *supra* note 131, at 143, 151–58; see also SCHACHT & THOMAS, *supra* note 159; Willis, *supra* note 131.

163. Thomas, *supra* note 131, at 143, 152.

164. 35 U.S.C. § 102(g) (2006); see also SCHACHT & THOMAS, *supra* note 159, at 13.

165. Thomas, *supra* note 131, at 143, 153.

to different individuals for the same invention.¹⁶⁶ Proponents of the first-to-invent argue that it is a more equitable system, ensuring that the original inventor secures the patent.¹⁶⁷ Supporters of the first-to-file system believe that it provides greater legal certainty within innovative industries because the date of priority is stable and easily discernable.¹⁶⁸ Moreover, it reduces the complexity and limits the delays and the costs that arise when the true inventor is contested.¹⁶⁹

The priority system has several implications for open innovation. In a world where intellectual property assets are used offensively (rather than merely guarded jealously) the international community must consider the best way to manage licensing. Certainty of patent ownership facilitates efficient transfers of licensing and technology.¹⁷⁰ However, the first-to-invent system breeds uncertainty in a manner that is particularly harsh on small firms. When attempting to sell or license internally developed intellectual property, small firms may have reduced bargaining power since "true" ownership may be contested.¹⁷¹ Alternatively, lengthy and costly proceedings are often mandatory to prove priority of inventorship, and this leaves smaller (perhaps geographically removed) partners at a distinct disadvantage. In collaborative partnerships, the evidence necessary to win such a contest may be harder to manage or even inaccessible after the alliance ends. Further, U.S. law is ambiguous with respect to the level of contribution required by a team member to qualify as an inventor, and this fosters uncertainty and apprehension during collaboration.¹⁷² Hence,

166. *Id.* at 143, 172. Consider the following example that takes place among applicants from member nations of the previously mentioned treaties: applicant A files for a patent in country Y (a first-to-file country), as well as in country Z (a first-to-invent country). One month later, applicant B also files for a patent in both countries Y and Z claiming the exact same invention as applicant A. In country Y, applicant A clearly wins the patent as well as all subsequent patents filed in first-to-file countries using the priority principle under the Paris Convention. However, if applicant B can in fact prove that it is the first inventor, applicant B will win patent protection in country Z. Thus, different parties hold the rights to the same invention in different nations, and the international community lacks legal certainty.

167. Willis, *supra* note 131, at 295.

168. SCHACHT & THOMAS, *supra* note 159, at 14.

169. *Id.*

170. See BESSEN & MEURER, *supra* note 37, at 184 (stating that patents can facilitate licensing or sale of technology but only when boundaries are well defined).

171. *Cf. id.* at 167 ("Small inventors especially suffer because fuzzy boundaries mean that they realize less value from licensing or selling their patents.").

172. JOHN R. THOMAS, CONGRESSIONAL RESEARCH SERVICE, INTELLECTUAL PROPERTY AND COLLABORATIVE RESEARCH 15 (2005). Further, it should be noted that the U.S. system raises issues of apprehension and uncertainty even once the collaboration is complete. Where both parties to an invention are named as "joint inventors," they each, indi-

pre-research contracting is exceedingly important; meanwhile, this also carries serious implications for unsophisticated parties.¹⁷³

B. Grace Periods

Grace periods are another hotly contested issue within international negotiations. After a public disclosure of an invention (through publication or sale) by either the inventor or a third-party, the U.S. grants the inventor a grace period of one year to file a patent application.¹⁷⁴ Foreign jurisdictions are not as lenient. In Japan, an inventor has six months after personally disclosing the invention and no grace period at all for disclosures by third parties,¹⁷⁵ and the EU holds that “any sales or publication of an invention anywhere in the world prior to the filing date defeats the patentability of an invention.”¹⁷⁶ Proponents of the grace period argue that it allows leeway for inventors who are unfamiliar with foreign patent regimes and that it encourages public testing of inventions.¹⁷⁷ Critics argue that grace periods only serve to elongate the patent term and increase commercial uncertainties.¹⁷⁸

Of particular interest in the case of open innovation are the debates concerning academic and scientific communities. Though these communities have long been partners in innovation, the academic research community relies on norms that contravene many patent law principles.¹⁷⁹ Based on the notion that the best way to further science is to share research results, academic researchers widely believe that new knowledge should be shared as quickly as possible.¹⁸⁰ Though academics are fairly patent-savvy today,¹⁸¹ grace periods help support the continued practice of quick publication of academic research results.¹⁸² Critics of

vidually, have exclusive rights granted under the patent. As with the real property concept of a “tenancy in common,” each can do with the patent what he will, including licensing or selling the innovation to his or her partner’s competitors. Clearly, this system raises some concerns for open innovation.

173. *Id.*

174. 35 U.S.C. § 102(b) (2006).

175. Tokkyohō [Patent Act], Act No. 121 of 1959, arts. 29(1), 30 (amended 2006).

176. Thomas, *supra* note 132, at 153; *see also* European Patent Convention, *supra* note 136, art. 54(2).

177. JOSEPH STRAUS, EXPERT OPINION ON THE INTRODUCTION OF A GRACE PERIOD IN EUROPEAN LAW 50 (2000).

178. JAN E.M. GALAMA, EXPERT OPINION ON THE CASE FOR AND AGAINST THE INTRODUCTION OF A GRACE PERIOD IN EUROPEAN LAW 13 (2000).

179. Rebecca S. Eisenberg, *Proprietary rights and the Norms of Science in Biotechnology Research*, 97 YALE L.J. 177, 182 (1987).

180. *Id.*

181. SCHACHT & THOMAS, *supra* note 159, at 9.

182. STRAUS, *supra* note 177, at 54.

grace periods contend that academics and scientists choosing to participate in the commercial sphere must accept the legal rules that govern that sphere and adjust their behavior accordingly.¹⁸³ However, businesses are increasingly reaching out to fund university R&D,¹⁸⁴ though it has been argued that “[u]niversities are less well equipped to employ a ‘pro-active’ [intellectual property rights] strategy.”¹⁸⁵

Ultimately, the patent regime should help ensure that collaborative partnerships are mutually beneficial. Where one partner adheres to the norms of a specific community, the grant of patent rights should not be predicated upon the relinquishment of community norms.¹⁸⁶ Thus, as long as the norms of these communities do mandate prompt publication of findings, grace periods would facilitate open collaboration.¹⁸⁷

C. Enforcement

TRIPs provides for the first international dispute resolution mechanism for issues regarding intellectual property violations. However, disputes at the WTO are brought by and against nations, and, while they regard individual instances of violation, the WTO adjudicators are not able to coerce nations into providing remedies,¹⁸⁸ and they do not have any true law-making authority.¹⁸⁹ Therefore, patent litigation largely takes place

183. GALAMA, *supra* note 178, at 23.

184. De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 11.

185. OECD *supra* note 3, at 116 (“[For universities,] management of IP in an open innovation context—as opposed to the technology transfer approach of licensing patents—remains a challenge, especially in their interactions with firms.”).

186. The choice to publish rather than patent does not always rest on community norms. Sometimes it is in a company’s economic interest to publish knowledge so that it is available to everyone without cost. This would be the case where the company knows it wouldn’t be able to maintain exclusivity for long. Thus, it is in the firm’s interest to make sure no one else tries to patent the idea while also promoting industry advancement through disclosure.

187. Some critics argue further that, for the reliability of knowledge production, it is essential that big businesses do not impede access to knowledge for the sole purpose of commercial exploitation. This is interesting considering that the “public good” of knowledge dissemination is the goal of patent law; however, these critics believe that the regime may actually serve as an impediment to that very goal. See Paul A. David, *Will Building “Good Fences” Really Make “Good Neighbors” in Science?* 2 (Stanford Inst. for Econ. Policy Research, Discussion Paper No.00-33, 2001) (citing Laxenburg Statement on the Global Science System, (Oct. 10, 1997)).

188. CHOW & SCHOENBAUM, *supra* note 140, at 52 (explaining that the WTO system works by peer pressure rather than any inherent enforcement authority).

189. See Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154 art. IX(2) (granting exclusive authority to the Ministerial Conference and the General Council to interpret the agreements of the WTO); Panel Report, *Japan—Taxes on Alcoholic Beverages*, WT/DS8 (adopted Nov. 1, 1996) (interpreting art.

in the national court systems, subject to national patent laws. Further, patent holders bear the responsibility for monitoring their own patents in each individual country.¹⁹⁰ Both of these activities are costly and have implications for actual patent value. It has been stated, as an industry rule of thumb, that \$1.5 million in legal fees can be expected in the course of defending any given patent infringement lawsuit.¹⁹¹ Hence, some have found that litigation costs are in fact a *disincentive* to innovate.¹⁹² One study found that “worldwide patent profits were about 6 percent of R&D while litigation costs were also about 13 percent . . . that is, patents acted as a net *tax* on R&D.”¹⁹³

Thus, for any party using open innovation, the threat of litigation and the cost of monitoring worldwide patents may be prohibitive. Further, with open innovation, the need for protection extends beyond the issuance of the patent itself and must also contemplate an increase in contractual exchanges of intellectual property rights. Small firms may be at a particular disadvantage in terms of protecting their rights since they are not as well positioned to spread the cost of litigation over large numbers of patents.¹⁹⁴ This has implications for the relative bargaining power of different sized partners in a collaborative partnership. While a firm like IBM may have a handle on monitoring and protecting its intellectual property, a small firm from a remote location might not stand a chance. Additionally, though the Paris Convention assures equal access to protection and remedies for all members, the practicalities of that access are likely to prove prohibitive.

D. Patent Quality

Patent Quality is a concern that arises concurrently with many of the above-mentioned issues. For example, some commentators argue that shifting to a first-to-file system encourages a rush to the patent office at the expense of patent quality.¹⁹⁵ Grace periods allow for the receipt of feedback on inventions, which would facilitate perfection of patents prior

IX(2) of the Marrakesh Agreement as a deliberate grant of exclusive interpretive authority, thus, precluding the existence of the authority elsewhere); see Strandburg, *supra* note 2, at 308 (“TRIPs suffers from a law-making deficit because of the rarity and non-precedential character of WTO panel decisions.”).

190. THOMAS, *supra* note 172, at 7.

191. Mark H. Webbink, *A New Paradigm for Intellectual Property Rights in Software*, DUKE LAW AND TECH. REV., May 1, 2005, 15, 22.

192. BESSEN & MEURER, *supra* note 37, at 14.

193. *Id.* at 145 (emphasis in original).

194. *Id.* at 178.

195. Thomas, *supra* note 131, at 143, 153.

to filing and would thus enhance patent quality.¹⁹⁶ This could, in turn, reduce litigation because poor patent quality often leads to inadvertent infringement.¹⁹⁷ Poor patent quality cannot be tied to any one source, though the flood of patent applications in recent years does not bode well for quality control. Patent boundaries are often fuzzy and their scope can be hard to determine, which give rise to inadvertent infringement.¹⁹⁸ Further, unclear rights raise bargaining costs and heighten the chance that deals will break down.¹⁹⁹ Thus, it becomes “increasingly costly to find and negotiate the necessary patent license in advance of . . . technology development and adoption decisions.”²⁰⁰ To better support the increased movement of technology in light of open innovation, patent reform must focus on enhancing patent quality.

E. Open Innovation Raises Additional Concerns with International Patent Law

In addition to these common areas of focus for patent harmonization, open innovation raises unique questions about the appropriateness of the international patent regime. Some scholars argue that advances like open innovation do not readily fit under the sales-oriented, proprietary model of intellectual property, which underlies agreements such as TRIPs.²⁰¹ TRIPs applies a one-size-fits-all standard of strong protection for all technologies, reflecting its primary goal as an instrument of trade.²⁰² It is questionable whether an instrument of trade is even an appropriate means to regulate innovation since “innovative practices are simply not well-described as means by which goods invented and produced in one place are sold in another.”²⁰³ Further, as previously discussed, the WTO seems ill-equipped as an adjudicatory body for disputes arising among patent holders.

The particular grounds covered—or neglected—by TRIPs are also problematic in the context of open innovation. One basic concern is that an across-the-board mandate of a minimum of 20 years of exclusory protection could be excessive. With product life cycles drastically short-

196. *Cf. id.* (“[Grace periods] encourage[] the development of inventions that require a certain amount of public testing before the invention can be said to be complete.”).

197. *Cf. Schacht & THOMAS, supra* note 159, at 5–6.

198. BESSEN & MEURER, *supra* note 37, at 22.

199. *Id.* at 21.

200. *Id.* at 46.

201. Strandburg, *supra* note 2, at 284.

202. *Id.* at 298; Long, *supra* note 124, at 243 (“TRIPs . . . undeniably established that intellectual property protection is a trade matter.”).

203. *Id.* at 16.

ened—for example, most software is only used for two to three years²⁰⁴—patents could bar further innovation on a given technology even if that technology is no longer actively used. This raises another concern regarding the cumulative nature of inventions.²⁰⁵ The highly complex nature of products today is often the result of a cumulative process²⁰⁶ whereby knowledge from one innovation becomes input for subsequent research.²⁰⁷ This interdependence of knowledge creation raises questions of infringement protection. Notably, TRIPs does not set an upper bound for intellectual property protection which creates a potential holdout problem.²⁰⁸ Original patent holders are able to block future development and capture a disproportionate amount of the value of new innovations. Future inventors are also left with an often impossible task of obtaining licenses from disperse and numerous *ex ante* patent owners.²⁰⁹ Open innovation only further exacerbates this problem, though some companies have tried to remedy the situation by creating patent pools of the intellectual property required for any given product. Nevertheless, patent reform must contemplate better systems to support cumulative knowledge production.

One of the most important assumptions undergirding the international patent regime is that patents are a positive incentive to innovate and that the inventor would have no means to recoup his investment without a patent.²¹⁰ However, some research indicates that an open innovation regime may in fact be superior as it results in lower innovation costs, as well as lower imitation costs.²¹¹ This finding is premised on the assumption that innovators are able to gain advantages simply by being the first to discover such knowledge.²¹² R&D managers have themselves indicated that other means of appropriating value—for instance, lead-time

204. VAN WENDEL DE JOODE, DE BRUIJN & VAN EETEN, *supra* note 124, at 62.

205. EUROPEAN PATENT OFFICE, *supra* note 1, at 88.

206. *Id.*

207. David, *supra* note 187, at 3; *see* Sawyer, *supra* note 2, at 313 (“In a collaborative web, each innovation builds incrementally on a long history of prior innovations. The creative products that are successful in the market rarely spring to life full-grown.”).

208. *See* Strandburg, *supra* note 2, at 302.

209. Sawyer, *supra* note 2, at 319–20 (“[I]t can take a year or more to contact everyone with an ownership right, find out the price, and get all of the release forms signed.”); Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCI. MAG. 698, 698 (1998) (describing the granting of patents as creating an anticommons in biomedical research).

210. Rufus Pollock, *Innovation, Imitation and Open Source* 2 n.3 (Econ. & Econometrics Research Inst., Research Paper No. 20/2008, 2008).

211. *Id.* at 16.

212. *Id.* at 17.

advantages, complementary products, or trade secrecy—are more effective than patents in earning returns on investment.²¹³ These mechanisms lend themselves well to open innovation strategies, which suggests that open innovation may be steering companies away from proprietary patent models. Further, in the absence of patent rights, there has not been a corresponding dip in innovation,²¹⁴ while stringent enforcement of intellectual property rights has actually blocked innovation.²¹⁵ Along with the factors listed above, market forces may step in to ensure an optimal level of invention.²¹⁶ Notably, thriving open-source communities provide a prime example of continued innovation in the absence of intellectual property rights.

IV. CHANGING THE WAY WE THINK ABOUT PATENT RIGHTS

The debate around patent harmonization should be framed with innovation in mind. However, for the benefit of the ever-evolving global business landscape, the discussion on patent reform must shift to reexamine the underlying rationale of patent law. Open innovation is the next chapter of global R&D, and, in this technological world, businesses must adapt or retreat. When businesses work together to license their unused intellectual property and to seek needed intellectual property from others, the world of technology and innovation multiplies exponentially.²¹⁷ Still, the interconnectedness of these businesses creates dependence; thus, these businesses need trust and clarity in order to thrive. Patent law continues to be based on static notions of incentives to innovate, inventor rewards, and public disclosure.²¹⁸ The time has come to reevaluate this one-size-fits-all system²¹⁹ and redefine the goals of patent law. To better support today's global businesses, the patent system should aim to clarify boundaries, simplify processes, and facilitate an ever growing intellectual property marketplace.

Patents are not always easily defined, and the lack of notice within the system makes infringement almost inevitable.²²⁰ As with real property, the notice system should serve as a warning to potential trespassers and

213. BESSEN & MEURER, *supra* note 37, at 89.

214. *Cf.* THOMAS, *supra* note 172, at 5 (“Some of our most dynamic industries arose at a time when patent rights were unavailable or uncertain.”).

215. Sawyer, *supra* note 2, at 317.

216. *Id.* at 5.

217. *Cf.* OECD, *supra* note 3, at 45 (discussing the emergence of intermediary markets and brokers for ideas in response to open innovation strategies).

218. VAN WENDEL DE JOODE, DE BRULIN & VAN EETEN, *supra* note 124, at 52–53.

219. SCHACHT & THOMAS, *supra* note 159, at 11.

220. BESSEN & MEURER, *supra* note 37, at 46, 147.

should aid in the movement of resources to the most efficient users. This would make technology markets more efficient²²¹ and reduce the transaction costs of open innovation. As explained by Ronald Coase, “transaction costs” include the costs of: searching, information provision, bargaining, decision-making, and contracting.²²² Through a better international notice system, search costs would be reduced as parties could easily access the patents they need or find buyers for those patents they are looking to sell. Making information accessible to all parties would equalize bargaining power and reduce litigation costs from inadvertent infringement. Open innovation also raises the need for more robust licensing mechanisms and patent registries to help facilitate connections and the efficient allocation of resources.

This signals the emergence of an intellectual property marketplace. Many prematurely assumed that the marketplace was already here and patent brokers and online innovation marketplaces emerged to cater to the new clientele.²²³ However, key problems bar the emergence of a functional intellectual property market.²²⁴ A general lack of information and a lack of standards for valuation make the coordination of market exchange difficult.²²⁵ Additionally, in a world of virtual interconnectedness, assets are now created and held in virtual spaces, and this gives rise to questions of origin and jurisdiction. An effective patent system will become not only a defense mechanism, but will also be expected to define and regulate an emergent innovation market.

One proposed solution is to set up an administrative type of approach that would allow for continuous adjustments to a global innovation policy.²²⁶ This system would rely on WIPO as a locus of innovation policy tasked with the interpretation of TRIPs’ flexibilities and exceptions in accordance with the needs of the innovation community.²²⁷ Ultimately, amendments to TRIPs could be made to extend exceptions for innovation, and WIPO’s administrative role would expand to vet these exceptions.²²⁸ This is an interesting suggestion and a potentially viable solution. However, while innovation is the focus, this focus is still situated

221. *Id.* at 21.

222. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937), reprinted in *ECONOMIC ANALYSIS OF CONTRACT LAW, ANTITRUST LAW, AND SAFETY REGULATIONS* 244 (Jenny B. Wahl ed, 1998).

223. See Terra, *supra* note 3, at 7 (detailing the advent of virtual auctions and online showroom websites).

224. CHESBROUGH, *supra* note 13, at 74.

225. *Id.* at 75.

226. Strandburg, *supra* note 2, at 286.

227. *Id.* at 24.

228. *Id.*

within the proprietary, trade-based paradigm of TRIPs. And, while enhancing the flexibilities of this international instrument on an *ad hoc* basis may provide innovators some protection, it is unlikely to encourage and support the continued development of innovation strategies.

It is important to consider a way forward that will avoid further entrenchment of outdated intellectual property rationales that are likely to stifle the evolution of innovation.²²⁹ Any successful solution will have to be flexible. Even the WIPO delegates have pointed out that “[i]n view of the rapid technological innovation and the social and economic challenges, the function, value[,] and impact of the patent system need to be constantly adjusted”²³⁰ Further, it has been suggested that the effectiveness of patents depends largely on the implementing institution.²³¹ Not only must a new institution other than the WTO be named as the arbiter of patents, but the definition of “effective” must be reexamined as well. As noted, owners of intellectual property are taking increasingly proactive roles in the management of their assets under open innovation. The ethos of patent law must shift accordingly to “[redefine] ‘ownership’ to focus on the right to distribute, rather than the right to exclude.”²³² Patent law is ripe for a paradigm shift akin to that of innovation with a focus on a more comprehensive notion of the law’s end goals.

CONCLUSION

The lone inventor no longer dominates the field of innovation. In fact, the companies who command these activities are beginning to embody the fundamental principle that two heads are better than one.²³³ Yet, the patent system, built to encourage innovation and reward inventors, remains faithful to the lone inventor. Thus, patents have become, at times, obstacles to successful innovation rather than incentives.²³⁴ Firms respond to the failure of the patent system by finding alternative means of protection and value creation.²³⁵ However, because intellectual property

229. David, *supra* note 187, at 5.

230. R&D, *Innovation and Patents*, WORLD INTELLECTUAL PROP. ORG., <http://www.wipo.int/patent-law/en/developments/research.html> (last visited Apr. 21, 2010).

231. BESSEN & MEURER, *supra* note 37, at 93.

232. Peter Evans, *The New Commons vs. The Second Enclosure Movement: Comments on an Emerging Agenda for Development Research*, STUD. COMP. INT’L DEV., June 2005, at 85, 87.

233. IBM Business Innovation Centre: *Collaborate Globally*, IBM, <http://www-07.ibm.com/innovation/in/exploit/cbp.html> (last visited Apr. 21, 2010).

234. Heller & Eisenberg, *supra* note 209, at 698–99; *see also* BESSEN & MEURER, *supra* note 37, at 14; Sawyer, *supra* note 2, at 317–18.

235. BESSEN & MEURER, *supra* note 37, at 89.

assets remain at the center of open innovation strategies, complete abandonment of the patent regime is not a viable solution.

Open innovation signals a shift in focus from isolated product development to faster, increasingly proactive management of intellectual property assets.²³⁶ Firms look “outside-in” for knowledge and technology to compliment their internal efforts, and they look “inside-out” to capitalize on others’ uses of their unused intellectual property.²³⁷ Though businesses have long employed these tactics, the rate at which they occur today—and the overall integration of the strategy into business models—signals a new era of R&D.²³⁸ Firms can no longer deny the importance of knowledge produced outside their four walls, and those that have learned to efficiently locate and integrate this knowledge have found a competitive edge. Today, complex technologies composed of multiple patents and ideas are created faster, produced faster, and, ultimately, replaced faster. The key to this cycle is the proactive, offensive use and management of intellectual property rights.²³⁹

Patent laws remain rooted in a traditional notion of reactive, defensive exclusion of others.²⁴⁰ In fact, the regime offers no affirmative rights to inventors—it merely offers the right to prevent others from exploiting one’s invention.²⁴¹ This and other substantive minimum mandates in the TRIPs agreement were heralded in the international arena as a great step forward. However, the harmonization debate has neglected changing global trends for too long. To continue to root patent law in a proprietary, sales-oriented model of intellectual property²⁴² is to ignore the full potential of innovation and intellectual property.

At the least, the debate over patent harmonization should be refocused through a new lens. The push to coordinate national regimes must keep in mind the ways in which these rights are utilized, the different players who use the system, and the clarity needed to meet users’ varying goals. However, if patent harmonization continues to rely on the nineteenth century rationale, open innovation may lead companies away from the

236. See OECD, *supra* note 3, at 103; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7; WEST & GALLAGHER, *supra* note 15, at 320.

237. OECD, *supra* note 3, at 18.

238. *Id.* at 24; De Backer, Lopez-Bassols & Martinez, *supra* note 3, at 7; see WEST & GALLAGHER, *supra* note 15, at 320.

239. CHESBROUGH, *supra* note 11, at 155 (noting a shift from intellectual property rights as a means to control to a means of value creation).

240. VAN WENDEL DE JOODE, DE BRUIJN & VAN EETEN, *supra* note 124, at 52.

241. TRIPs, *supra* note 142, at art. 28 (mandating that members provide patent rights that “confer exclusive rights . . . to prevent third parties . . . from the acts of: making, using, offering for sale, selling, or importing”).

242. Strandburg, *supra* note 2, at 284.

use of patents. Patent reform should thus reevaluate the underlying goals of patent law and recognize that innovation does not always have to result in product creation to generate economic value. With this understanding, patent law can move in a new direction with an aim to further knowledge production, ease the sharing of ideas, and promote and police the growing international intellectual property market.

The lone inventor is not extinct. She continues to discover radical new ideas and technologies that change our lives. However, today, this inventor is not alone; she exists in a network of interconnected knowledge producers. The inventor thrives, despite the stunted growth of the patent law meant to support her. Patent reform must take up the torch and adapt to the globalizing world.

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THE GLOBAL DILEMMA IN SHORT SELLING REGULATION: IOSCO'S INFORMATION DISCLOSURE PROPOSALS AND THE POTENTIAL FOR REGULATORY ARBITRAGE

INTRODUCTION

The tumultuous events leading up to the financial crisis in the fall of 2008 resulted in the rapid enactment of global securities rules and regulations that were designed to limit, curb, or outright ban short selling activity. Undoubtedly, Credit Default Swaps¹ played a critical role in corroding the global economy by providing insurance on risky mortgage bonds and encouraging reckless behavior during the housing bubble.² However, according to many regulatory authorities, short sellers greatly exacerbated global economic turmoil, driving some of the world's largest financial institutions to the brink of ruin.³ Indeed, some industry experts debate that the bankruptcy of Lehman Brothers Holdings Inc., (“Lehman Brothers”)—the largest in history—could have been avoided had Wall Street been restrained from “practicing one of its darkest arts.”⁴ The same experts have expressed concerns that certain short selling techniques may amount to “gasoline on the fire” in distressed markets.⁵

In order to respond to unprecedented deterioration of market stability and investor confidence in the financial sector, national regulatory authorities imposed bans or additional restrictions on short selling with great haste and little or no notice.⁶ The resulting regulatory measures exposed a general lack of consistency among national regulators concerning the types of restrictions imposed on short selling as well as short po-

1. A Credit Default Swap (“CDS”) is a contract, where the buyer pays a premium and the seller agrees to make a specific payment if a particular event, such as a bond default, occurs. Thus, if an investor is holding certain bonds and is concerned that the issuer will not be able to pay, purchasing CDSs should cover the potential loss. In this manner, CDS transfers credit risk among market participants. See Nicholas Varchaver & Katie Benner, *The \$55 Trillion Question*, FORTUNE, Oct. 13, 2008, at 134.

2. See *id.*

3. Tom Lauricella, *Lehman Legacy Alters Global Markets. Short-Sellers Took Flak as Stocks Fell, But Did Ban Help?*, WALL ST. J., Sept. 14, 2009, at C1.

4. Gary Matsumoto, *Naked Short Sales Hint Fraud in Bringing Down Lehman*, BLOOMBERG.COM (Mar. 19, 2009), <http://www.bloomberg.com/apps/news?pid=20670001&sid=aB1j1qmFOTCA>.

5. *Id.* (quoting U.S. Senator Ted Kaufman).

6. Kym Sheehan, *Principled Regulatory Action? The Case of Short Selling 1* (Mar. 12, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1368531.

sition disclosure requirements.⁷ In order to resolve this global regulatory disparity, the Task Force of the Technical Committee⁸ of the International Organization of Securities Commission (“IOSCO” or the “organization”)⁹ issued its Final Report on Regulation of Short Selling (“Short Selling Report”).¹⁰ The report identified the primary risks attributed to short selling and proposed four regulatory principles designed to limit those risks, while retaining certain market benefits associated with short selling activity.¹¹ However, while IOSCO’s Short Selling Report aimed at providing a consistent global approach to short selling regulation in

7. *See id.*

8. IOSCO’s Technical Committee is a “specialized working group, made up of fifteen agencies that regulate some of the world’s larger, more developed and internationalized markets.” Press Release, Int’l Org. of Sec. Comm’ns, IOSCO Launches Task Force On Recent Market Events (Nov. 8, 2007), *available at* <http://www.iasplus.com/iosco/0711subprime.pdf>. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. *Id.* Kathleen Casey, Commissioner, Securities and Exchange Commission, is the Chairman of the Technical Committee. *Members of the Technical Committee*, INT’L ORG. OF SEC. COMM’NS, http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (last visited Oct. 16, 2009). Other members of the Technical Committee are regulatory agencies located in the Netherlands, Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, Ontario, Quebec, Spain, Switzerland, United Kingdom, and the United States. *Id.* The Technical Committee’s Task Force is generally comprised of the same agencies as the Technical Committee but is chaired by the Securities and Futures Committee, Hong Kong. *See* INT’L ORG. OF SEC. COMM’NS, CONSULTATION REPORT REGULATION OF SHORT SELLING (2009), *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD289.pdf> [hereinafter SHORT SELLING REPORT]; *IOSCO Committee Lists*, INT’L ORG. OF SEC. COMM’NS, http://www.iosco.org/lists/display_committees.cfm?cmtid=3 (last visited Oct. 16, 2009).

9. IOSCO is the International Organization of Securities Commissions comprised of member agencies that have resolved, through its permanent structures, “to cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets; to exchange information on their respective experiences in order to promote the development of domestic markets; to unite their efforts to establish standards and an effective surveillance of international securities transactions; to provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.” *See About IOSCO*, INT’L ORG. OF SEC. COMM’NS, <http://www.iosco.org/about/> (last visited Nov. 4, 2009). The Objectives and Principles of Securities Regulation published by IOSCO in February of 2008 set out the three objectives of securities regulation: (1) the protection of investors, (2) ensuring that markets are fair, efficient and transparent, and (3) the reduction of systemic risk. *See* INT’L ORG. OF SEC. COMM’NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION at i (2008), *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> [hereinafter OBJECTIVES AND PRINCIPLES REPORT].

10. *See* SHORT SELLING REPORT, *supra* note 8.

11. *Id.*

the areas of compliance, enforcement, and disclosure obligations,¹² the Short Selling Report did not offer a specific regulatory mechanism to achieve these goals.¹³

This Note will suggest that IOSCO's one-size-fits-all approach to short selling regulation ultimately fails to set forth meaningful regulatory standards that are applicable on an international basis. This Note will further intimate that the absence of such standards, especially with regard to consistent information disclosure obligations, may result in information asymmetry among jurisdictions, leaving the gate open for regulatory short selling arbitrage, which hinders market efficiency. Finally, this Note will conclude that IOSCO should address concerns arising from the dissonance in short selling disclosure regulations by implementing meaningful and consistent disclosure and reporting standards. In this vein, IOSCO could follow the Committee of European Securities Regulators' ("CESR") approach¹⁴ in determining the most consistent regulatory disclosure requirements, which maximize the utility of short selling information in the market. Such measures would undoubtedly promote the effectiveness of global short selling regulation and minimize the risk of regulatory arbitrage.

II. BACKGROUND

The objective of the Short Selling Report was to develop broad regulatory principles designed to assist domestic regulators in constructing a national short selling regulatory regime.¹⁵ The goal of IOSCO's proposed principles was to enhance investor protection, market fairness, efficiency, and transparency, and to reduce systemic risk.¹⁶ In this vein, the organization considered the nature of short selling, its risks and benefits, and its role in the global economy.¹⁷ IOSCO's four principles of short selling regulation discussed in this Note reflect the organization's view that while short selling plays an important role in the global markets, certain methods of short selling, such as naked short selling, pose serious economic risks and should be restrained.¹⁸

12. *Id.* at 4–5.

13. *Id.*

14. For a discussion of CESR approach, see *infra* Part III.

15. SHORT SELLING REPORT, *supra* note 8, at 4 (discussing the background and purpose of IOSCO's four principles of short selling regulation in the Executive Summary).

16. *Id.*

17. *Id.*

18. *Id.*

A. The Benefits and Risks of Short Selling in the Global Economy

Although the precise legal definition of short selling varies according to jurisdiction, a transaction is generally defined as a short sale when it involves the sale of stock that the seller does not legally own at the time of the sale.¹⁹ Investors normally seek to make a profit from constantly fluctuating prices of securities that are traded on the markets.²⁰ If investors believe that a company's stock price will decline (e.g., due to the company's announcement of lower than anticipated earnings), they will place themselves in a position to profit from this event by selling the company's stock.²¹ However, if such investors do not own the company's stock at the relevant time, they may borrow²² the stock from other investors (or "lenders"), sell it in the market, and deliver it to the buyer.²³ If the short seller is correct in thinking that the stock's price will decline, he or she will purchase the stock at the lower price and return it to the lender, thereby making a profit.²⁴

The utility of short selling has historically been a subject of debate between those who espouse the ability of short selling to increase market transparency²⁵ and critics, who highlight its propensity to destabilize se-

19. IOSCO's Technical Committee accumulated certain short selling features common to most jurisdictions into a 'bucketed' definition. A particular transaction is defined as a falling within the 'realm of short selling' if it consists of the following two factors: (1) a sale of stock and (2) that the seller does not own at the point of sale. SHORT SELLING REPORT, *supra* note 8 at 24; *see also* Piero Cinquegrana, *Short Selling: A Known Unknown* (European Capital Mkts. Inst., ECMI Commentary No. 23/29, 2009), available at <http://www.ceps.eu/node/1671>.

20. ELIOT NORTON, ON "SHORT SALES" OF SECURITIES THROUGH A STOCKBROKER 5-6 (1907).

21. *Id.*

22. Shares are often borrowed from a long-term share owner, such as an insurance fund or a pension fund, and the owner will receive lending fees from the borrower. *See* FINANCIAL SERVICES AUTHORITY, SHORT SELLING, DISCUSSION PAPER, 2009, 09/1, at 6, available at http://www.fsa.gov.uk/pubs/discussion/dp09_01.pdf [hereinafter FSA SHORT SELLING PAPER].

23. *Id.*

24. In other words, the classic theory for short selling rests upon the premise that an investor believes that negative information concerning an issuer (such as lower earnings, major litigation, or a downturn in the sector) will lead to a decline in the price of its publicly-traded securities. Based on this belief, the investor will sell the stock at the current price, deliver the borrowed shares to the buyer, and repurchase those shares later in the market when the share price will purportedly be lower based on the investor's theory. NORTON, *supra* note 20, at 5; Sheehan, *supra* note 6.

25. Transparency may be defined as the degree to which information about trading is made publicly-available on a real-time basis. OBJECTIVES AND PRINCIPLES REPORT, *supra* note 9, at 6.

curity prices during stressful market periods.²⁶ Proponent economists consider short selling to be instrumental in “unearthing overvalued companies and contributing to efficient stock prices.”²⁷ For instance, some market analysts believe that without the ability to short sell, stock prices would rise and become overvalued, shutting relevant negative information out of the market.²⁸ In this manner, short selling contributes to the price discovery of a particular security.²⁹ Certain empirical evidence also highlights that short sellers tend to be the better informed market participants and when short sellers are shut out of the market, stocks tend to be more expensive and generate abnormally low future returns.³⁰ In sum, the benefits incurred by the market from nonabusive short selling activity include correcting overpriced stock, facilitating hedging and risk management techniques,³¹ and providing liquidity³² to the markets.³³

Conversely, critics of short selling consider it to be a largely speculative and high risk activity.³⁴ A short seller has the potential to incur essentially unlimited losses if the price of the security continuously rises

26. *Id.*

27. The benefits of short selling are also evidenced by the Securities and Exchange Commission’s repeal of the uptick rule and other price tests in 2007 in order to “simplify” short sale regulation. *See* SHORT SELLING REPORT, *supra* note 8, at 25. *See generally* Ekkehart Boehmer, Charles M. Jones & Xiaoyan Zhang, *Shackling Short Sellers: The 2008 Shorting Ban* (Johnson Sch., Research Paper Series No. 34-09, 2009), available at <http://ssrn.com/abstract=1412844>.

28. Boehmer, Jones & Zhang, *supra* note 27, at 2.

29. Price discovery could be described as a method of determining the price of a specific security through basic supply and demand factors related to the market. Investopedia, Price Discovery, <http://www.investopedia.com/terms/p/pricediscovery.asp> (last visited Jan. 28, 2010).

30. Boehmer, Jones & Zhang, *supra* note 27, at 3.

31. For example, curtailing the risk of a long position in stock or call options via establishing a short position in the stock. *See id.*

32. Liquidity may be defined as “being readily convertible to cash.” With respect to securities, a stock is considered liquid when there are enough shares trading in the market so that large transactions can occur without substantial price variations. BLACK’S LAW DICTIONARY (8th ed. 2004); *see also* Lauricella, *supra* note 3.

33. *See* Boehmer, Jones & Zhang, *supra* note 27.

34. THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS (“CESR”), MEASURES ADOPTED BY CESR MEMBERS ON SHORT SELLING, CESR/08-742 (2009) (emphasizing that unregulated short selling may increase market risk) [hereinafter CESR SHORT SELLING MEASURES]. CESR is an independent Committee of European Securities Regulators. *See* CESR in Short, <http://www.cesr-eu.org/index.php?page=cesrinshort&mac=0&id=> (last visited Dec. 10, 2009). CESR’s mission is to improve coordination among securities regulators, act as an advisory group to assist the EU Commission and work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States. *Id.*

rather than falls.³⁵ Furthermore, market authorities stipulate that unregulated short selling may lead to more serious and damaging consequences such as creation of disorderly markets, settlement disruptions, and market abuse.³⁶ In fact, many commentators have blamed short sellers for past stock market declines and crashes—from the financial troubles of the East India Company in 1609, to the stock market crash of 1929, to the 2008 global financial crisis.³⁷ Thus, most market authorities attempt to regulate short selling with an objective of retaining the benefits, while mitigating the risks.³⁸

In the Short Selling Report, IOSCO classified the risks inherent in unregulated short selling activity into three categories of regulatory and market risk, which are common to most jurisdictions.³⁹ The first category concerns the accelerant-like effect of short selling on an issuer that creates a spiraling downward pressure on the share prices of stock. Essentially, the speed and weight of aggressive short selling may cause market disorder when investors do not have enough time to respond to the increasing downward pressure on the stock.⁴⁰ This activity may cause potential buyers to withhold from purchasing the security and encourage holders of the security to sell it.⁴¹ If the price of the stock decreases exponentially, the issuer will have difficulty borrowing money and attracting investors, such that it cannot improve its financial condition before its stock becomes worthless.⁴² When the issuer is a bank, ag-

35. INT'L ORG. OF SEC. COMM'NS, REPORT ON TRANSPARENCY OF SHORT SELLING 7 (2003), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD147.pdf> [hereinafter TRANSPARENCY REPORT].

36. Amendments to Regulation SHO, Exchange Act Release No. 34-60388, 73 Fed. Reg. 61,706 at 5-7, 8 (Oct. 14, 2008); see also CESR SHORT SELLING MEASURES, *supra* note 34.

37. INT'L SEC. LENDING ASS'N, SECURITIES LENDING AND SHORT SELLING (2009), available at [http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SECURITIES%20LENDING%20AND%20SHORT%20SELLING%20\(3\).pdf](http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SECURITIES%20LENDING%20AND%20SHORT%20SELLING%20(3).pdf) (“The International Securities Lending Association (ISLA) is a trade association established in 1989 to represent the common interests of participants in the securities lending industry. ISLA has more than 100 members comprising insurance companies, pension funds, asset managers, banks and securities dealers representing more than 4,000 clients. Whilst based in London, ISLA represents members from more than twenty countries in Europe, the Middle East, Africa and North America.”) [hereinafter SECURITIES LENDING AND SHORT SELLING].

38. See, e.g., Boehmer, Jones & Zhang, *supra* note 27.

39. See generally Amendments to Regulation SHO, *supra* note 36; FSA SHORT SELLING, *supra* note 22; SHORT SELLING REPORT, *supra* note 8.

40. SHORT SELLING REPORT, *supra* note 8, at 7, 22.

41. FSA SHORT SELLING PAPER, *supra* note 22, at 12.

42. *Id.* at 11-14.

gressive short selling of the bank's shares may also lead to depositor run.⁴³ In this sense, normal fluctuations of stock prices are exacerbated by aggressive short selling, which has the potential to lead the issuer into bankruptcy even though it may be otherwise well-capitalized.⁴⁴ Therefore, the activity of aggressive short selling may itself be disorderly, in addition to the fact that the outcome of such activity may lead to undesirable consequences.⁴⁵

The second regulatory concern identified by IOSCO is the potential for abusive market behavior.⁴⁶ Abusive market behavior is apparent when short selling, accompanied by false rumors designed to encourage others to sell, drives down the price of the security and triggers a large profit at the expense of the issuer whose security is being oversold.⁴⁷ The regulatory concern highlighted in this instance is that short selling may provide a valuable tool for those who intend to abuse the market.⁴⁸ Regulators often define market abuse or market manipulation as an illegal "intentional interference with the free forces of supply and demand."⁴⁹ Although the definition of manipulative activity varies slightly among jurisdictions, most regulatory authorities recognize that when a market participant spreads false rumors designed to encourage others to sell, and he or she sells the security in question, such activity is a "clear case of abusive behavior."⁵⁰

43. A depositor run or "bank run" takes place when the customers of a bank fear that the bank will become insolvent. Customers rush to the bank to take out their money as quickly as possible to avoid losing it. In this situation, short selling may become a rapid self-fulfilling prophecy resulting in the potential collapse of issuers that are targeted by the short sellers. *About.com: Economics, Bank Run—Dictionary Definition of Bank Run*, http://economics.about.com/cs/economicsglossary/g/bank_run.htm (last visited Oct. 1, 2010); see also FSA SHORT SELLING PAPER, *supra* note 22, at 12.

44. TRANSPARENCY REPORT, *supra* note 35, at 22.

45. See SHORT SELLING REPORT, *supra* note 8.

46. *Id.* at 22.

47. *Id.*

48. SECURITIES LENDING AND SHORT SELLING, *supra* note 37, at 4 (explaining that propensity to abuse the market may arise from any other form of trading, so the regulatory concern in this instance is not that short selling is an abusive strategy in itself).

49. John D. Finnerty, *Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation* 2–4 (Mar. 2005) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687282 (explaining that manipulative trading strategies—such as releasing false information about a company into the market, naked short selling and employing trading strategies that impede the price formation process—corrupt the market's price formation process, and inject misleading information into the market to move stock prices in the direction that benefits the manipulator. It is important to note that market manipulation can be profitable when there is a difference between the price elasticity of purchases and sales that the manipulator can exploit).

50. SHORT SELLING REPORT, *supra* note 8, at 22.

For example, some market authorities blamed abusive short selling for exacerbating the circumstances which eventually led to the collapse of Bear Stearns & Co., Inc. ("Bear Stearns") and Lehman Brothers.⁵¹ According to the Financial Services Authority ("FSA"), market conditions in the fall of 2008 led to an unacceptably high risk of abusive behavior, precipitated by false rumors and aggressive short selling, which created self-fulfilling prophecies with respect to the collapse of already vulnerable issuers (such as Bear Stearns and Lehman Brothers).⁵² In a similar manner, some market analysts contend that American International Group, Inc. ("AIG") may have averted the need for government financial assistance had its stock price not been driven down by short sellers, thereby triggering a credit downgrade, which then required the company to raise \$14 billion in capital overnight in order to meet collateral requirements on its credit default swaps.⁵³

The third regulatory concern identified by IOSCO regarding short selling is the potential for settlement⁵⁴ disruption, which causes difficulties for the purchasers of the security.⁵⁵ Settlement disruption⁵⁶ may arise in the context of "naked" short selling, where the short seller has not borrowed or arranged to borrow the securities ahead of the sale.⁵⁷ As a result, the seller fails to deliver securities to the buyer when delivery is due.⁵⁸ Naked short selling may increase the potential for market abuse by

51. Bill Saporito, *Are Short Sellers to Blame for the Financial Crisis?*, TIME, Sept. 18, 2008, <http://www.time.com/time/business/article/0,8599,1842499,00.html>.

52. FSA SHORT SELLING PAPER, *supra* note 22.

53. Saporito, *supra* note 51.

54. "Settlement" is the date on which payment is made for a trade. For stocks traded on US exchanges, settlement is currently three business days after the trade. In some regional markets, foreign shares may require months to settle. *Id.*; see also Bloomberg Financial Glossary, <http://www.bloomberg.com/invest/glossary/bfgloss.htm> (last visited Oct. 19, 2009).

55. See Saporito, *supra* note 51.

56. Settlement disruption is a situation where one party pays for the shares he or she purchased and the counterparty (i.e., the short seller) does not deliver the shares (and vice-versa). See SECURITIES LENDING AND SHORT SELLING, *supra* note 37. Short selling carries with it a certain level of "settlement risk." *Id.* Settlement risk, sometimes called "Herstatt risk," was "named after the well-known failure of the German bank Herstatt whose license was withdrawn by regulators on June 26 1974 due to its inability to cover its liabilities. This forced the bank into liquidation and it ceased operating." Reuters Financial Glossary, http://glossary.reuters.com/index.php?title=Herstatt_Risk&redirect=no (last visited Oct. 16, 2009). When German banking regulators closed the bank down, counter parties were left with substantial losses. *Id.*

57. Amendments to Regulation SHO, *supra* note 36, at 5.

58. This is also known as "failure to deliver" or "fail." See SEC, Naked Short Sales, <http://www.sec.gov/answers/nakedshortsale.htm> (last visited Dec. 12, 2009).

manipulating the price of a particular security.⁵⁹ Price manipulation occurs when the naked short seller creates an overall imbalance in the supply and demand in the securities markets, thereby influencing the price of the targeted issuer's stock.⁶⁰ Without the stock borrowing requirement, a short sale effectively increases the supply of a targeted issuer's stock, which, in turn, decreases the stock's price.⁶¹ The theory is that the artificial increase in a company's outstanding stock⁶² essentially devalues it,⁶³ and the failure to deliver the shares is tantamount to issuing new stock without the company's permission.⁶⁴ The Securities and Exchange Commission ("SEC") has recognized that short sellers may intentionally fail to deliver securities as part of a scheme to manipulate (i.e., artificially decrease) their price. The injection into the market of misleading information concerning the supply and the price of an issuer's stock causes unwarranted reputational damage to the issuer and undermines investor confidence in the issuer's financial stability.⁶⁵ In addition, untimely delivery may hinder the purchaser's ability to meet obligations with respect to an onward series of transactions.⁶⁶

Naked short selling also gives rise to potential corporate governance issues.⁶⁷ For example, when naked short selling leads to settlement failure, shareholders are deprived of their stock ownership benefits, such as

59. SHORT SELLING REPORT, *supra* note 8, at 23.

60. *Id.*

61. See FSA SHORT SELLING PAPER, *supra* note 22; Boehmer, Jones & Zhang, *supra* note 27.

62. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 108 (9th ed. 2007) (explaining that outstanding stock, also known as issued stock, is stock that has been authorized to be issued by the company in its certificate of incorporation).

63. For example, the same thing happens to a currency when a government prints more of it. Lauricella, *supra* note 3 at 2 (quoting Susanne Trimbath, a trade-settlement expert and president of STP Advisory Services).

64. *Id.*

65. Amendments to Regulation SHO, *supra* note 36, at 5–8 (For example, in Rhino Advisors, Inc. and Thomas Badian, Lit. Rel. No. 18003 (Feb. 27, 2003), the SEC alleged that the defendants profited from "engaging in massive naked short selling that flooded the market with the [issuer's] stock and depressed its price"); FSA SHORT SELLING PAPER, *supra* note 23 at 11; Brooke Masters, *Crackdown on 'Naked Short-Selling Intensifies'*, FIN. TIMES, Aug. 5, 2009, at C2.

66. SHORT SELLING REPORT *supra* note 8, at 23 (explaining that disruption of timely settlement of shares also contributes to wider systemic risk); see also Amendments to Regulation SHO, *supra* note 36, at 6 ("large and persistent fails to deliver may deprive shareholders of the benefits of ownership such as voting and lending." In addition, the seller avoids incurring the costs normally required to borrow the security.).

67. Finnerty, *supra* note 49, at 6 n.9 (explaining the corporate governance issue).

voting.⁶⁸ This is because the buyer of so-called “phantom shares” created by the naked short seller believes that they are real shares and therefore hold voting rights. Consequently, “if brokers send the proxy materials to owners of phantom shares who then vote for them, there could be more votes cast for the directors than actually exist.”

The impact of settlement disruption is illustrated in the collapse of Lehman Brothers. Because of the lack of controls applicable to short selling, “as many as 32.8 million shares in Lehman Brothers were sold and not delivered to buyers on time as of Sept. 11[, 2008], according to data compiled by the Securities and Exchange Commission and Bloomberg.”⁶⁹ Many industry professionals believed that the naked short selling of Lehman Brothers stock, coupled with the alleged spread of false rumors designed to encourage others to sell the stock, may have been largely responsible for the firm’s demise.⁷⁰ In a similar case, stock delivery failures increased for Bear Stearns as well, peaking the day after it was announced that JPMorgan Chase & Co. would acquire the company for two dollars per share.⁷¹ Although both Lehman Brothers and Bear Stearns were experiencing grave financial problems during 2008, the theory was that short sellers were exacerbating the situation by driving their stock prices lower than they should have been with such speed that recovery was virtually impossible.⁷²

Without regulatory constraints, naked short selling may threaten the stability of broader markets and create “systemic risk.”⁷³ Systemic risk has been broadly defined as the potential breakdown in an entire system, where “an event will trigger a loss of economic value or confidence . . . in a substantial portion of the financial system that is serious enough to . . . have significant adverse effects on the real economy.”⁷⁴ In this scenario, the magnitude and/or speed of short selling are not constrained by the short seller’s ability to borrow the stock in the market before executing the sale.⁷⁵ This trading technique generally increases the manipulator’s

68. SECURITIES LENDING AND SHORT SELLING, *supra* note 37, at 4.

69. Matsumoto, *supra* note 4.

70. *Id.* at 1 (quoting Richard Fuld, former Chief Executive Officer of Lehman Brothers).

71. *Id.*

72. See, e.g., Posting of Alex Singleton to Telegraph, *Short Selling Helped Promote Truth About HBOS and Lehman Brothers*, <http://blogs.telegraph.co.uk> (Sept. 18, 2008).

73. See FSA SHORT SELLING PAPER, *supra* note 22.

74. ORG. FOR ECON. CO-OPERATION AND DEV., G10 REPORT ON CONSOLIDATION IN THE FINANCIAL SECTOR (2001), *available at* http://www.oecd.org/document/60/0,3343,end_2649_34593_1895868_1_1_1_1,00.html [hereinafter G10 REPORT].

75. FSA SHORT SELLING PAPER, *supra* note 22, at 11; see also *id.*

profit and aggravates price decline of the underlying stock.⁷⁶ In this sense, naked short selling can be especially damaging to an issuer's stock price because "ignoring the regulatory requirement to borrow the shares eliminates the main quantitative constraint on the amount of short selling and intensifies the resulting downward pressure on price."⁷⁷ Significant price declines in the stock of issuers that has been subject to extensive naked short selling can create a crisis in investor confidence without a fundamental underlying reason. In the financial world, contagious loss of investor confidence in the market creates a high probability of systemic breakdown.⁷⁸ Once a financial event has become systemic, economic effects may include bank runs, failures of illiquid but solvent firms, and reductions in the supply of funds to finance profitable investment opportunities.⁷⁹

B. Regulatory Restraints on Short Selling

Due to the risks posed by unregulated short selling, regulatory authorities in countries with the most active global capital markets have maintained some forms of restrictive measures controlling naked short selling activities.⁸⁰ The events leading up to the bankruptcies of Bear Stearns and Lehman Brothers led regulators worldwide to conclude that short selling was used in an abusive manner, creating widespread investor panic and destabilizing the markets.⁸¹ As part of its response to the ensuing market instability, the SEC, for example, issued a temporary order restricting short selling in the shares of 19 financial firms deemed systemi-

76. Finnerty, *supra* 49, at 5–6, 33.

77. At the extreme, short position in a stock may even exceed a firm's entire supply of outstanding shares. *Id.* at 33.

78. See G10 REPORT, *supra* note 74.

79. See *id.* (explaining that most systemic crises that have occurred in G10 and other countries in the past 50 years have exhibited at least one of the defining characteristics of systemic risk).

80. Cinquegrana, *supra* note 19, at 10–14 (explaining that although "different jurisdictions use the term 'naked' in slightly different ways, the common regulatory concern . . . is that a seller does not own the stock he is selling and has made no provision to borrow or provide for delivery of stock to the purchaser by the settlement date"); see, e.g., Amendments to Regulation SHO, *supra* note 36 (where the SEC has made permanent a temporary rule that was approved in 2008 in response to continuing concerns regarding "fails to deliver" and potentially abusive "naked" short selling. In particular, temporary Rule 204T makes it a violation of Regulation SHO and imposes penalties if a market participant does not purchase or borrow shares to close—out a "fail to deliver" resulting from a short sale in any equity security. . . . Moreover, Regulation SHO reflects the SEC's concern that "pervious restrictions on short selling had not been effective in preventing its use as manipulative device).

81. See Matsumoto, *supra* note 4; see also FSA SHORT SELLING PAPER, *supra* note 22.

cally important, by reinforcing the penalties for failing to deliver the shares on time.⁸² In September 2008, the Securities and Exchange Commission temporarily banned short selling in 799 stocks, while the FSA instituted its own short selling ban on 29 leading financial stocks.⁸³ When the financial crisis of 2008 reached international markets, global regulatory agencies took emergency actions to further restrain, or outright prohibit short selling activities. The regulatory efforts included outright jurisdiction-wide bans on short selling, partial bans on certain types of short selling activities, and the institution of short position disclosure and reporting requirements in view of the permitted short selling activities.⁸⁴

However, the regulatory measures implemented by global market authorities in order to restrain potentially abusive short selling were largely dissimilar across jurisdictions.⁸⁵ Regulatory judgments of what constituted abusive short selling varied according to jurisdiction. In addition, domestic regulatory efforts were largely uncoordinated with respect to the types of restrictions imposed on short selling and short position disclosure requirements.⁸⁶ For example, after the SEC banned short selling for 799 stocks in September 2008, Taiwan, Netherlands, and France enacted outright country-wide bans of all short selling activities.⁸⁷ Full bans on short selling were eventually lifted in all jurisdictions with developed capital markets. Consequently, many national regulators enhanced certain disclosure-based controls over short selling.⁸⁸

82. *Searching for the Naked Truth* (Aug. 2008), *ECONOMIST*, available at http://www.economist.com/finance/PrinterFriendly.cfm?story_id=11951246.

83. Cinquegrana, *supra* note 19, at 5.

84. Sheehan, *supra* note 6, at 1–2.

85. TRANSPARENCY REPORT, *supra* note 35.

86. *Id.*

87. Australia suspended covered short selling on all stocks. Cinquegrana *supra* note 19, at 5. Canadian regulatory authority also banned the short selling of all financial stocks. *Id.*

88. IOSCO's Technical Committee recognized the concern stemming from unregulated short-selling activities:

The Technical Committee believes that short selling plays an important role in the market for a variety of reasons, such as providing more efficient price discovery, mitigating market bubbles, increasing market liquidity, facilitating hedging and other risk management activities. However, there is also a general concern that especially in extreme market conditions, certain types of short selling, or the use of short selling in combination with certain abusive strategies, may contribute to disorderly markets.

SHORT SELLING REPORT, *supra* note 8, at 4 (quoting the Executive Summary of the Report); see also TRANSPARENCY REPORT, *supra* note 35.

The implementation of short position disclosure requirements reflects the theory that short position disclosure generally provides valuable information to the market⁸⁹ and informed markets are less prone to manipulation and disorder.⁹⁰ Valuable information related to short selling activity, if widely available, could enhance market transparency, which is one of the theoretical conditions required for the free markets to function efficiently.⁹¹ Essentially, well-informed markets exhibit less information asymmetry and present less opportunity for arbitrageurs to profit at the expense of uninformed market participants. Sufficient disclosure can also remove the opportunity for market manipulators to spread false rumors designed to influence trading activity, and can thereby deter market manipulation.⁹² However, when regulatory disclosure requirements differ among jurisdictions,⁹³ the timeliness and availability of information in those jurisdictions are affected. As a consequence, regulatory efforts aimed at curbing market manipulation may be undermined if manipulators take advantage of information asymmetry among different jurisdictions.

C. The Risks Information Asymmetry and the Potential for Regulatory Arbitrage

Conventional financial theory suggests that market efficiency stems from informational efficiency. For example, a market may be more efficient when security prices reflect more information useful to investors within shorter periods of time.⁹⁴ Information asymmetry can occur when one market participant has more or better information than another market participant.⁹⁵ This creates an imbalance of power in transactions, giving rise to potentially large discrepancies between buy and sell orders when better-informed participants exploit their informational advantage.⁹⁶

89. See TRANSPARENCY REPORT, *supra* note 35.

90. *Id.*

91. A market is said to be transparent if information is available with regard to the relevant assets and prices trading on the market. *Id.*

92. *Id.*

93. For example, in some jurisdictions disclosure involves publishing cumulative short sales volumes in individual securities on a daily basis, while in others it involves periodic publication of the overall short position in individual securities as measured at specific moment. *See id.* at 14, 21.

94. Amir N Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 564, 567 (1998).

95. See Stephen Brown & Stephen A. Hillegeist, *How Disclosure Quality Affects the Level of Information Asymmetry*, 12 REV. ACCT. STUD. 443 (2007).

96. *See id.*

Some studies suggest that over a long time horizon, there is a negative association between disclosure quality and information asymmetry.⁹⁷ Analogously, higher quality of information disclosure may contribute to the balancing of power among the buyers and sellers in the market, or decrease the average level of asymmetry among investors. This phenomenon can be applied to regulatory short position disclosure requirements.⁹⁸ Any market efficiencies created by short selling have the potential of being offset by the information asymmetry with regard to other market participants who are unaware of the short sales.⁹⁹ This may be especially true in developed capital markets, where the prices of publicly-traded securities reflect a “mechanism for communicating information.”¹⁰⁰ Thus, failing to disclose the amount of short interest in a stock may remove certain negative information about the issuer from the market, rendering the market less efficient. It is important to note, however, that disclosure quality and effectiveness ultimately depends on the amount, timeliness, and precision of the disclosed information.¹⁰¹

Even though disclosure-based short selling regulations exist in many jurisdictions, these regulations vary with respect to the scope of the disclosures and short position reporting requirements. Divergent disclosure regulations also give rise to regulatory compliance issues for companies that operate internationally.¹⁰² These companies are operationally and financially burdened by having to comply with a multiplicity of different regimes.¹⁰³ Arguably, the greater concern is a threat to market efficiency, where different short position disclosure requirements among jurisdictions may lead to information asymmetry and open the gate for regulatory arbitrage.

Regulatory conflicts may develop when some jurisdictions take the view that the market is benefitted by rigorous short position disclosures, while other jurisdictions deem such disclosure requirements to be inefficient or prefer different disclosure approaches. The ensuing divergence in regulatory regimes may give rise to regulatory arbitrage, which indicates a migration trend toward the more lenient regulatory regimes, and is often associated with a “race to the bottom” argument.¹⁰⁴ The race to

97. See *id.* (referencing studies of information asymmetry and disclosures).

98. Empirical studies suggest that this will occur over a long time period. *Id.*

99. SHORT SELLING REPORT, *supra* note 8, at 14.

100. Licht, *supra* note 94, at 609 (citing F. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 527 (1945)).

101. Brown and Hillegeist, *supra* note 95, at 26.

102. FSA SHORT SELLING PAPER, *supra* note 22, at 23.

103. *Id.*

104. See Licht, *supra* note 94.

the bottom argument recognizes that when two jurisdictions with different regulatory regimes are pitted against each other, market participants will find a way to adopt whatever regulatory framework they feel is best.¹⁰⁵ When competing regulatory regimes simultaneously interact with one another, certain externalities are exerted on those subject to a particular regime.¹⁰⁶ One such externality is the erosion of regulatory effect on market participants.¹⁰⁷ This may develop when companies have multiple stock listings and international operations.¹⁰⁸ For example, if one jurisdiction implements stringent exchange-listing rules for the purpose of curbing certain activity, a company may avoid the more stringent rules by listing its stock in a different jurisdiction with less demanding listing standards.¹⁰⁹

Similarly, with respect to information disclosure obligations, when a stock trades on multiple markets with varying regulatory disclosure regimes, arbitrageurs may use trading information obtained from one jurisdiction, which is untimely or unavailable in another jurisdiction, in order to profit at the expense of uninformed market participants. In this regulatory arbitrage scenario, the economic “law of one price” theory is significantly shattered.¹¹⁰ This theory holds that “if an identical commodity or asset sells in two different markets, then the price of this item should be the same barring transaction costs.”¹¹¹ “Departure from [this theory] may lead to arbitrage profits, generated from buying the underpriced security or selling the overpriced security.”¹¹² In this manner, arbitrageurs may profit when information obtained from one market indicates that the same security is overpriced in another market because the latter does not reflect certain relevant negative information, such as the level of short interest in the security. After acquiring the necessary negative information about the security in the more informed market, the arbitrageur will sell what he believes to be an overpriced security in the less informed market, thereby profiting from the divergence of regulatory disclosure regimes. Therefore, regulatory arbitrage may occur as a consequence of

105. Roberta S. Karmel & Claire R. Kelly, *The Hardening of Soft Law in Securities Regulation*, 34 BROOK. J. INT’L. L. 883, 885–886 (2009); Licht, *supra* note 94, at 633.

106. Licht, *supra* note 94, at 633.

107. *Id.* at 630–33.

108. *Id.* at 630

109. *Id.*

110. *See id.* at 590.

111. *Id.* (quoting Kiyoshi Kato et al., *Are There Arbitrage Opportunities in the Market for American Depository Receipts?*, 1 J. INT’L FIN. MARKETS, INSTITUTIONS & MONEY 73 (1991)).

112. *Id.*

different disclosure regimes when some market participants profit financially from the less informed markets.¹¹³

In addition, different short position disclosure requirements may contribute to the free-rider problem.¹¹⁴ In this scenario, a market that captures valuable information through disclosure requirements will invite free-rider markets, which do not implement rigorous disclosure obligations.¹¹⁵ Essentially, free-riders wind up utilizing the information obtained from more informed markets without incurring the costs of generating that information.¹¹⁶ Another externality of different short position disclosure requirements is the fact that markets with less rigorous disclosure regimes resort to “chasing” the information.¹¹⁷ Consequently, when relevant information is conveyed to the free-rider market at a time lag, arbitrageurs are presented with the opportunity to take advantage of the less informed markets.

D. IOSCO's Role in Implementing Internationally-Consistent Short Selling Regulatory Principles

As presented above, discerning the consequences of the interactions of different regulatory regimes is essential when international regulatory initiatives are considered by such organizations as IOSCO.¹¹⁸ The organization's members cooperate to propose internationally-consistent regulatory guidelines via published reports or consultation papers.¹¹⁹ IOSCO's publications set forth proposed legal or regulatory principles, which are not automatically codified into binding international or domestic law.¹²⁰ When the proposed guidelines are accepted and implemented by the international community and domestic securities regulators, IOSCO principles often evolve into “soft law,” which represents “non-binding standards and principles of conduct.”¹²¹

As a voluntary international standard-setting body, IOSCO's soft law is developed largely through its consultation papers and reports (such as

113. *Id.* at 567.

114. *Id.*

115. *Id.* at 566–67.

116. *Id.* at 566.

117. *Id.*

118. *Id.* at 567.

119. Press Release, Int'l Org. of Sec. Comm'ns, IOSCO Launches Task Force On Recent Market Events, *supra* note 8.

120. Karmel & Kelly, *supra* note 105, at 883–86.

121. *Id.* at 884, 885 (explaining that while IOSCO's members pledge to implement the Organization's standards domestically, the standards do not have the force of either international or domestic law).

the Short Selling Report), which aim to guide regulatory behavior.¹²² On the surface, IOSCO lacks the force of either international or national law, and its enforcement power is largely toothless.¹²³ However, IOSCO's soft law can "harden" when countries incorporate the organization's principles into statutes and binding domestic law.¹²⁴ In fact, many statutes in the securities field are enacted in response to some current financial concerns, and because international organizations like IOSCO are generally thought to be more efficient and faster at responding to current socioeconomic events,¹²⁵ domestic regulations are often drafted in the shadow of soft law.¹²⁶ Therefore, IOSCO's presence in the international securities industry has a significant effect on developing effective international regulatory measures, which are likely to be incorporated into binding domestic securities law.

In the current global markets, securities regulations are no longer considered "domestic" due to the magnitude of financial globalization and innovation.¹²⁷ As illustrated by the regulatory arbitrage phenomenon, regulatory principles implemented in one jurisdiction may have significant consequences on the market participants in other jurisdictions.¹²⁸ This is the reason that international cooperation by national regulatory authorities is absolutely vital.¹²⁹ Indeed, many authorities perceive soft law as the better medium through which market conditions are addressed faster and more effectively, both on an international scale and domestically.¹³⁰ For example, in response to the 2007 market turmoil surrounding Credit Rating Agencies ("CRAs"), United States government offi-

122. *Id.* at 894.

123. *Id.* at 885.

124. *Id.* at 884 (for example, the SEC incorporated IOSCO's best practices into binding legal rules governing the US securities industry).

125. "[S]oft law is frequently more informed and more effective than statutory law. . . ." *Id.* at 885.

126. *Id.*

127. Charles McCreedy, European Commissioner, Internal Market and Services, Remarks at the Inaugural Global Financial Services Centre Conference: Regulating in a Global Market (June 16, 2008), *available at* <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/33> [hereinafter McCreedy Speech].

128. Christopher Cox, Chairman, SEC, Speech at FEI 2008 Current Financial Reporting Issues Conference: Future of International Standards and Cooperation in Light of the Credit Crisis (Nov. 18 2008), *available at* <http://www.sec.gov/news/speech/2008/spch111808cc.htm> [hereinafter Cox Speech].

129. *Id.*

130. Karmel & Kelly, *supra* note 105, at 890 (emphasizing that the alternative means, namely treaty and customary law enactments take much longer to develop and conclude, and do not provide the speed and efficiency needed for dynamic markets).

cials swiftly passed legislation granting authority to the SEC to exercise regulatory oversight of CRAs. The SEC turned to IOSCO for assistance in formulating standards of conduct applicable to CRAs.¹³¹ After the SEC implemented appropriate regulations, the Commission then proceeded with enforcement actions.¹³²

Although IOSCO's Code of Conduct concerning the regulation of CRAs was welcomed by some, critics condemned the rules for not going far enough.¹³³ It became clear to some industry experts that without meaningful and consistent regulatory principles, the process of incorporating soft law into domestic legislation may lead to under-enforcement of the established regulations and a lack of efficient compliance mechanisms.¹³⁴ As a consequence, implementation of IOSCO's soft law may "leave us without real rules that actually implement the policies that are needed."¹³⁵ Indeed, some industry experts believe that many of IOSCO's recommendations set forth in the Short Selling Report do not provide meaningful and enforceable regulatory guidelines.¹³⁶

II. THE REGULATORY APPROACH TO SHORT SELLING — IOSCO'S FOUR PRINCIPLES

In its Short Selling Report, IOSCO proposes four regulatory principles, which aim to eliminate "gaps in various regulatory approaches to naked short selling, including delivery requirements and disclosure of short positions."¹³⁷ The goal of IOSCO's proposed principles is to develop a consistent approach to short selling regulation in the international community.¹³⁸ The four principles are comprised of the following recommendations:

Short selling should be subject to appropriate controls to reduce or minimize the potential risks that could affect the orderly and efficient functioning and stability of financial markets;

Short selling should be subject to a reporting regime that provides timely information to the market or market authorities;

Short selling should be subject to an effective compliance and enforcement system;

131. *Id.* at 886–96.

132. *Id.* at 924–29.

133. *Id.* at 928.

134. *Id.* at 885–86, 896.

135. *See id.* at 932.

136. McCreevy Speech, *supra* note 127.

137. SHORT SELLING REPORT, *supra* note 8, at 4.

138. *Id.*

Short selling regulation should allow appropriate exceptions for certain types of transactions for efficient market functioning and development.¹³⁹

IOSCO's first three principles identify the significance of placing appropriate controls on short selling activity, implementing consistent short position disclosure requirements, and ensuring appropriate compliance and enforcement procedures.¹⁴⁰ The fourth principle recognizes that the practice of short selling has certain market benefits, if conducted in a regulated, nonabusive manner.¹⁴¹ This Note will briefly discuss the first, third and fourth principles of short selling regulation. It will then focus on IOSCO's second principle, which suggests a short selling reporting regime that aims to provide timely information to the relevant entities. The Note will argue that IOSCO's recommended approach to short position disclosure and reporting requirements does not set forth consistent regulatory standards applicable on an international level. This Note will further suggest that allowing some markets to be more informed than others creates information asymmetry among jurisdictions and invites regulatory arbitrage. As a possible solution, this Note will offer CESR's approach to formulating regulatory short position disclosure standards for all jurisdictions within the European Union. Finally, this Note will suggest that while CESR's specific disclosure standards may not be optimal for all jurisdictions, its formulaic approach offers an effective method of implementing consistent regulatory standards that minimize potential information asymmetry and regulatory arbitrage issues related to divergent regulatory regimes.

A. An Overview of IOSCO's First, Third, and Forth Principles of Short Selling Regulation

In its first principle of short selling regulation, IOSCO recommends a minimum requirement of enforcing strict settlement of failed trades.¹⁴² This can be achieved by compulsory buy-in (or close-out)¹⁴³ require-

139. SHORT SELLING REPORT, *supra* note 8, at 6.

140. *Id.*

141. *See id.*

142. *Id.* at 8.

143. Compulsory buy-in or close-out may be requested by the buyer who has not received the stocks after a certain number of days. Alternatively, the process may be initiated by the central counterparty of the securities settlement system. In addition, some markets impose monetary penalty on those who have failed to settle their trades within the standard settlement cycle. *See* SHORT SELLING REPORT *supra* note 8, at 10.

ments. IOSCO also proposes a shorter trade settlement cycle,¹⁴⁴ where trades are settled no later than T+3 (i.e., three days after execution), to avoid the risk of settlement disruption.¹⁴⁵ IOSCO's recommendations in this area directly address one of its main concerns with respect to settlement risk (one of the risks closely associated with naked short selling).¹⁴⁶ Moreover, IOSCO's approach to regulating settlement disruption presents clear regulatory guidelines, which could be applied consistently, on an international level.

IOSCO's third principle of short selling regulation addresses the implementation of international compliance and enforcement systems.¹⁴⁷ The basic tools for effective cross-border enforcement cooperation are set out in IOSCO Objectives and Principles of Securities Regulation, and IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU).¹⁴⁸ This Note does not examine compliance and enforcement procedures as such assessment would draw upon extensive literature analyzing legal and regulatory systems, as well as the availability of resources dedicated to such endeavor. IOSCO's fourth principle deals with exceptions for certain types of transactions and seems consistent, *mutatis mutandis*, with the approach taken by most regulatory authorities with developed capital markets.¹⁴⁹

B. The Need for Consistent Short Selling Information Disclosure Requirements—IOSCO's Second Principle of Short Selling Regulation

In contrast with IOSCO's clear standards for settlement discipline formulated under the first principle of short selling regulation, the organization fails to set forth similar guidelines with respect to short selling information disclosure obligations. Instead, the organization's second principle of short selling regulation confirms what is already known to the international community: that jurisdictions should "consider *some* form of reporting of short selling information either to the market or to market authorities."¹⁵⁰ However, IOSCO's proposal does not offer the necessary

144. Settlement cycle is the "time lapse between trade execution to the settlement of trade." *Id.*

145. *See id.*

146. Strict settlement rules have the potential to discourage and deter abusive short selling behavior (i.e., "those who short sold with no intention of . . . delivery"). *See* SHORT SELLING REPORT, *supra* note 8.

147. *Id.* at 17–20.

148. *Id.*

149. *See* SHORT SELLING REPORT, *supra* note 8.

150. *Id.* at 11–15 (emphasis added).

regulatory clarity and consistency with respect to disclosure requirements to the companies and market participants that operate on an international level.¹⁵¹

Many market authorities have recognized that the globalization of the securities markets has created a need for the sharing of information among regulators and market participants.¹⁵² In jurisdictions with developed capital markets, some regulators, such as the SEC, aim to regulate the markets by promoting the disclosure of relevant trading information rather than directly intervening in the functioning of a free market economy.¹⁵³ The theory supporting this regulatory approach is that by ensuring that investors possess relevant information, mandatory disclosure “leverages market discipline as a means of accountability that stands in contrast to more substantive government oversight.”¹⁵⁴ For example, the inclusion of risk factors in issuer’s prospectuses reflects the SEC’s long-held view that all investors should have access to a “common pool of knowledge” in order to judge for themselves whether to buy, to sell, or to hold a particular security.¹⁵⁵ It follows that the role of the regulators in this type of a regime is to create high quality, disclosure-based regulations that will supply the market with the optimal amount of information necessary for the market participants to make sound investment decisions. As such, IOSCO’s second principle, merits further consideration, namely with respect to the purpose of short position disclosure and reporting obligations.

In the securities markets, the price of a security ideally reflects all publicly-available information about the issuer, as well as other economic

151. *See id.*

152. Karmel & Kelly, *supra* note 105, at 914.

153. Christopher Cox, Chairman, SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission’s Disclosure System (Oct. 8, 2008), *available at* <http://www.sec.gov/news/speech/2008/spch100808cc.htm> (explaining that since its foundation, the SEC’s purpose has been to maintain investor confidence in the markets by providing them with reliable information).

154. Troy A. Paredes, Commissioner, SEC, Remarks before the Symposium on “The Past, Present and Future of the SEC” (Oct. 16, 2009), *available at* <http://www.sec.gov/news/speech/2008/spch101609tap.htm> (explaining that collective judgment of the informed marketplace should be respected as a worthy alternative to more substantive government control of private sector conduct) [hereinafter Paredes Speech].

155. The SEC believes that “[o]nly through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation’s economy.” The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://sec.gov/about/whatwedo.shtml> (last visited Jan. 29, 2010).

conditions. For financial markets to function, the information driving the trading of the securities should be reliable and transparent.¹⁵⁶ Thus, disclosure requirements are necessary to achieve transparency in the market and place market participants in a position to effectively evaluate investment opportunities.¹⁵⁷

While public knowledge of short selling differs among jurisdictions, markets where short position disclosure requirements are implemented tend to be better informed than those where there are no such requirements.¹⁵⁸ This is in part because short position disclosures may enhance the availability of information related to the issuers and the price of their securities. Specifically, short sellers, by betting on a company's stock price decline, signal to the market their view of the company's prospects.¹⁵⁹ In this manner, greater disclosure about short selling activities may provide more information to the market about an issuer, which in turn may enhance price discovery. A better-informed market makes it more difficult for market manipulators to spread false rumors in order to manipulate the price of a security.¹⁶⁰ In this sense, regulatory disclosures operate as a necessary means to ensure investor protection.¹⁶¹ Therefore, appropriate levels of short selling disclosure may supply investors with relevant information, enhance market efficiency and potentially deter market abuse.¹⁶² It is important to note that reporting of short positions should be timely to prevent information from becoming stale before it reaches the market.¹⁶³

While disclosure of information is generally considered to be an effective means of achieving market efficiency and investor protection, not all information is valuable, and information may be subject to misinterpretation.¹⁶⁴ Information overload (i.e., when too much information is released into the market) impairs the ability of a market participant to distinguish what is important in making his or her investment decisions and frustrates the purpose of the disclosure.¹⁶⁵ Moreover, the information ob-

156. Indeed, some regulatory authorities consider that insufficient transparency was at the heart of the 2008 financial crisis. Cox Speech, *supra* note 128.

157. Paredes Speech, *supra* note 154.

158. TRANSPARENCY REPORT, *supra* note 35.

159. In this manner, short sellers contribute to assessing the true value of a company's stock. *Id.*

160. Sheehan, *supra* note 6, at 9.

161. *Id.*

162. *Id.*

163. SHORT SELLING REPORT, *supra* note 8, at 14.

164. *Id.*

165. Paredes Speech, *supra* note 154 (explaining that when information is not processed and interpreted effectively, disclosure does not translate into better decision-

tained from a short sale may be ambiguous and open to various interpretations.¹⁶⁶ A short sale itself may not provide enough information to the market about the short seller's motive. For example, from the short itself it may be unclear whether the short seller sold the security short in order to express a negative view about the issuer or simply hedge¹⁶⁷ another position.

Mandatory disclosure also imposes substantial compliance costs on market participants.¹⁶⁸ Such costs are normally related to the implementation of disclosure mechanisms and compliance costs incurred by the constituents subject to the regulatory disclosure regime. An additional cost of information disclosure may be incurred by the market where public disclosure of short positions could compromise proprietary trading strategies¹⁶⁹ and discourage hedging activity.¹⁷⁰ Because industry experts recognize non-manipulative short selling strategies, including hedging, as socially valuable, markets may actually become less transparent and consequently, less informed when stringent disclosure obligations result in overall less short selling.¹⁷¹ Empirical studies further suggest that high quality disclosures reduce the incentives for market participants to search for information.¹⁷² In other words, full transparency in the market will give the investors less incentive to gather new information because they

making. As Justice Marshall (quoted by Commissioner Paredes) stated, "management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making." Therefore disclosure can result in less transparency and worse decisions).

166. SHORT SELLING REPORT, *supra* note 8, at 15.

167. A hedge is an investment made for the purpose of reducing the risk of adverse price movements in an asset. Investopedia, Hedge Definition, <http://www.investopedia.com/terms/h/hedge.asp> (last visited Jan. 27, 2010). Investors use this strategy when they are unsure of what the market will do. *Id.* For example, if an investor believes that the stock price of an issuer will rise in the near term due to a positive event for that issuer, the investor will purchase the issuer's stock. However, since the investor is interested in the issuer rather than the industry, he or she may hedge industry risk (or the risk that the industry which the issuer is in will experience decline) by short selling an equal value of shares of the issuer's direct competitor, who happens to be in the same industry. *Id.* In this manner, the investor decreases, or hedges industry risk related to the stock he or she desires to purchase. *Id.*

168. SHORT SELLING REPORT, *supra* note 8, at 4–6.

169. "Proprietary" relates to information in which the owner has a protectable interest. BLACK'S LAW DICTIONARY (8th ed. 2004).

170. TRANSPARENCY REPORT, *supra* note 35, at 15–17 (describing short sale disclosure as a two-edged sword); *id.* at 5.

171. Paredes Speech, *supra* note 154.

172. Brown and Hillegeist, *supra* note 95.

would not be compensated for the resources they expend.¹⁷³ Therefore, many regulatory authorities recognize the importance of providing the market with valuable information, while attempting to maintain the incentives for market participants to search for new information.¹⁷⁴

In sum, when establishing disclosure and reporting regimes, regulators should be clear about the objectives of such regulations.¹⁷⁵ The above-mentioned evidence concerning the effects of short position disclosure on the markets indicates that the most optimal regulations would ensure that investors receive socially-valuable information resulting from short selling activity and protect proprietary interests in gathering new information. Therefore, it is important to identify specific disclosure requirements that will allow for the most beneficial flow of information to the public markets. IOSCO's second principle of short selling regulation identifies various disclosure methods implemented by different jurisdictions but does not advance a solution that would unify current short position disclosure regimes.

C. IOSCO's Disclosure Approach Poses the Risks of Information Asymmetry and Regulatory Arbitrage

As discussed earlier, the primary motivation for legislative measures with respect to short selling is to ensure more effective reporting of short selling information.¹⁷⁶ In order to achieve this result, domestic regulators have implemented largely divergent approaches to setting short selling disclosure obligations for market participants.¹⁷⁷ IOSCO's second principle of short selling regulation addresses international discrepancies in reporting requirements by identifying two different methods of disclosure: (1) flagging of short sales¹⁷⁸ and (2) short positions reporting.¹⁷⁹ While IOSCO recognizes that "both models have their own merits," it neither endorses a specific measure, nor proposes a consistent regulatory standard for short position disclosure requirements.¹⁸⁰ This approach

173. FSA SHORT SELLING REPORT, *supra* note 22.

174. Sheehan, *supra* note 6.

175. SHORT SELLING REPORT, *supra* note 8.

176. Sheehan, *supra* note 6, at 27.

177. TRANSPARENCY REPORT, *supra* note 35.

178. CESR SHORT SELLING MEASURES, *supra* note 34, at 6; SHORT SELLING REPORT, *supra* note 8, at 16 (explaining that the strategy makes a short sale trade easily traceable).

179. CESR defines this concept as the "requirement to report individual significant short positions whether to the regulator and/or the market." THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS ("CESR"), MODEL FOR A PAN-EUROPEAN SHORT SELLING DISCLOSURE REGIME, CESR/10-088 (Mar. 2010); Short Selling Report, *supra* note 8, at 16.

180. SHORT SELLING REPORT, *supra* note 8, at 12.

sends a mixed message to the international securities industry and does not resolve the issue of regulatory dissonance in the area.

Although the flagging method is used by some countries such as Canada and Greece, IOSCO and CESR have identified certain flaws with mandating uniform flagging requirements.¹⁸¹ This method requires a marker to be placed on each individual short sale order that a broker sends to a regulated market or alternative trading venue for execution.¹⁸² The market then reads the order as a short sale, rather than just a sale of a security.¹⁸³ One issue with this approach is that while flagging short sales provides regulators with real-time data encompassing intra-day activities, the process of its aggregation raises issues of information redundancy (e.g., a large part of this information is already captured in the form of stock lending data).¹⁸⁴ The concern is that the costs incurred through aggregating and disclosing already-available information may outweigh any potential benefit of releasing such information into the market.¹⁸⁵ In addition, the market may encounter information overload, as supplying it with duplicative information will likely confuse, rather than help market participants.¹⁸⁶

The flagging approach also presents a lack of clarity with respect to the actual outstanding short positions, such that regulators would not be able to readily identify large short positions or aggressive short selling.¹⁸⁷ Marking an order as a short sale does not necessarily offer specific insight into whether the short seller is expressing a negative view about the issuer or simply hedging his position.¹⁸⁸ Therefore, market authorities would not receive enough information via flagging to determine whether a market participant is aggressively short selling the issuer's stock to manipulate the price of the stock, to express concerns about the issuer's financial health, or to simply hedge other positions.¹⁸⁹ In addition, be-

181. See Press Release, CESR, CESR to Consult on Pan-European Short Selling Disclosure Regime (July 8, 2009), available at www.cesr.eu/popup2.php?id=5792 [hereinafter Press Release, CESR].

182. SHORT SELLING REPORT, *supra* note 8, at 15.

183. *Id.*

184. CESR SHORT SELLING MEASURES, *supra* note 34; SHORT SELLING REPORT, *supra* note 8, at 16.

185. SHORT SELLING REPORT, *supra* note 8, at 16.

186. See FSA SHORT SELLING REPORT, *supra* note 22.

187. See *id.*; SHORT SELLING REPORT, *supra* note 8.

188. See FSA SHORT SELLING REPORT, *supra* note 22.

189. Even if purchase orders, which cancel out the existing short position, are flagged, this issue cannot be completely resolved. This is because "short sellers do not need to go to the market to close the short positions in some cases. For example, they may acquire

cause only a few jurisdictions implement this approach, achieving uniformity via flagging would be extremely cumbersome on market participants.¹⁹⁰ Regulated entities and/or stock exchanges that are currently subject to disclosure-based regimes would be required to contribute or divert considerable resources to operational and compliance measures in order to implement the system.¹⁹¹ In sum, while IOSCO does not take a definitive position on flagging as a disclosure mechanism, the SEC, FSA and CESR all favor short position reporting instead of the flagging approach, as way to disclose short sales to the market.¹⁹²

Short position disclosure necessarily requires a system of reporting short selling information either to the market or market authorities.¹⁹³ In developing a system of reporting, regulators must balance the utility of information disclosure to the market against the costs of providing such information.¹⁹⁴ Among other things, short position reporting raises concerns with respect to the appropriate trigger level of reporting, whether the focus should be on net or gross short position reporting, the timing of reporting, the types of securities reportable, and whether the short position details should be confidentially disclosed to the regulators or publicly disclosed to the market.¹⁹⁵ The notification of short positions exceeding a *de minimis* level deals with the trigger level of short positions reporting.¹⁹⁶ For example, some markets require reporting of existing short positions once the positions exceed 0.25% of the issued share capital of the relevant stocks.¹⁹⁷ The Short Selling Report suggests that the trigger level of reporting should not be set so high as to prevent the flow of useful information.¹⁹⁸ On the other hand, setting the threshold too low may be overly burdensome on those responsible for reporting.¹⁹⁹ Essentially, IOSCO leaves the issue of determining the trigger level at the discretion of national regulators.²⁰⁰

the equity shares from other instruments (such as options) to close the short positions.”
SHORT SELLING REPORT, *supra* note 8, at 15.

190. See also Press Release, CESR, *supra* note 181.

191. *Id.*

192. CESR SHORT SELLING MEASURES, *supra* note 34; FSA SHORT SELLING, *supra* note 22; SHORT SELLING REPORT, *supra* note 8.

193. SHORT SELLING REPORT, *supra* note 8, at 10.

194. See generally Paredes Speech, *supra* note 154.

195. See generally SHORT SELLING REPORT, *supra* note 8, at 12–15.

196. *Id.* at 14.

197. *Id.*

198. *Id.* at 30.

199. *Id.* at 14.

200. *Id.*

The decision regarding whether short position reporting should be implemented on a gross or net basis means determining whether to report current overall short sales of an issuer (gross basis) or current overall exposure to an issuer (net basis).²⁰¹ The benefit of net position reporting is that it takes into account long positions in the stock, which may cancel out the short positions.²⁰² For example, if the holder of a disclosed gross short position also has a similar-sized long position in the issuer, the positions cancel out and the holder is in fact “flat.” Gross position reporting does not take this into account and only shows the holder’s total short exposure to the issuer.²⁰³ Thus, net position reporting may be more useful than gross position reporting because it provides more accurate information about the total current short interest in the security.²⁰⁴

In order to be effective, IOSCO suggests that short position reporting should be timely.²⁰⁵ The time lag between the creation of positions and their reporting may render the information stale.²⁰⁶ The timeliness of available information raises the issue of whether short position information should be reported confidentially to the market authorities or publicly disclosed to the market. Public disclosure of significant individual short positions may have harmful commercial effects mentioned earlier, such as the disclosure of a proprietary trading strategy.²⁰⁷ In addition, public disclosure may make those holding large short positions in an issuer subject to a “short squeeze.”²⁰⁸ In this situation, when the demand for stock exceeds its supply, the rapid increase in the price of the stock may force short sellers to purchase the stock at a substantially higher price in order to cover their short positions, thus incurring large economic losses from the transaction.²⁰⁹

201. *Id.*

202. FSA SHORT SELLING REPORT, *supra* note 22.

203. *Id.*

204. This is especially relevant when a holder of disclosed gross short position also has a similarly—sized long position, which cancels out his short position. As such, gross position disclosure would not reflect accurate information related to the investor’s total holdings of the security. *Id.* at 30.

205. SHORT SELLING REPORT, *supra* note 8, at 14.

206. *See* FSA SHORT SELLING REPORT, *supra* note 22.

207. *See* discussion, *supra* p. 26.

208. *See* FSA SHORT SELLING REPORT, *supra* note 22.

209. National Futures Association, Glossary, <http://www.nfa.futures.org/BASICNET/glossary.aspx?term=S> (last visited Jan. 27, 2010) (A similar situation occurred in October 2008, when a short squeeze exponentially increased the price of the Volkswagen shares, temporarily making it the most valuable company in the world).

While public disclosure of short positions poses commercial concerns, confidential disclosure to a regulator may be less efficient due to the time lag created by reporting the information to market authorities before disclosing it publically.²¹⁰ As the time lag increases, the potential benefits derived from disclosures in terms of informed decision-making decrease.²¹¹ Still, disclosure to regulatory authorities may be helpful in identifying any unusual short selling activities potentially giving rise to market abuse.²¹² Once notified of potentially troublesome transactions, a regulator would then be able to determine whether intervention is required.²¹³

While addressing each of the above considerations, IOSCO fails to arrive at an internationally consistent approach or set a minimum threshold of short position reporting, instead leaving the ultimate decision with domestic regulators.²¹⁴ The organization's second principle of short selling regulation also does not take into consideration every asset class in which a seller may express short interest.²¹⁵ For example, securities that trade as common stock in the local market are also available to trade in foreign markets as depository receipts.²¹⁶ When trading in the same security is fragmented among different markets, arbitrageurs stand ready to take advantage of any gap that develops in the price of the security. As discussed earlier, because the price of a security ideally reflects all relevant information pertaining to the issuer, any information asymmetries resulting from different regulatory regimes may in fact create an arbitrage opportunity.²¹⁷ This is because information asymmetry could potentially affect the pricing of securities that trade on numerous national markets.²¹⁸ In other words, if the regulatory regime in one jurisdiction

210. FSA SHORT SELLING REPORT, *supra* note 22, at 29.

211. *Id.*

212. *Id.*

213. *Id.*

214. *See id.*

215. *Id.*

216. Depository receipts are "negotiable certificate[s] held in the bank of one country representing a specific number of shares of a stock traded on an exchange of another country. [These may] make it easier for individuals to invest in foreign companies, due to the widespread availability of price information, lower transaction costs, and timely dividend distributions." Investor Words, Global Depository Receipt Definition, http://www.investorwords.com/2180/Global_Depository_Receipt.html (last visited Oct 23, 2009).

217. *See* discussion, *supra* pp.16–17.

218. For example, the price of the security trading on Hong Kong's exchange may incorporate certain information that is not available and therefore not incorporated in the price of the same security trading in the US market. In fact, IOSCO recognized this issue

institutes less rigorous (or ineffective) short selling disclosure requirements, the price of a security trading in that jurisdiction will reflect less information about the issuer. Consequently, the same security trading in a different jurisdiction with more rigorous disclosure requirements will have a different price because it will likely reflect more information. The market which is dominant in the provision of information would also be dominant in the pricing of the securities traded on that market.²¹⁹ In this manner, information asymmetry stemming from different regulatory regimes may contribute to the difference in the prices of same security trading in different jurisdictions. The subsequent price difference of the same security may create a riskless profit opportunity and further contribute to regulatory arbitrage.²²⁰

Another potential effect of regulatory arbitrage stemming from different short position disclosure requirements is the frustration of purpose or values advanced by the domestic regulatory regime. To illustrate, if a market participant wishes to short sell a stock that is exchange-listed in a jurisdiction that requires full position disclosure, he or she may be inclined to circumvent more stringent disclosure regulations by short selling the depository receipts, which are trading in a jurisdiction with less aggressive disclosure requirements.²²¹ This is problematic when two jurisdictions have strong but opposite opinions as to what level of disclosure is best.²²² The jurisdiction which adheres to stringent disclosure principles will find that its regulations are undermined when investors choose to short sell depository receipts, which trade in a jurisdiction with less stringent disclosure requirements. IOSCO's principles do not address this regulatory concern.

IOSCO's Short Selling Report repeatedly concedes that the regulation of short selling activities varies from jurisdiction to jurisdiction, depending on a range of domestic factors, including, but not limited to, market conditions and domestic regulatory landscape.²²³ Responding to these concerns, "international standards usually grant a fair amount of discretion to national regulators."²²⁴ However, IOSCO grants national regulators virtually unlimited discretion in implementing short sale reporting

in its Transparency Report. See TRANSPARENCY REPORT, *supra* note 35, at 23 (stating that an issue might arise if different venues are subject to different disclosure requirements).

219. Licht, *supra* note 94, at 566.

220. *See id.*

221. *See id.*

222. *Id.* at 630.

223. *See id.*

224. Karmel & Kelly, *supra* note 105, at 963.

obligations.²²⁵ The organization's failure to resolve regulatory dissonance leaves national regulators with no other source for arriving at consistent international standards of short selling regulation in times of greatest economic need.²²⁶ Discretion is by definition nontransparent, and the fact that IOSCO's national regulators develop standards that grant those same regulators virtually unlimited discretion is troubling,²²⁷ as this ultimately leaves securities regulation in the hands of national regulators who are not required to arrive at consistent international standards.²²⁸ Therefore, while some discretion should be afforded to national regulators in order to fine-tune IOSCO's principles of securities regulation to be more in line with domestic needs, unlimited discretion could leave the markets without any internationally consistent regulatory principles. The organization's Short Selling Report fails to address the concern shared by many regulators that information asymmetries between informed short sellers and uninformed market participants could result in price variations.²²⁹ Once price variations occur, the gateway is opened for regulatory arbitrage, where market manipulators are free to take advantage of less-informed markets.

III. CESR'S SHORT POSITION DISCLOSURE APPROACH

There are a number of different approaches to implementing internationally consistent short position disclosure regulations.²³⁰ For example, the SEC, permits confidential short position disclosures to regulatory authorities, while Self-Regulatory Organizations publish daily short selling volume and individual short sale transactions.²³¹ The FSA, on the other hand, considers public disclosure of relevant short sale positions to be the key in improving transparency and market efficiency.²³² One possible solution that attempts to reconcile conflicting disclosure standards is CESR's two-tiered system of disclosure.²³³

225. See SHORT SELLING REPORT, *supra* note 8; see also OBJECTIVES AND PRINCIPLES REPORT, *supra* note 9, at 3.

226. Karmel & Kelly, *supra* note 105 at 910–11.

227. *Id.* at 935–946.

228. *Id.*

229. FSA SHORT SELLING PAPER, *supra* note 22, at 13.

230. TRANSPARENCY REPORT, *supra* note 35, at 20–23.

231. Amendments to Regulation SHO, *supra* note 36.

232. See generally FSA SHORT SELLING PAPER, *supra* note 22. Critics of the SEC's approach argue that it is costly and inefficient because disclosure to the regulators leads to the delay in public disclosure, eventually making the information useless. See Deloitte Financial Group, *Banking and Capital Markets Insight* (Aug. 2009), MONDAQ, Sept. 2, 2009, available at 2009 WL 17191577.

233. Press Release, CESR, *supra* note 181.

CESR's first level of disclosure is the private short position disclosure to a national regulator when that position reaches a specified initial threshold (CESR proposes to set this threshold at 0.1% of the company's issued share capital).²³⁴ This technique provides the regulators with early warning signs of large short position accumulations, thereby alerting them to potentially abusive behavior and allowing them to monitor and take action more effectively.²³⁵ If the short position reaches a second-tier threshold (proposed at 0.5%), the holder of the position would be required to publicly disclose the position to the market.²³⁶ Disclosure calculations and reports would be made on a net basis²³⁷ and reported on the day following the day on which the relevant trigger threshold was crossed.²³⁸ CESR also makes room for exemptions from disclosure obligations for short positions resulting from market making activities.²³⁹

IV. CONCLUSION

While CESR's approach is subject to some criticism,²⁴⁰ its objectives are not unlike those of IOSCO, in that CESR aims at harmonizing the disclosure regime for short selling within the European Union.²⁴¹ As such, CESR illustrates that it is possible to implement clear, meaningful standards with respect to short selling regulation and disclosure requirements. While this Note does not advocate CESR's specific approach as the best-fitting international regulatory measure for short position disclosure, CESR's approach illustrates a compromise among the European Union's national regulators and an implementation of functional and specific regulatory standards.

IOSCO is an "international association of securities regulators with tremendous influence on the development of international norms for the regulation of securities."²⁴² In times of economic crises, international legislative bodies tend to look to IOSCO for advice on appropriate regu-

234. *Id.*

235. *Id.* at 5.

236. Any private or public disclosure would also be necessary if the positions fell below any of the trigger thresholds or crossed the incremental 0.1%. *Id.*

237. Any long economic exposures to the subject security would need to be subtracted from the short position. *Id.*; CESR SHORT SELLING MEASURES, *supra* note 34.

238. *See* CESR SHORT SELLING MEASURES, *supra* note 34.

239. *Id.* Generally, market makers are entities that as part of their businesses, deal as principals in securities in order to (i) fulfill clients' orders and/or (ii) provide liquidity on a regular basis to the market on both, bid and offer sides. FSA SHORT SELLING PAPER, *supra* note 22, at 33.

240. *See* Deloitte Financial Group, *supra* note 232.

241. *Id.*

242. Karmel & Kelly, *supra* note 105, at 898 (internal quotations omitted).

latory measures and to “bring a consensus to the complex and divergent regimes that exist globally.”²⁴³ To wit, it is the only organization with the power to develop internationally consistent standards of short selling regulation through its consultation papers and reports.²⁴⁴

Without clear and consistent guidelines, regulatory dissonance in disclosure obligations breeds information asymmetry among jurisdictions, which erodes market efficiency. The differences in regulatory short position disclosure regimes may also invite unwanted regulatory arbitrage. Many industry experts believe that the securities industry requires a uniform approach to short selling regulation, which can operate on a cross-border basis.²⁴⁵ This type of a regime could eradicate the negative effects of information asymmetry and regulatory arbitrage. These experts also propose that achieving internationally consistent standards of regulation could significantly improve investor confidence and reduce systemic risk in global capital markets.²⁴⁶ Considering the risks that information asymmetry and regulatory arbitrage may pose to the international securities industry, the organization’s short position disclosure and reporting principles should embody the best-fitting rules, which provide the international securities industry with clarity and consistency in the area of short selling regulation.

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243. Deloitte Financial Group, *supra* note 232.

244. *Id.*

245. CESR SHORT SELLING MEASURES, *supra* note 34.

246. *Id.*

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