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Dodd-Frank Sampler: How Congress Codified an Article 1 Financial Takeover

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DODD-FRANK SIMPLER: HOW CONGRESS CODIFIED AN ARTICLE 1 FINANCIAL TAKEOVER

ANTHONY HEARN*

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“Moral hazard: Actions of economic agents maximizing their own utility to the detriment of others, in situations where they do not bear the full consequences or, equivalently, do not enjoy the full benefits of their actions due to uncertainty and incomplete or restricted contracts which prevent the assignment of full damages (benefits) to the agent responsible.”¹

I. INTRODUCTION

Following the pop of the dot com bubble at the turn of the twenty-first century and its attendant recession, the Board of Governors Bank of the United States reduced the federal funds rate eleven times in an effort to stimulate economic growth.² During this period, the United States real estate market clearly emerged as the vehicle of choice to build wealth via

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¹ Steve Allen, *Institutional Background in Financial Risk Management*, 8, http://www.math.nyu.edu/fellows_fin_math/allen/institut_risk.pdf.

² FEDERAL RESERVE, *Open Market Operations*, <http://www.federalreserve.gov/monetarypolicy/openmarket.htm> (last visited May 22, 2011).

speculation.³ Seeking to capitalize on the trend, major banks and mortgage firms developed and sold a plethora of exotic mortgage products.⁴

Gradually, lending standards deteriorated as securitization seemingly arose to replace their need.⁵ Mortgages were milled to consumers, creditworthy and non-creditworthy alike, and readily bundled and sold as securities.⁶ The thinking was that securitization would mitigate the risk posed by lending to the non-creditworthy consumer.⁷ These asset backed securities were sold as mortgage backed securities, included in collateralized debt obligations (CDOs),⁸ CDOs squared,⁹ and CDOs cubed.¹⁰ It is estimated that over 1 trillion dollars of CDOs were issued between 2004 and 2007.¹¹

In response to massive exposure in the credit markets contingent on the home buyers' ability to timely pay their mortgages, Wall Street firms used yet another financial instrument – the credit default swap – to both speculate and ameliorate risk.¹² Through the use of credit default swaps¹³

³ Paul Mizen, *The Credit Crunch of 2007- 2008: A Discussion of the Background, Market Reactions, and Policy Responses*, 90(5) FED. RES. BANK ST. LOUIS REV. 531, 535 (2008).

⁴ *Id.*

⁵ See generally James D. Hamilton & Menzie Chinn, *Deteriorating Lending Standards*, ECONBROWSER (Oct. 17, 2007), http://www.econbrowser.com/archives/2007/10/deteriorating_1.html (providing graphical analysis depicting the declining lending standards throughout the housing boom).

⁶ Jason Cox et al., *Why Did the Credit Crisis Spread to Global Markets?*, THE UNIV. OF IA. CTR. FOR INT'L FL. AND DEV. (Mar. 2010), <http://www.uiowa.edu/ifdebook/ebook2/contents/part5-II.shtml>.

⁷ *Id.*

⁸ *Collateralized Debt Obligation-CDO*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/c/cdo.asp> (last visited Jan. 18, 2011) (“An investment-grade security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds . . . CDOs are unique in that they represent different types of debt and credit risk. In the case of CDOs, these different types of debt are often referred to as ‘tranches’ or ‘slices’. Each slice has a different maturity and risk associated with it. The higher the risk, the more the CDO pays.”).

⁹ *Collateralized Debt Obligation Squared or CDO Squared*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/c/cdo2.asp> (last visited Jan. 12, 2011) (“A special purpose vehicle (SPV) with securitization payments in the form of tranches. A collateralized debt obligation squared (CDO-squared) is backed by a pool of collateralized debt obligation (CDO) tranches.”).

¹⁰ *Collateralized Debt Obligation Cubed or CDO Cubed*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/c/cdo3.asp> (last visited Jan. 12, 2011) (“A special purpose vehicle (SPV) with securitization payments in the form of tranches. Collateralized debt obligation cubeds (CDO-cubeds) are backed by a pool of collateralized debt obligation squared (CDO-squared) tranches.”).

¹¹ Cox et al., *supra* note 6.

¹² *Credit Default Swap Explained*, ECONOMICS HELP (Nov. 11, 2008), <http://www.economicshelp.org/blog/finance/credit-default-swaps-explained/> [hereinafter *CDS Explained*].

¹³ *Credit Default Swap (CDS)*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Jan. 18, 2011) (“The buyer of a credit swap receives credit

(CDS), banking firms were able to pay a quarterly premium to a protection seller in exchange for the purchase of the underlying interest in the asset by the protection seller in the event of default by the home buyer.¹⁴ Naked default swaps allow parties without any interest in an asset to buy similar contracts, which are simply bets that an unrelated party will or will not default on their debt.¹⁵ The International Swaps and Derivative Association reports that although the market for CDS in 2003 was \$3.7 trillion, it grew to a notional value of \$62.2 trillion (approximately four times gross domestic product of the U.S.) in 2007 before that amount fell to \$38.6 trillion in 2008.¹⁶ CNBC journalist, David Faber, reported on the development of the many opportunities built upon U.S. mortgages and described the resulting configuration as a house of cards.¹⁷ The observation, however astute for its recognition of that structure's proclivity to collapse, is upside down. The more apt symbolic image is an inverted pyramid, vast and unwieldy at the top, ill-conceived at its base, and doomed to collapse from the start.

Inevitably, prices in the housing market began to decline, and by 2007 many of the firms directly exposed to the subprime mortgage market filed for bankruptcy as defaults on the riskiest mortgages mounted.¹⁸ Securitization of subprime mortgages virtually ceased, and by mid-2007 ratings agencies began downgrading the securities backed by risk-prone mortgages.¹⁹ The downgrades sent shockwaves through the entire financial system.²⁰ The tip of the inverted pyramid evaporated, and everything built upon it collapsed.²¹

protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.”).

¹⁴ *CDS Explained*, *supra* note 12.

¹⁵ Dawn Kopecki & Shannon D. Harrington, *Banning 'Naked' Default Swaps May Raise Corporate Funding Costs*, BLOOMBERG (July 24, 2009), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a0W1VTiv9q2A>.

¹⁶ INT'L SWAPS AND DERIVATIVES ASSOCIATION, INC. (2010), <http://www.isda.org/statistics/pdf/ISDA-Market-Survey-historical-data.pdf>.

¹⁷ David Faber, *House of Cards*, CNBC, <http://www.cnbc.com/id/28892719/> (last visited May 22, 2011).

¹⁸ *The Financial Crisis: A Timeline of Events and Policy Actions*, FED. RESERVE BANK OF ST. LOUIS, <http://timeline.stlouisfed.org/index.cfm?p=timeline#> (last visited May 22, 2011) [hereinafter *Timeline*].

¹⁹ *Id.*

²⁰ See, e.g., Paul Jackson, *S&P Cuts Four Major Mortgage Insurers; Projects Worsening Housing Slump*, HOUSINGWIRE (Apr. 8, 2008, 7:57 PM), <http://www.housingwire.com/2008/04/08/s-projects-worsening-housing-slump> (quoting credit analyst James Brender at Standard & Poor's, “[t]he deterioration in the housing markets has also been worse than our expectations. Now, we believe

In 2008, as a result of the faulty understanding of risk and securitization, no one on Wall Street – or anywhere else – was adequately assessing the threat posed by counterparty risk.²² The extreme opacity in the CDS market and the realization by major financial institutions of faulty risk assessment froze interbank lending.²³ In what amounted to a game of high-stakes musical chairs, firms were stuck with whatever holdings they had in their possession.²⁴ Ultimately, Wall Street investment vehicles had encouraged a metamorphosis of the subprime crisis into a global financial crisis.²⁵

The extent of the damage became public as staple investment houses failed, and others were absorbed by larger institutions.²⁶ In an effort to unfreeze credit and prevent a collapse of the entire global financial system, the Board of Governors and U.S. Treasury requested \$700 billion to purchase bad loans off the ailing firms' balance sheets.²⁷ The Treasury and Board of Governors defended the Wall Street bailout over calls to allow the market to correct itself, and argued that many firms are “too big to fail” without creating a global market collapse.²⁸ On October 3, 2008, the Wall Street bailout was approved by Congress, causing the public collective psychic pain.²⁹

When the immediate threat of global economic failure had subsided and panic was no longer hanging in the halls of the Capitol, the 110th Congress undertook to reign in Wall Street's new innovations, while seeking to prevent future financial crises.³⁰ As ideological forces

median home prices will decline 20 percent from the peak in 2006.”).

²¹ See *Timeline*, *supra* note 18.

²² See, e.g., Craig Torres, *U.S. Bank Regulators Issue Guidance On Counterparty Risk Management*, BLOOMBERG (July 5, 2011 10:00 AM), <http://www.bloomberg.com/news/2011-07-05/u-s-bank-regulators-issue-guidance-on-counterparty-credit-risk.html> (“The Federal Reserve, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, and the Office of Thrift Supervision said today the financial crisis of 2007-2009 ‘revealed weaknesses’ in counterparty credit risk management ‘at many banking organizations.’ The regulators pointed to the ‘shortcomings’ in the ability of banks to determine exposures in a timely way, and noted “poor selection” of counterparty credit risk metrics.”).

²³ *Id.*

²⁴ Mizzen, *supra* note 3, at 544.

²⁵ See generally *id.*

²⁶ *Timeline*, *supra* note 18.

²⁷ See Joe Nocera, *Lehman Had to Die So Global Finance Could Live*, N.Y. TIMES (Sept. 11, 2009), http://www.nytimes.com/2009/09/12/business/12nocera.html?_r=1&ref=businessspecial4.

²⁸ *Timeline*, *supra* note 18.

²⁹ *Id.*

³⁰ Brady Dennis, *Congress Passes Financial Reform Bill*, WASHINGTON POST (July 16, 2010),

attempted to frame the future of the American financial economy, the monumental legislation was forged amidst claims of legislative capture, anti-competitiveness, and anti-Americanism.³¹ Underlying the incendiary environment was a multi-faceted battle between free-marketeers, seeking to limit the sweep of the impending regulation, those who sought greater regulation to reduce the likelihood of future market failures, those that wanted to dismantle the “too big to fail” banks and bring them down to size, and innumerable combinations of the above.³² Regardless of each member’s view on financial regulation, Congress had to make a policy decision central to the “too big to fail” paradigm: Should the “too big to fail” banks be broken?³³

On the one hand, massive banking institutions within the “too big to fail” category have achieved incredible economies of scale.³⁴ As a result, each is able to offer the consumer high quality banking services globally, conveniently, and less expensively than smaller institutions.³⁵ Additionally, it is argued that many large non-financial institutions require banking services which can only be provided by the largest banks.³⁶ There is also speculation that the largest firms are more stable than many of the smaller firms because the smaller firms have less diverse holdings to support themselves when one revenue stream is threatened, which may result in future bailouts.³⁷ Each of these views is undergirded by the belief

<http://www.washingtonpost.com/wp-dyn/content/article/2010/07/15/AR2010071500464.html>.

³¹ See, e.g., Jim Puzanhera, *Dispute Over Proposed Financial Regulations Escalates*, CHICAGO TRIBUNE (Mar. 24, 2010), http://articles.chicagotribune.com/2010-03-24/news/sc-biz-0325-chamber-20100324_1_financial-regulations-wolin-chamber-conference (reporting on a speech by Deputy Secretary Neal Wolin’s to the Chamber of Commerce in which he accused the Chamber of deceit in their advertising against financial reform).

³² See Dean Baker, *Why We Must Break up the Banks*, GUARDIAN (Apr. 7, 2010, 5:30 PM BST), <http://www.guardian.co.uk/commentisfree/cifamerica/2010/apr/07/paul-krugman-break-up-banks>.

³³ See, e.g., Letter from Brad Miller et al., Representative from the 13th District, North Carolina, to Members of Congress, (Apr. 29, 2010), <http://georgewashington2.blogspot.com/2010/04/congressman-miller-introduces-bill.html> (seeking co-sponsors for “The Safe, Accountable, Fair and Efficient Banking Act of 2010,” which proposes strict caps on total deposits among a host of other measures).

³⁴ Felix Salmon, *The Too-Big-to-Fail Debate Continues*, SEEKING ALPHA (Nov. 16, 2009), <http://seekingalpha.com/article/173539-the-too-big-to-fail-debate-continues>.

³⁵ *Id.*

³⁶ See Roger Lowenstein, *Jamie Dimon: America’s Least-Hated Banker*, NY TIMES MAGAZINE (Dec. 1, 2010), <http://www.nytimes.com/2010/12/05/magazine/05Dimon-t.html?adxnrl=1&pagewanted=all&adxnrlx=1313366622-iA4QmuTMw5oDpCm4AHwvzA>.

³⁷ Shahien Nasiripour, *Larry Summers Defends Megabanks, Says Too Many Small Banks Make U.S. ‘Less Stable,’* HUFFINGTON POST (Apr. 23, 2010, 2:49 PM), http://www.huffingtonpost.com/2010/04/23/larry-summers-defends-meg_n_549574.html (quoting Larry Summers, Chief Economic Advisor to President Obama as saying, “[Observers] believe that it would actually make us less stable,

that “too big to fail” is not linked to size, but instead to risk profiles and financial relationships.³⁸

On the other hand, when a “too big to fail” bank is on the precipice of collapse, history demonstrates conclusively that the taxpayer will foot the bill to save the institution.³⁹ Supporters of limiting the size of banks posit that in spite of the convenience and savings the largest banks offer, banks that control such a vast swath of market share, where their failure threatens the global financial system, should be limited to whatever size allows their failure to be conceivable.⁴⁰ These supporters argue that failing to break the “too big to fail” banks is tantamount to an implicit governmental guarantee of future bailouts.⁴¹ Under this view, only the risk of failure will preserve rational incentive structures and prevent mega-banks from taking excessive risks.⁴² Additionally, they argue that capping the size of banks assists in disentangling the systemic banks from the political process, reducing their ability to influence legislation and regulation.⁴³

The Dodd-Frank Wall Street Reform and Consumer Protection Act⁴⁴ (Dodd-Frank) was signed into law July 21, 2010 and reflected Congress and the Administration’s belief that it was not the size of the banks that was central to addressing the “too big to fail” paradigm.⁴⁵ Adopting the

because the individual banks would be less diversified and, therefore, at greater risk of failing, because they would haven’t profits in one area to turn to when a different area got in trouble. . . [A]nd most observers believe that dealing with the simultaneous failure of many -- many small institutions would actually generate more need for bailouts and reliance on taxpayers than the current economic environment.”).

³⁸ Chen Zhou, *Are Banks Too Big to Fail? Measuring Systemic Importance of Financial Institutions*, 205 INT’L J. CENTRAL BANKING 206 (2010) (“Recently, both policymakers and academicians have begun to distinguish the size of a [f]inancial institution from the systemic importance it has by introducing new terms focusing on what the potential systemic impact might be if that particular institution fails. For example, Bernanke addresses the problem of [f]inancial institutions that are deemed “too interconnected to fail”; Rajan uses the term “too systemic to fail” to set the central focus of new regulation development. This urges the design of alternative measures on systemic importance.”).

³⁹ For a useful graphical representation of the history of economic intervention in the United States, see *History of U.S. Gov’t Bailouts*, PROPUBLICA (Apr. 15, 2009, 12:02 PM), <http://www.propublica.org/special/government-bailouts>.

⁴⁰ Baker, *supra* note 32.

⁴¹ See *id.*

⁴² See Steve Verdon, *It’s the Incentives, Stupid*, OUTSIDE THE BELTWAY (Mar. 11, 2009), http://www.outsidethebeltway.com/its_the_incentives_stupid-2/.

⁴³ SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 6 (2010).

⁴⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. §§ 5301-5641 (2010).

⁴⁵ See *id.* §§ 5311- 5374.

view that a regulation-only approach is viable, Dodd-Frank's 848 pages are dedicated to the reconfiguration and further empowerment of existing federal financial regulatory entities.⁴⁶ Consistent with that view, Dodd-Frank unites the existing federal financial regulators by statutory decree in the Financial Stability Oversight Council to protect the public from future market failures.⁴⁷

In Section II, this note provides the historical context which ultimately led to the creation and enactment of Dodd-Frank. Next, Section III describes the provisions of the Act most likely to affect the operations of banks with operations in the United States. Section IV asserts that Dodd-Frank cannot fulfill its stated legislative purpose of ending "too big to fail" without reducing the size of the current "too big to fail" banks. Finally, Section V argues that where Congress attempted to address "too big to fail" without capping the size of the banks, it likely delegated too much of its power to the financial regulatory state to remain within the constitutionally defined parameters of federalism.

II. BAILOUT FATIGUE

A. *The Continental Illinois Saga*

It is useful to understand the modern tensions that developed surrounding systemic bank regulation when failure was imminent to acquire some understanding of what caused Congress to birth a statutory behemoth with an eye toward preventing "too big to fail." Prior to 2008 and the failures of IndyMac⁴⁸ and Washington Mutual,⁴⁹ the Continental Illinois bank failure of 1984 sat comfortably atop the list of largest banking failures in U.S. history, and it quickly became emblematic of the "too big to fail" paradigm.⁵⁰ In addition, the collapse illuminated an ideological

⁴⁶ See *id.*

⁴⁷ *Id.*

⁴⁸ Due to liquidity problems arising from risky subprime loans, "IndyMac Bancorp Inc. became the second-biggest federally insured financial company to be seized by U.S. regulators after a run by depositors left the California mortgage lender short on cash." Ari Levi, *IndyMac Seized by U.S. Regulators; Schumer Blamed for Failure*, BLOOMBERG (July 12, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aAYLeK3YAie4>.

⁴⁹ Eric Dash & Andrew Ross Sorkin, *Government Seizes WaMu and Sells Some Assets*, N.Y. TIMES, Sept. 25, 2008, <http://www.nytimes.com/2008/09/26/business/26wamu.html> ("[I]n what was by far the largest bank failure in American history . . . [r]egulators simultaneously brokered an emergency sale of virtually all of Washington Mutual, the nation's largest savings and loan, to JPMorgan Chase for \$1.9 billion.").

⁵⁰ Richard J. Herring, *The Collapse of Continental Illinois National Bank And Trust Company: The*

regulatory chasm between advocates of market capitalism and those who preferred governmental interventionism.⁵¹ Beginning in the mid-1970's, the banking firm Continental Illinois (CINB) embarked on a growth strategy, whereby the firm focused on expanding its lending portfolio heavily in the energy sector and implemented an aggressive pricing model.⁵² The strategy was a staggering short-term success. Between 1976 and 1981, the bank increased its commercial and industrial lending 180% from \$5 billion to \$14 billion, while increasing its total assets 110% to \$45 billion from \$21.5 billion.⁵³ During this period, CINB outgrew most of its peers in the top ten largest U.S. banks.⁵⁴

Equity analysts were beholden by the Enron-esque ascent of CINB and their rapture was understandable – CINB was realizing return on equity at 14.35%, second only to Morgan Guaranty among its competitors.⁵⁵ CINB's stock price reflected the market's adoration doubling from \$13 to \$27 by 1979.⁵⁶ But, like the prince of Morocco, the markets required reminding that "all that glisters is not gold."⁵⁷

Implications For Risk Management and Regulation, 2, <http://fic.wharton.upenn.edu/fic/case%20studies/continental%20full.pdf>.

⁵¹ Alan Greenspan stated "I don't think merely raising the fees or capital on large institutions or taxing them is enough. I think they'll absorb that, they'll work with that, and it's totally inefficient and they'll still be using the savings." Carolyn Austin, *Heavyweights Debate "Too Big to Fail,"* WALL ST. CHEAT SHEET (Nov. 30, 2009), <http://wallstcheatsheet.com/breaking-news/heavy-weights-debate-too-big-to-fail?p=4194/>. The head of the Bank of England, Mervyn King proclaimed, "[t]he belief that appropriate regulation can ensure that speculative activities do not result in failures is a delusion." *Id.* On the other hand, Ben Bernanke and Paul Krugman noted, "[w]e can address these issues in a way that doesn't destroy the economic value of large, complex multifunction firms through other mechanisms." *Id.*

⁵² FED. DEPOSIT INS. CORP., HISTORY OF THE 80S: VOL. I, AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, ch. 7 CONTINENTAL ILLINOIS AND "TOO BIG TO FAIL", at 240 (1997), available at http://www.fdic.gov/bank/historical/history/235_258.pdf [hereinafter CONTINENTAL ILLINOIS] (describing in considerable detail the events surrounding the crisis of the Continental Illinois National Bank and Trust Company).

⁵³ *Id.* at 237.

⁵⁴ *Case Study: Continental Illinois*, SUNGARD AMBIT ERISK (Nov. 2002), <http://www.erisk.com/learning/CaseStudies/ContinentalIllinois.asp#STORY> [hereinafter *Case Study*].

⁵⁵ CONTINENTAL ILLINOIS, *supra* note 52, at 238.

⁵⁶ *Id.* at 237.

⁵⁷ WILLIAM SHAKESPEARE, THE MERCHANT OF VENICE act 2, sc. 7 (M.M. Mahood, ed., Cambridge University Press 1987) (1596-98) ("All that glisters is not gold; Often have you heard this told: Many a man his life hath sold; But my outside to behold: Gilded tombs do worms enfold. Had you been as wise as bold, Young in limbs, in judgment old, Your answer had not ben inscroll'd: Fare you well; your suit is cold. Cold, indeed; and labor lost: Then farewell, hear, and welcome, frost! Portia adieu. I have too grieved a heart. To take a tedious leave: thus losers part.").

By 1981, the upward trend in energy prices had reversed, and the catalyst of CINB's growth became the albatross around its neck.⁵⁸ In calamitous succession, CINB's debtors defaulted, \$1 billion dollars was lost in speculative oil and gas ventures, and the less-developed-country debt crisis, where CINB was a major player, led to a run on the bank in 1984.⁵⁹ When a multi-billion dollar private loan deal orchestrated by CINB's management failed to stabilize matters, it became clear that some form of government intervention would be necessary to prevent collapse.⁶⁰

Although the FDIC had three options available,⁶¹ the organization only considered one realistic – guaranteeing *all* of CINB's debt, while the Board of Governors provided liquidity to support operational costs.⁶² As part of the deal, the FDIC purchased an 80% interest in CINB via preferred shares.⁶³ Effectively, only those parties with an equity interest in CINB took a haircut, while debt holders and depositors walked away.⁶⁴ This action led to serious questions regarding moral hazard, nationalization, and competitive unfairness.⁶⁵

The regulatory community considered CINB “too big to fail” and, by implication, the policy held for all of the major banking players.⁶⁶ In response to the CINB episode, Congress granted regulators greater flexibility to deal with large bank failures, including the addition of bridge-bank⁶⁷ authority.⁶⁸ Otherwise, the problems presented by “too big

⁵⁸ See CONTINENTAL ILLINOIS, *supra* note 52.

⁵⁹ *Case Study*, *supra* note 54.

⁶⁰ *Id.*

⁶¹ CONTINENTAL ILLINOIS, *supra* note 52, at 248.

⁶² *Id.* at 244.

⁶³ *Case Study*, *supra* note 54.

⁶⁴ *Id.* In the aftermath, the Comptroller of the Currency, Todd Conover, stated, “[w]e debated at some length how to handle the situation. In our collective judgment, had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not international, financial crisis the dimensions of which were difficult to imagine. None of us wanted to find out.”

⁶⁵ CONTINENTAL ILLINOIS, *supra* note 52, at 247-48.

⁶⁶ *Id.*

⁶⁷ FED. DEPOSIT INS. CORP. INDUS. ANALYSIS DIV., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE, ch. 6 BRIDGE BANKS, 171 (2005), available at <http://www.fdic.gov/bank/historical/managing/history1-06.pdf> (“A bridge bank is a temporary national bank chartered by the Office of the Comptroller of the Currency (OCC) and organized by the FDIC to take over and maintain banking services for the customers of a failed bank. It is designed to ‘bridge’ the gap between the failure of a bank and the time when the FDIC can implement a satisfactory acquisition by a third party.”).

⁶⁸ CONTINENTAL ILLINOIS, *supra* note 52, at 254; see Competitive Equality Banking Act (CEBA) of 1987, 12 U.S.C. § 1821 (2007).

to fail” banking institutions went unaddressed by specific legislation.⁶⁹ Despite knowledge that systemic risk remained acute in big banks, regulators viewed subsequent denials of bailouts as a sign “too big to fail” may have been addressed.⁷⁰

B. *The Invisible Hand Falls Asleep*

In response to the dot com bubble and the terrorist attacks of September 11, 2001, Board of Governors Chairman Alan Greenspan embarked on an aggressive and extended period of low short-term interest rate policies meant to encourage lending.⁷¹ Meanwhile, savings rates declined internationally, as nations moved to purchase U.S. Treasury bonds in an effort to establish foreign currency reserves as a buffer against domestic financial turmoil.⁷² The high demand in U.S. Treasury notes abroad had the effect of reducing long-term interest rates in the United States.⁷³

Although widely acknowledged to be an unsustainable arrangement, the trend nonetheless encouraged credit growth in the domestic United States, English, and Canadian marketplaces.⁷⁴ Greater access to credit led to greater household spending on revolving credit and further reductions in savings.⁷⁵ The expansion in credit also allowed housing prices to outstrip incomes as home buyers, speculating that housing prices would

⁶⁹ See CONTINENTAL ILLINOIS, *supra* note 52, at 254.

⁷⁰ See *id.* (“Moreover, without addressing TBTF directly, by the late 1980’s regulators were no longer, in L. William Seidman’s words, ‘as solicitous of the interests of the bank’s owners and bondholders: as they had been in the case of Continental.’ This changed policy had partly evolved by the time of the First City Bancorporation assistance in 1988, and was clearly evident in the case of First Republic, also in 1988, when FDIC money was channeled directly into the banking subsidiaries and not into the holding company.”).

⁷¹ Paul Mitzen, *The Credit Crunch of 2007-2008: A Discussion of the Background, Market Reactions, and Policy Responses*, 90(5) FED. RES. BANK ST. LOUIS REV. 531, 533 (2008).

⁷² *Id.* at 534.

⁷³ *Id.*; see Susan Lee, *It Really is All Greenspan’s Fault*, FORBES Apr. 3, 2009, <http://www.forbes.com/2009/04/02/greenspan-john-taylor-fed-rates-china-opinions-columnists-housing-bubble.html> (“The Greenspan loose policy went on to fuel a boom, while the Taylor Tight would have avoided one. As Taylor says, all the Fed needed to do was follow ‘the kind of policy that had worked well during the period of economic stability called the Great Moderation, which began in the early 1980’s.’ The connection between Greenspan loose and the housing boom is also clear.”).

⁷⁴ Mitzen, *supra* note 29, at 534.

⁷⁵ The U.S. saving ratio fell from 6 percent of disposable income to below 1 percent over the course of the previous decade. Additionally, the total debt to disposable-income ratio rose to 120% from 75%. *Id.* at 534.

continue to rise, took on unaffordable loans.⁷⁶ Recognizing an opportunity to profit, lenders began increasing the volume of “subprime mortgage”⁷⁷ offerings.⁷⁸ The increase in originations was largely attributable to the appetite of investors for mortgage backed securities and CDO’s, which required new mortgages as a portion of their underlying assets.⁷⁹ By 2006, the risk presented by the subprime mortgages became clear.⁸⁰ Moreover, it became evident that the process of pooling the mortgages into securitized assets did not necessarily mitigate those risks.⁸¹ As default rates increased, the repercussions of excessive subprime lending became highly visible. The Federal Home Loan Mortgage Corporation announced that it would no longer purchase the risky notes and related securities.⁸² Soon after, major subprime lenders slipped into default and sought bankruptcy protection and, as a result, mortgage backed securities were down-graded by all of the major credit rating agencies.⁸³ As demand

⁷⁶ See David M. Walker, *The Larger Subprime Challenge*, POLITICO (Mar. 31, 2008, 9:36 PM), <http://www.politico.com/news/stories/0308/9283.html>. (“The current mortgage disruption evolved from homebuyers speculating that real estate prices would continue to rise and interest rates would stay low. Too many mortgage loan transactions were based on the assumed value of a home rather than the creditworthiness of the borrower. As a result, many of the loans that were made did not pass the ‘straight-face test’ of a considered evaluation of the ability of the borrower to pay and the related credit risks.”).

⁷⁷ *The Financial Crisis: A Timeline of Events and Policy Actions (Glossary)*, FED. RESERVE BANK OF ST. LOUIS, <http://timeline.stlouisfed.org/index.cfm?p=glossary> (last visited Mar. 29, 2011) [hereinafter *Timeline*] (defining Subprime Mortgage Loan: “The classification ‘subprime’ generally is a lender-given designation for loans extended to borrowers with some sort of credit impairment, say, due to missing installment payments on debt or the lack of a credit history. Along with an individual’s credit rating, characteristics of the mortgage loan can contribute to a lender classifying a loan as subprime—features such as limited or no documentation about income or assets, high loan-to-value ratios or high payment-to-income ratios. Subprime loans typically have a FICO credit score of 620 or less.”).

⁷⁸ Inside Mortgage Finance asserts that subprime mortgage originations grew approximately \$400 billion between 2001 and 2005. Mizen, *supra* note 29, at 536.

⁷⁹ See Thomas Adams & Yves Smith, *CDO Market: Rife With Collusion and Manipulation?*, NAKED CAPITALISM (Apr. 23, 2010), <http://www.nakedcapitalism.com/2010/04/cdo-market-%E2%80%93-rife-with-collusion-and-manipulation.html>. (“CDO’s distorted the mortgage market because they undermined the normal processes for pricing risky assets. For subprime debt, demand for the lower rated tranches had served to constrain market growth. If investors started to shun the BBB to AA rated tranches of subprime mortgage bonds, dealers were not willing to retain them, no new deals would be sold, and the market would need to find better quality mortgages or grind to a halt. But CDO’s were the dumping ground for these tranches.”).

⁸⁰ See Mizen, *supra* note 29, at 535.

⁸¹ Jason Cox et al., *Why Did the Credit Crisis Spread to Global Markets?*, THE UNIV. OF IA. CTR. FOR INT’L FIN. AND DEV. (Mar. 2010), <http://www.uiowa.edu/ifdebook/ebook2/contents/part5-II.shtml>.

⁸² *Timeline*, *supra* note 35.

⁸³ *Testimony of Vickie A. Tillman, Standard & Poor’s Credit Market Services: Hearing Before the Subcommittee On Capital Markets, Insurance And Government Sponsored Enterprises United States House of Representatives*, 110th Cong. 21 (2007), available at <http://financialservices.house.gov/hearing110/tillman.pdf>.

for the securities shrank in response to the downgrades, premier securities firms wound down hedge funds specializing in the MBS/CDO niche, or declared the funds bankrupt.⁸⁴

The good-time fog burned away under the bright, unrelenting light of depreciation in the real estate market and, in response, major financial players took an immediate defensive strategy, signaling the onset of a “Minsky moment.”⁸⁵ The widespread loss mitigation and containment strategies of financial firms across the economic spectrum immediately stranded those firms over-exposed to the MBS and CDO market.⁸⁶ Bear Stearns, which survived the depression of 1929, immediately fell victim and was forced to merge into JP Morgan Chase in a deal brokered by the Board of Governors Bank of New York.⁸⁷ Soon thereafter, Lehman Brothers, another Wall Street icon, was allowed to collapse⁸⁸ amidst a chorus of ballyhoos that the Treasury and Board of Governors were playing favorites.⁸⁹

Despite the moral hazard concerns, head of the Treasury, Henry Paulson, pressed Congress for approval to take radical action.⁹⁰ With the looming threat that the Lehman collapse had destabilized the financial viability of other even larger banks, Congress, on October 3, 2008, enacted House Resolution 1424, which established the Troubled Asset Relief Program (TARP).⁹¹ Just as the FDIC and Board of Governors attempted to take the toxic energy holdings off of the CINB balance sheet

⁸⁴ *Citi May Have a New Mess On Its Hands*, BLOOMBERG BUSINESSWEEK, Nov. 12, 2007, http://www.businessweek.com/magazine/content/07_46/b4058049.htm.

⁸⁵ Charles Whalen, *The U.S. Credit Crunch of 2007 A Minsky Moment*, THE MARKET ORACLE (Nov. 13, 2007, 12:04 PM), <http://www.marketoracle.co.uk/Article2751.html>. (“[A] prolonged period of rapid acceleration of debt” in which more traditional and benign borrowing is steadily replaced by borrowing that depends on new debt to repay existing loans. Then the “moment” occurs, “when lenders become increasingly cautious or restrictive, and when it isn’t only overleveraged structures that encounter financing difficulties. At this juncture, the risks of systemic economic contraction and asset depreciation become all too vivid.”); Justin Lahart, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007, <http://online.wsj.com/public/article/SB118736585456901047.html>.

⁸⁶ David Enke, *Merrill Lynch’s Counterparty Risk*, SEEKING ALPHA (Apr. 17, 2008), <http://seekingalpha.com/article/72787-merrill-lynch-s-counterparty-risk>.

⁸⁷ *See No Picnic: JP Morgan Chase Quintuples Bid For Its Rival. Now For the Hard Part*, THE ECONOMIST, Mar. 27, 2008, <http://www.economist.com/node/10926298>.

⁸⁸ Jim Puzanghera, *Ex-Lehman CEO Blames Government for Firm’s Collapse*, L.A. TIMES, Sept. 2, 2010, <http://articles.latimes.com/2010/sep/02/business/la-fi-crisis-inquiry-20100902>.

⁸⁹ *See* Nocera, *supra* note 7.

⁹⁰ Henry Paulson, *Text of Draft Proposal for Bailout Plan*, N.Y. TIMES, Sept. 20, 2008, http://www.nytimes.com/2008/09/21/business/21draftcnd.html?_r=2&ref=business.

⁹¹ H.R. Res. 1424, 110th Cong. (2008) (enacted).

in 1984, TARP was meant to remove toxic assets from balance sheets of the entire financial industry.⁹² TARP's implementation marked an exhumation of "too big to fail" in American banking regulatory discourse, and the beginning of a populist political backlash which birthed TARP's derisive sobriquet, "bailout."

Transactions under the plan fell into four broad categories: capital purchases and repayments, additional support for large financial institutions, financial assistance to automakers and related businesses, and other.⁹³ Among the highest profile assistance packages were those offered to international bank Citigroup and American Insurance Group (AIG). The Citigroup bailout was structured so that the bank initially received \$25 billion through the Capital Purchase Program⁹⁴ and another \$20 billion through the Treasury's Targeted Investment Program.⁹⁵ In addition, the Treasury agreed to absorb up to \$5 billion in losses that could result from the federal guarantee of a pool of \$301 billion of Citigroup's assets.⁹⁶

Although AIG initially received support from the Board of Governors, TARP accounted for a \$40 billion purchase of preferred stock by the Treasury, followed by a \$30 billion line of credit.⁹⁷ Both the bailout of AIG, a non-banking entity, and the subsequent bailout of the American automakers⁹⁸ were justified under the banner of "too big to fail."⁹⁹ Public disapproval of the bailout soared, and the policy of "too big to fail" became the object of great public scorn.¹⁰⁰

Congress began crafting an overhaul of the regulatory framework for the entire financial sector to address concerns of structural deficiencies in the financial regulatory scheme.¹⁰¹ Although many objectives informed

⁹² *Id.* at § 101(a)(1).

⁹³ Avi Lerner, CONGRESSIONAL BUDGET OFFICE, CBO 4112, *Report on the Troubled Asset Relief Program*, March 2010, available at <http://www.scribd.com/doc/28527535/CBO-TARP-Report-March-2010>.

⁹⁴ Press Release, U.S. DEPT OF TREASURY, Treasury Announces Participation in Citigroup's Exchange Offering (Feb. 27, 2009), <https://ustreas.gov/press/releases/tg41.htm>.

⁹⁵ *Id.*

⁹⁶ Lerner, *supra* note 52, at 4.

⁹⁷ *Id.*

⁹⁸ See Lucian Bebchuk, *AIG Still Isn't Too Big to Fail*, WALL ST. J., Mar. 20, 2009, <http://online.wsj.com/article/SB123751263240591203.html>.

⁹⁹ See Chris Nelder, *The Big Three "Stuck-Up"; Bailing Out the Automakers is Stepping Backwards*, ENERGY & CAPITAL (Nov. 19, 2008), <http://www.energyandcapital.com/articles/big-three-bailout/786>.

¹⁰⁰ See generally www.nobailout.org (last visited Apr. 8, 2011); www.voteno bailout.org (last visited Apr. 8, 2011); www.nowallstreetbailout.com (last visited Apr. 8, 2011).

¹⁰¹ G. Michael O'Leary et al., *Obama Administration Announces Financial Regulatory Overhaul*, ANDREWS

the creation of the legislation, a centerpiece of Congress' concerns was addressing "too big to fail."¹⁰² The endeavor yielded the Dodd-Frank Act, named after its Senate and House sponsors, and included vast rulemaking authority assigned to the regulatory community.¹⁰³

III. DODD-FRANK SIMPLER

A. Title I: The Financial Stability Oversight Council

Central to the Dodd-Frank legislation is the creation of the Financial Stability Oversight Council (FSOC).¹⁰⁴ A virtual regulatory pyramidion, the FSOC is a committee comprised of existing regulatory directors and appointed officials charged with monitoring systemic risk across the country.¹⁰⁵ In an effort to ensure the Council's success, Congress dropped a few arrows in the Council's quiver. Indeed, once identified by the FSOC as a systemic financial entity, a banking firm may enter into an entirely new regulatory paradigm requiring the firm to: comply with heightened prudential standards,¹⁰⁶ maintain a living will,¹⁰⁷ participate in annual stress tests at the behest of the Board of Governors,¹⁰⁸ develop approved early remediation strategies,¹⁰⁹ and restrict merger and acquisition activities.¹¹⁰ Each of the foregoing tools at the FSOC's disposal is discussed below.

KURTHATTY'S LLP (June 24, 2009), <http://www.andrewskurth.com/pressroom-publications-641>.

¹⁰² Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301-5641 (2010) ("An act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.").

¹⁰³ *See id.*

¹⁰⁴ *Id.* § 5321(a).

¹⁰⁵ The FSOC will be comprised of ten voting members: the secretary of the Treasury, Chairman of the Board of Governors, Comptroller of the Currency, Director of the Bureau of Consumer Financial Protection, Chairperson of the SEC, Chairperson of the FDIC, Chairperson of the CFTC, Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member appointed by the President whose term is 6 years. The five non-voting members are: Director of the Office of Financial Research, Director of the Federal Insurance Office, a state insurance commissioner, a state banking supervisor, a state securities commissioner. *Id.* § 5321(b).

¹⁰⁶ Generally declaring that the FSOC is to "give due regard to the principle[s] of national treatment and equality of competitive opportunity" in addition to considering the extent to which the foreign bank is regulated domestically. *Id.* § 5325(b)(2).

¹⁰⁷ *See id.* § 5325(b)(1)(D).

¹⁰⁸ *Id.* § 5365(i)(1)(A) (2010).

¹⁰⁹ *Id.* § 5366(c).

¹¹⁰ *Id.* § 5331(a)(1).

The identification of systemically important firms falls primarily within the domain of the FSOC.¹¹¹ Beyond this designation, the council serves to advise existing regulatory bodies – for the purposes of foreign banks the Board of Governors – on what measures should be taken to mitigate risk.¹¹² The Act vests in the Board of Governors the authority to promulgate exemptions from a systemic importance designation.¹¹³ However, the Act specifies that firms with consolidated assets exceeding \$50 billion come immediately within the ambit of the FSOC reporting requirements, the Act's leverage limits and, thus, imminently closer to a systemic importance designation.¹¹⁴ The impact of such designation is not insignificant.

At the discretion of the Board of Governors, a systemic bank may be required to meet heightened prudential standards.¹¹⁵ The measures that fall under this banner include more stringent risk-based and contingent capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, disclosure rules, short-term debt limits, and overall risk management requirements.¹¹⁶ Uniformity of application of these standards is not required by the Act and, therefore, application of the heightened prudential standards will be tailored to each institution.¹¹⁷ The FSOC's ability to monitor individual institutions in this capacity is enhanced by the creation of the Office of Financial Research (OFR),¹¹⁸ which is granted the authority to request information from a litany of financial institutions,¹¹⁹ including foreign bank subsidiaries.¹²⁰

Insofar as the Board of Governors and FSOC determine that more stringent capital and liquidity requirements should be imposed on a

¹¹¹ *Id.* § 5322(a)(1)(A).

¹¹² *Id.* § 5323.

¹¹³ *Id.* § 5365(k)(2).

¹¹⁴ *Id.* § 5326(a).

¹¹⁵ *Id.* § 5325.

¹¹⁶ *Id.* § 5325(b)(1).

¹¹⁷ *Id.* § 5365(a)(2)(a).

¹¹⁸ *Id.* § 5342.

¹¹⁹ *Id.* § 5343.

¹²⁰ *Id.* § 5311(a)(1) ("A foreign bank or company that is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, pursuant to 3106(a) of this title, shall be treated as a bank holding company for purposes of this subchapter."); *see also* 12 U.S.C. § 3106(a) ("Except as otherwise provided in this section (1) any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary shall be subject to the provisions of the Bank Holding Company Act of 1956.").

systemic foreign bank, the “Basel III” standards are likely to serve as the basis for whatever heightened requirements are settled upon.¹²¹ Basel III further restricts which assets qualify as Tier 1 capital, while requiring banks to maintain minimum common equity of seven percent.¹²² It further enables enforcement of counter-cyclical buffers of 2.5% in times of expanding access to credit.¹²³ Generally, the new banking standards will require banks to maintain more assets relative to what they loan and invest, while restricting what types of assets count toward the Tier 1 requirements.¹²⁴ The G20 formally endorsed the international standard Nov. 12, 2010.¹²⁵

While a systemic bank faces the *possibility* of various heightened prudential standards at the behest of the Board of Governors,¹²⁶ each foreign bank determined to be systemic *will* undergo annual stress tests conducted by the Board of Governors¹²⁷ and be required to develop and maintain “living wills.”¹²⁸ The stress tests are meant to ensure that each systemic institution has the total consolidated capital on hand to withstand adverse market conditions and events.¹²⁹ In addition to the stress tests conducted by the Board of Governors, each systemic bank will be required to conduct their own stress test on a semi-annual basis,¹³⁰ and submit the results to the Board of Governors Board and the bank’s respective primary federal regulator.¹³¹

The “living will” requirement is the second guaranteed requirement placed upon a systemic bank by the FSOC.¹³² The living will is a rapid dissolution plan created and maintained by the foreign bank and filed with

¹²¹ Leal Brainard, Under Secretary for International Affairs, Remarks at the Institute of International Bankers’ Breakfast, U.S. DEP’T OF TREASURY (Oct. 11, 2010) available at <http://www.america.gov/st/texttrans-english/2010/October/20101012133926su8.553278e-02.html&distid=ucs> (“The new Basel III requirements will be the bedrock of the new, more resilient global financial system, and America is committed to implement Basel III.”).

¹²² *Basel III – The Whimper: New Rules on Bank Capital Are Not Particularly Tough*, THE ECONOMIST, Sept. 13, 2010, <http://www.economist.com/node/17027188>.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ Debbie Scanlon, *G20 Endorses Basel III Capital Standards*, FINANCIAL REFORM INSIGHTS (Nov. 16, 2010), <http://financialreforminsights.com/2010/11/16/g20-endorses-basel-iii-capital-standards/>.

¹²⁶ 12 U.S.C. § 5365 (a)(1).

¹²⁷ *Id.* § 5365(i)(1)(A).

¹²⁸ *Id.* § 5365(b)(1)(A)(iv).

¹²⁹ *Id.* § 5365(i)(1)(A).

¹³⁰ *Id.* § 5365(i)(2)(A).

¹³¹ *Id.* § 5365(i)(2)(B).

¹³² *Id.* § 5365(d)(1).

the FSOC, FDIC, and Board of Governors.¹³³ Essentially a roadmap for the dissolution of a firm seized by the government, the living will should include: (1) information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbanking subsidiaries of the company;¹³⁴ (2) full descriptions of the ownership structure, assets, liabilities and contractual obligation of the company;¹³⁵ (3) identification of any cross-guarantees tied to different securities, identification of major counterparties and a process for determining to whom the collateral of the company is pledged¹³⁶ and (4) any other information that the Board of Governors and the Corporation jointly require by rule or order.¹³⁷ The information contained in the “living will” must be approved by the Board of Governors and the FDIC and kept up to date by periodic reporting by the bank.¹³⁸ A bank’s failure to submit an adequate “living will,” according to accepted FSOC and Board of Governors Standards, may result in implementation of increased prudential requirements until submission of an acceptable “living will” is tendered.¹³⁹ Failure to submit an adequate “living will” a second time *may* result in forced divestiture of assets by command of the Board of Governors.¹⁴⁰

In the event that a systemic firm has been identified as presenting a grave threat—think Bear Stearns—the FSOC, upon a two-thirds vote may authorize the Board of Governors to take aggressive steps to control the impact of that firm’s impact on the greater economy.¹⁴¹ Those measures include: (1) restrictions on the company’s freedom to merge, acquire, consolidate with or otherwise become affiliated with another company;¹⁴² (2) limitations on the company’s ability to offer certain financial products;¹⁴³ (3) requirements that the company cease engaging in certain activities¹⁴⁴; or (4) restrictions on the manner in which the company

¹³³ *Id.* § 5365(d)(1).

¹³⁴ *Id.* § 5365(d)(1)(A).

¹³⁵ *Id.* § 5365(d)(1)(B).

¹³⁶ *Id.* § 5365(d)(1)(C).

¹³⁷ *Id.* § 5365(d)(1)(D).

¹³⁸ *Id.* § 5365(d)(3).

¹³⁹ *Id.* § 5365(d)(5)(A).

¹⁴⁰ *Id.* § 5365(d)(5)(B).

¹⁴¹ *Id.* § 5331(a).

¹⁴² *Id.* § 5331(a)(1).

¹⁴³ *Id.* § 5331(a)(2).

¹⁴⁴ *Id.* § 5331(a)(3).

engages in certain activities.¹⁴⁵ If the Board of Governors determines that these measures are inadequate to confront the threat posed by the troubled firm, the FSOC, upon a two thirds vote, may grant it the authority to force the sale or transfer of assets off of its balance sheet.¹⁴⁶ This authority is detailed below.

B. Title II: Orderly Liquidation Authority

Title II of the Act, dubbed the “Orderly Liquidation Authority” (OLA), reserves for the FDIC the power to force covered financial companies into receivership.¹⁴⁷ Although the Act will not change the current regulatory reality for commercial banks, which were barred from bankruptcy reorganization prior to adoption of Title II, the OLA expands the reach of the FDIC power to all entities that qualify as “covered financial companies.”¹⁴⁸ The Act provides that the term “financial company,” as understood by the term “covered financial company,” includes any company that is incorporated or organized under any provision of Federal law or the laws of any State¹⁴⁹ and; is a bank holding company,¹⁵⁰ any non-bank financial company supervised by the Board of

¹⁴⁵ *Id.* § 5331(a)(4).

¹⁴⁶ *Id.* § 5331(a)(5).

¹⁴⁷ *Id.* § 5381.

¹⁴⁸ *Id.* § 5381(a)(8) (“The term ‘covered financial company’ (A) means a financial company for which a determination has been made under section 5383(b) of this title; and (B) does not include an insured depository institution.”); *see also* § 5383(b) (“Determination by the Secretary Notwithstanding any other provision of Federal or State law, the Secretary shall take action in accordance with section 5382(a)(1)(A) of this title, if, upon written recommendation under subsection (a), the Secretary (in consultation with the President) determines that—(1) the financial company is in default or in danger of default; (2) the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States; (3) no viable private sector alternative is available to prevent the default of the financial company; (4) any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under this subchapter is appropriate, given the impact that any action taken under this subchapter would have on financial stability in the United States; (5) any action under section 5384 of this title would avoid or mitigate such adverse effects, taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company; (6) a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and (7) the company satisfies the definition of a financial company under section 5381 of this title.”)

¹⁴⁹ *Id.* § 5381(a)(11)(A).

¹⁵⁰ *Id.* § 5381(a)(11)(B)(i).

Governors,¹⁵¹ a company predominantly engaged in transactions which are financial in nature¹⁵² or any subsidiary of any company described in the foregoing categories.¹⁵³ A firm that falls within one of the “covered” categories must first be designated a “systemic risk” to become subject to the powers of the OLA.¹⁵⁴ There are a number of regulatory procedural hurdles, meant to protect due process rights, which must be overcome prior to a final designation of systemic risk.

First, the financial entities primary regulator (in the case of foreign banks the Board of Governors) must submit a written recommendation to the Secretary of Treasury that the FDIC be appointed as the threatening firm’s receiver.¹⁵⁵ The written recommendation is required to contain a number of evaluations bearing on the appropriateness of the firm’s designation as a systemic risk and, thus, within the power of the OLA. Those evaluations include: whether the firm is “in default or danger of default,”¹⁵⁶ what effect such default will have on the greater U.S. economy, whether private sector alternatives exist to the OLA of the FDIC, an analysis of why the bankruptcy alternative is inappropriate, and an evaluation of the effects of the default on the firm’s creditors, counterparties, and shareholders.¹⁵⁷ The written recommendation is then considered by the Secretary in concert with the President of the United States.¹⁵⁸ In a marked shift away from bankruptcy procedure, it is possible that the financial firm plays *no* role in the procedure to this point, including implementation.¹⁵⁹ Upon approval of the recommendation and a determination by the Secretary that no viable alternatives exist, the Secretary will notify and seek the acquiescence of the board of directors of

¹⁵¹ *Id.* § 5381(a)(11)(B)(ii).

¹⁵² *Id.* § 5381(a)(11)(B)(iii).

¹⁵³ *Id.* § 5381(a)(11)(B)(iv).

¹⁵⁴ *Id.* § 5383.

¹⁵⁵ *Id.* § 5383(a)(1)(A).

¹⁵⁶ “In default or in danger of default” is a broad definition in the act, affording primary regulators a fair amount of discretion in making determinations of ‘systemic’ importance and ‘covered’ status. Specifically, a financial company is in default or in danger of default if: “a bankruptcy has been, or likely will be, commenced with respect to the financial company; the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital and there is no reasonable prospect for the company to avoid such depletion; the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or the financial company is, or is likely to be, unable to pay its obligation (other than those subject to a bona fide dispute in the ordinary course of business.”). *Id.* § 5383(c)(4).

¹⁵⁷ *Id.* § 5383(a)(2).

¹⁵⁸ *Id.* § 5383(b).

¹⁵⁹ *Id.* § 5383.

the financial firm to appoint the FDIC as receiver.¹⁶⁰ If the board acquiesces to the recommendation, the Act immunizes the directors from liability from shareholders for such acquiescence.¹⁶¹ A board's refusal to acquiesce will force the Secretary to petition the United States District Court for the District of Columbia for an order authorizing the appointment of the FDIC as receiver.¹⁶²

The firm's board may challenge the petition in the District Court, but the court's review will be limited to the highly deferential "arbitrary and capricious" standard.¹⁶³ Moreover, a finding that the Secretary made the determinations under review in an arbitrary and capricious manner simply results in the court being forced to allow the Secretary to amend and re-file the petition.¹⁶⁴ If the District Court fails to render a decision on the challenge to the Secretary's determination within twenty-four hours, the Secretary's determination is automatically approved by operation of law.¹⁶⁵

Once the FDIC is appointed receiver, the procedure for liquidation under the OLA provides notable variations from the reorganization proceedings under Chapter 11 of the Bankruptcy Code, where a debtor remains in possession of the operation and the board and management stay in place.¹⁶⁶ Under the OLA, the FDIC succeeds to all rights, titles, powers, and privileges of the company and its assets, and of any stockholder, member, officer, or director of the company.¹⁶⁷ In effect, the FDIC may exert control over the company with the authority of the shareholder and board of directors in all of the company's affairs.¹⁶⁸ The extent of the grant of FDIC authority is exemplified by the FDIC's power to transfer any asset or liability of the company without obtaining approval or consent from any stakeholder.¹⁶⁹

¹⁶⁰ *Id.* § 5382(a)(1)(A)(i).

¹⁶¹ *Id.* § 5387.

¹⁶² *Id.* § 5382(a)(1)(A)(i).

¹⁶³ *Id.* § 5382(a)(1)(A)(iii); *see also Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971) ("Section 706(2)(A) requires a finding that the actual choice made was not 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.' To make this finding the court must consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error in judgment. Although this inquiry into the facts is to be searching and careful, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency." [citations omitted]).

¹⁶⁴ *Id.* § 5382(a)(1)(A)(iv)(II).

¹⁶⁵ *Id.* § 5382(a)(1)(A)(v).

¹⁶⁶ 11 U.S.C. §§ 363(b), 1107, 1108 (2010).

¹⁶⁷ 12 U.S.C. § 5390(a)(1)(A).

¹⁶⁸ *Id.* § 5390(a)(1)(B).

¹⁶⁹ *Id.* § 5390(a)(1)(G).

Certain guiding principles, meant to inform the FDIC's actions once appointed receiver of a covered financial entity, are included in Title II.¹⁷⁰ Among them, the mandate to conduct the liquidation in a manner which maximizes returns while mitigating the risk presented to the U.S. financial system.¹⁷¹ The Act also establishes the priority of claims against the liquidated firms, where the costs of the entities' liquidation come second only to claims by secured creditors.¹⁷² All claims owed to the United States are next in line, followed by all other claims.¹⁷³

C. *The Collins Amendment*

The Collins Amendment affects a number of changes to the existing capital regulatory regime for all bank and thrift holding companies.¹⁷⁴ The Amendment disallows the use of hybrid capital instruments—most notably trust preferred securities (TruPS)—to satisfy Tier 1 capital requirements.¹⁷⁵ By express provision, the Collins Amendment applies to banks organized in the United States but under the control of a foreign parent. Thus, the Collins Amendment effectively obfuscates SR-01-1,¹⁷⁶ which was an avenue to exemption from the Board of Governors Board's capital requirements for bank holding companies controlled by non-U.S. financial holding companies prior to the enactment of Dodd-Frank.¹⁷⁷ Compliance by systemic banks and banks with more than \$15 billion in capital will be expected by May 19, 2013.¹⁷⁸

D. *The Volcker Rule*

Although subject to many exemptions, the Volcker rule against proprietary securities trading by “banking entities”¹⁷⁹ is included in the Act

¹⁷⁰ *Id.* § 5390(b).

¹⁷¹ *Id.* § 5390(b)(4)(A)(i).

¹⁷² *Id.* § 5390(b)(1).

¹⁷³ *Id.* § 5390(b)(1).

¹⁷⁴ *Id.* § 5371(a)(3).

¹⁷⁵ Erik Krusch, *Dodd-Frank: TruPS Moving From Tier 1 to 2nd Rate*, WESTLAW BUSINESS CURRENTS (Sept. 2, 2010), <http://currents.westlawbusiness.com/Article.aspx?id=64926116-9ad0-4079-b13e-4b1fc663a01f>.

¹⁷⁶ 12 U.S.C. § 5371(b)(4)(E).

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* § 5371(b)(4).

¹⁷⁹ The term ‘banking entity’ means any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978,

as an amendment to the Bank Holding Company Act of 1956.¹⁸⁰ The Act defines proprietary trading as:

engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine.¹⁸¹

The “trading account” consists of any account used for acquiring or taking positions in covered instruments “principally for the purpose of selling in the near term.”¹⁸² A number of exemptions are carved out from the Act and are available to all banking entities including: transactions with government or government entities; transactions which are incidental to market making or underwriting provided such activity is for near term demands of clients, customers and counterparties; risk-mitigating hedging activities for a banking entity; and transactions in securities on behalf of customers.¹⁸³ Other activity not covered by the Act includes transactions occurring strictly outside of the United States¹⁸⁴ and transactions by insurance companies subject to equivalent regulatory coverage.¹⁸⁵

In addition to the ban on proprietary trading within a bank, the Volcker rule prohibits certain types of relationships and transactions between banking entities and certain “covered” private equity or hedge funds.¹⁸⁶ Covered funds are those that rely on Sections 3(c)(1) or 3(c)(7)

and any affiliate or subsidiary of any such entity. *Id.* § 1851(h)(1).

¹⁸⁰ *Id.*

¹⁸¹ *Id.* § 1851(h)(4).

¹⁸² *Id.* § 1851(h)(6).

¹⁸³ *Id.* § 1851(d).

¹⁸⁴ *Id.* § 1851(d)(1)(H) (“Proprietary trading conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c), provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.”).

¹⁸⁵ *Id.* § 1851(h)(1)(F).

¹⁸⁶ *Id.* § 1851(f); *Id.* § 1851(h)(2). (“Hedge Fund; Private Equity Fund—The terms ‘hedge fund’ and ‘private equity fund’ mean an issuer that would be an investment company as defined in the Investment

of the Investment Company Act of 1940.¹⁸⁷ Banking entities are restricted from either “sponsoring”¹⁸⁸ these covered funds or entering into a transaction which is not exempt from 23A of the Board of Governors Act,¹⁸⁹ which was itself heavily amended by the Act.¹⁹⁰

Despite inclusion of the Volcker rule, neither proprietary trading activity, nor commingling of private equity/hedge funds with commercial banks will cease entirely. The *de minimus* exemption allows for a banking entity to invest up to three percent of its Tier 1 capital in a “covered fund,”¹⁹¹ and can provide startup capital for a fund seeking unaffiliated investors.¹⁹² There is also a fiduciary exemption which requires satisfaction of eight criteria,¹⁹³ extension of the offshore exemption for activities *exclusively* outside of the United States, a public welfare exemption, and a delegation of authority to the Board of Governors to create other exemptions they determine “would promote and protect the safety and soundness of the banking entity and the financial stability of the

Company Act of 1940 (15 U.S.C. 80a-1 et seq.) The Volcker rule applies to all “banking entities” and transactions in any: security, derivative, or future, or option on any of the foregoing, or any other security or financial instrument designated by the federal banking agencies, the SEC and the CFTC. The ban will not extend to commodities, agricultural products or foreign exchange or loans, but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.”

¹⁸⁷ 15 U.S.C. § 80a-3(c) (“Notwithstanding subsection (a), none of the following persons is an investment company within the meaning of this title: (1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities . . . (7) Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. Securities that are owned by persons who received the securities from a qualified purchaser as a gift or bequest, or in a case in which the transfer was caused by legal separation, divorce, death, or other involuntary event, shall be deemed to be owned by a qualified purchaser, subject to such rules, regulations, and orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”).

¹⁸⁸ 12 U.S.C. § 1851(h)(5) (“The term to ‘sponsor’ a fund means—(A) to serve as a general partner, managing member, or trustee of a fund; (B) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or (C) to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.”).

¹⁸⁹ 12 U.S.C. § 371c.

¹⁹⁰ See H.R. 4173 §§ 608, 609.

¹⁹¹ 12 U.S.C. § 1851(d)(4)(B)(ii)(I), (II).

¹⁹² *Id.* § 1851(d)(4)(A)(i).

¹⁹³ *Id.* § 1851(d)(1)(G)(i)–(viii).

United States.”¹⁹⁴ Importantly, the Volcker Rule’s exemptions are each subject to interpretation by the “appropriate federal regulatory agencies.”¹⁹⁵ This provision provides the Board of Governors the authority to restrain the freedom of foreign entities to trade with counterparties in the United States, or conduct transactions on U.S. exchanges if such activity is determined by the Board to result in a conflict of interest, exposure by the banking entity to high-risk trading strategies, a threat to the safety and soundness of such banking entity or a threat to the financial stability of the United States.¹⁹⁶

IV. “TOO BIG TO FAIL” WAS TOO BIG TO KILL

Although the Dodd Frank reform will likely succeed in reducing volatility in the financial markets temporarily, by forcing derivative and swap instruments into clearinghouses and partially segregating activities meant to ensure safety (saving) from those meant to ensure risk (trading), it will fail to prevent the “too big to fail” market phenomenon.¹⁹⁷ As a result, Dodd-Frank is contrary to good public policy.¹⁹⁸ Moreover, the legislation delegates such unbridled authority to the financial regulatory agencies in an effort to scare accountability into systemic banks, that it may run afoul of the fundamental Constitutional principle of separation of powers.¹⁹⁹ Each of these observations is addressed below.

A. *The Simpler Solution*

Titles I and II of Dodd-Frank address systemic risk, and reflect an underlying assumption on behalf of the democratic Congress and Administration that the existence of systemically threatening financial firms is inevitable.²⁰⁰ Resultantly, the legislative response to the financial

¹⁹⁴ *Id.* § 1851(d)(1)(I).

¹⁹⁵ *Id.* § 1851(d)(1).

¹⁹⁶ *Id.* § 1851(d)(2)(A)(i)-(iv).

¹⁹⁷ *Government Support for U.S. Banks: Is It Really Over?*, STANDARDANDPOORS.COM (July 13, 2011), <http://video.standardandpoors.com/?video=taFbSqFPkjcTYj7b3wGMQhOjET#>.

¹⁹⁸ Frederic S. Mishkin, *How Big a Problem is Too Big to Fail? A Review of Gary Stern and Ron Feldman's "Too Big to Fail: The Hazards of Bank Bailouts,"* 44 J. ECON. LIT. 988, 988-92 (2006).

¹⁹⁹ *See, e.g.*, Stephen Bainbridge, *Dodd-Frank and the Non-Delegation Doctrine*, PROFESSOR BAINBRIDGE.COM (July 16, 2010), <http://www.professorbainbridge.com/professorbainbridge.com/2010/07/doddfrank-and-the-nondelegation-doctrine.html> (asserting that the Act’s vast rulemaking raises the spectre of non-delegation but conceding the unlikelihood the court would entertain that doctrine).

²⁰⁰ Paul Krugman, *Too Big to Fail?*, N.Y. TIMES (Jan. 11, 2010, 8:12 AM), <http://krugman.blogs>.

crisis is not a forced break up of systemically threatening firms, but a system of regulation which strives to increase transparency and oversight.²⁰¹ In the abstract, the financial regulations work to provide regulatory helmsman with the data necessary to identify problematic activity, and the tools to prevent that troubling activity from infecting the larger financial marketplace.²⁰² The theoretical underpinnings of this view are frequently vocalized by economist Paul Krugman.²⁰³ Krugman subscribes to the Diamond-Dybvig²⁰⁴ perspective on banking risk analysis, where banks, acting without regulation, are inherently risky institutions prone to periods of instability.²⁰⁵ From this theoretical foundation, Krugman presumes government intervention during a banking crisis.²⁰⁶ In keeping with these views, Krugman advocates a comprehensive system of banking regulation during normal economic conditions, “both to reduce the need for rescues and to limit the moral hazard posed by the rescues when they happen.”²⁰⁷ Professor Krugman’s most salient view is that there is not enough correlation between “too big to fail” and bank size to justify breaking the banks into smaller entities.²⁰⁸ In support of this position, he points out that despite the major losses in mortgage backed securities being concentrated in the largest banks, the smaller banks are set to see even larger losses in commercial real estate.²⁰⁹ Krugman argues that the banks’ leverage ratios, not their ultimate size, are what will best protect the public from future bank bailouts.²¹⁰

However, some prominent economists argue that Professor Krugman’s approach is only half correct.²¹¹ These economists argue that

nytimes.com/2010/01/11/too-big-to-fail-fail-2/.

²⁰¹ See 12 U.S.C. §§ 5321- 5374.

²⁰² *Id.* §§ 5321- 5394.

²⁰³ See, e.g., Krugman, *supra* note 200.

²⁰⁴ See Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 3 J. POL. ECON. 401 (1983), reprinted in 24 FED. RESERVE BANK OF MINNEAPOLIS Q. REV. 14, 15 (2000), available at <http://minneapolisfed.org/research/QR/QR2412.pdf> (describing banking model postulating that the combination of long term maturity of assets and short term liabilities is inherently unstable and results in what is termed a self-fulfilling run on the bank).

²⁰⁵ Paul Krugman, *Too Big to Fail?*, N.Y. TIMES (Jan. 11, 2010, 8:12 AM), <http://krugman.blogs.nytimes.com/2010/01/11/too-big-to-fail-fail-2/>.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ See *Banking Industry Insiders Call for Breaking Up Giant Banks*, WASHINGTON’S BLOG (Apr. 7, 2010), <http://georgewashington2.blogspot.com/2010/04/banking-industry-insiders-call-for.html>.

both a reduction in size *and* meaningful regulation of banking activities are required to prevent financial institutions from reaching “too big to fail” status.²¹² One of these economists, Simon Johnson, espouses a gloomy forecast following the Dodd-Frank regulation-only approach. Johnson argues that by allowing “too big to fail” institutions to exist, they will invariably engage in high-risk, innovative behavior in the future, and that the public will once more face a Hobson’s Choice.²¹³ This sentiment was echoed by former Board of Governors Chairman, Alan Greenspan when he stated, “[y]ou know, break them up . . . [i]n 1911, we broke up Standard Oil. So what happened?”²¹⁴ Professor Johnson’s conclusion is to recommend hard caps on aggregate assets of four percent Gross Domestic Product (GDP) and two percent GDP for banks and investment firms, respectively.²¹⁵ According to his calculations, six domestic firms would need to be broken up by the caps: Goldman Sachs, JPMorgan Chase, Citigroup, Bank of America, Wells Fargo & Co., and Morgan Stanley.²¹⁶ Johnson posits Dodd-Frank fails to effectively address “too big to fail” by providing regulation, but failing to reduce bank size because the legislation was captured²¹⁷ by the industry early in the legislative process.

²¹² See Colin Barr, *Let Big Banks Fail, Bailout Skeptics Say*, CNN MONEY (Apr. 21, 2009, 1:22 PM), <http://money.cnn.com/2009/04/21/news/too.big.fortune/index.htm?postversion=2009042112>.

²¹³ See *Hobson’s Choice*, THEPHRASEFINDER.COM, <http://www.phrases.org.uk/meanings/hobsons-choice.html> for an explanation of what Simon Johnson refers to when he discusses what the public may again face if too big to fail institutions are allowed to exist (A Hobson’s choice is a free choice in which only one option is offered. As a person may refuse to take that option, the choice is therefore between taking the option or not; ‘take it or leave it.’ The phrase is said to originate from Thomas Hobson (1544–1631), a livery stable owner at Cambridge, England. To rotate the use of his horses he offered customers the choice of either taking the horse in the stall nearest the door or taking none at all.).

²¹⁴ Michael McKee & Scott Lanman, *Greenspan Says U.S. Should Consider Breaking Up Large Banks*, BLOOMBERG (Oct. 15, 2009, 10:50 P.M.), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJ8HPmNUfchg>.

²¹⁵ Michael Corkey, *Break Out the C-4: New Book Say Let’s Blow Up Wall Street*, WALL ST. J. BLOG (Mar. 26, 2010, 3:19 PM), <http://blogs.wsj.com/deals/2010/03/26/break-out-the-c-4-new-book-say-lets-blow-up-wall-street/>.

²¹⁶ See Sewell Chan, *Financial Debate Renews Scrutiny on Banks’ Size*, N.Y. TIMES, Apr. 20, 2010, http://www.nytimes.com/2010/04/21/business/21fail.html?_r=1.

²¹⁷ For a discussion on what it means for the legislation to be captured, see *Does Size Matter? Simon Johnson vs. Paul Krugman on Whether to Break Up “Too Big to Fail” Banks*, THE VIBE BOX (Apr. 12, 2010), <http://thevibebox.com/politics/does-size-matter-simon-johnson-vs-paul-krugman-on-whether-to-break-up-too-big-to-fail-banks/> [*hereinafter* “*Does Size Matter*”] (“[R]egulatory capture’ is the idea that there’s tendency for regulators to be captured by the very institutions that they’re supposed to be regulating. New regulatory legislation tends to start out with a big bang. But the details of regulation are complex and boring and within a

The idea of agency and legislation capture by the banks fits neatly within Johnson's broader perspective on the role of the modern U.S. financial sector. Johnson takes the position that Wall Street has entrenched itself in the United States as an oligarchic class.²¹⁸ Accordingly, Johnson asserts, the Wall Street banks accrue immense political power incidental to their economic strength, and then use that political influence to further entrench themselves in a position of power.²¹⁹ This "negative power loop" continually reinforces itself until, ultimately, it is broken by an external force.²²⁰ Johnson analogizes the scenario to the industrial trusts which had obtained such influence at the turn of the twentieth century.²²¹ They held tremendous influence over the U.S. economy until President Theodore Roosevelt used antitrust laws to break them apart.²²²

The Act's failure to force a downsizing of the major financial players will only work to reinforce or *actually create* the negative power loop of oligarchic banking institutions that Johnson argues already exist.²²³ This will be the inevitable result of the legislation erecting costs of entry around the systemic banks in the form of reporting requirements and assessments, while simultaneously discouraging competitors from growing large enough to enter the systemic designation.²²⁴ By discouraging firms from becoming systemic, the bill insulates the banking entities already designated systemic from industry competition, lending them a distinct market advantage to grow even larger.

few years, the public stops paying attention and the only ones paying attention are the civil servants paid to implement the regulations and the institutions being regulated. Pressure for strong regulation diminishes. The regulators increasingly come to identify with, or be intimidated by, the regulated institutions, particularly when the regulators are earning government salaries and the regulated institutions employ Ivy League-educated executives and lawyers making hundreds of thousands or millions of dollar a year. Experienced regulators often leave the government and go to work for more money working for the institutions that they formerly regulated, and don't want to alienate their potential future employers. And if a regulator does get too aggressive, a top executive of a TBTF institution like Jamie Dimon of JP Morgan Chase or Lloyd Blankfein of Goldman Sachs can always pick up the phone to a favorite Senator or Treasury Department official who will in turn call the regulator's boss and tell them to back off.").

²¹⁸ JOHNSON & KWAK, *supra* note 43.

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ *Id.*

²²² *Id.*

²²³ *Id.*

²²⁴ See *International Banking Being Changed by Regulation*, FINANCIAL REGULATION FORUM (May 13, 2011), <http://www.financialregulationforum.com/wpmember/international-banking-being-changed-by-regulation-5923/>.

Simultaneously, systemic firms regulated by the FSOC will attempt to influence the rulemaking and policy decisions of the FSOC and its member agencies.²²⁵ Because systemic firms will have more routine contact and interaction with each of these agencies, they will enjoy a distinct advantage over their peers in this regard.²²⁶ The result is an anti-market effect, where smaller firms will be assisted or disadvantaged depending on whether their business model aligns with those systemic firms which are able to exert their influence through the regulatory and legislative state. Consequently, the legislation either creates or works to institutionalize an acutely powerful, upper echelon in the American financial system.

In addition to the inherent market corrupting effect of the Act, the second failing of the Dodd-Frank approach is that it fails to account for dangerous innovation in finance. Certainly, the financial crisis of 2008 made clear the threat posed by products that are kept off the balance sheet and traded in the shadows away from public exchanges. Dodd-Frank, by statutory decree, brings the swap market into the light but its drafters cannot look into the legislative tea leaves to know in what form the next threat comes. Invariably, market forces will encourage risk seekers—"too big to fail" banks among them—toward a bastion free of Dodd-Frank, where the return on investment is plentiful and transaction costs are minimal. As an illustration, suppose the future holds the rise of digital assets which have no physical form or intrinsic value.²²⁷ Further suppose that these assets surge in popularity over peer-to-peer networks because their supply is limited by their originating algorithm and because they are being traded peer-to-peer, no central authority can regulate them in any meaningful way.²²⁸ Transaction costs are low as a result. The assets

²²⁵ See, e.g., Lauren Tara LaCapra, *Top Lobbying Banks Got Biggest Bailout: Study*, REUTERS (May 26, 2011, 3:25 P.M.), <http://www.reuters.com/article/2011/05/26/us-lobbying-imfreport-idUSTRE74P7AF20110526> ("In an interview with Reuters on Thursday, Igan said her counterparts at the Board of Governors have expressed concern to her that "some of the concepts would get watered down in the process because the financial industry is lobbying hard against them.").

²²⁶ See *Does Size Matter supra*, note 217.

²²⁷ See, e.g., Chris Morris, *What is Bitcoin?* CNBC.COM (July 20, 2011 3:47 P.M.), <http://www.cnbc.com/id/43823614?par=yahoo> ("Bitcoin is striving to be a global currency of sorts—one that's not backed by any government or institution. Bitcoins aren't cash, technically. They're an entirely virtual currency. Users exchange online credits for goods and services from select retailers, contractors and online trading houses. Rather than going through a bank or financial institution, these credits—called tokens by users—are exchanged directly from person to person. When a transaction occurs, the bitcoin is automatically sent from the buyer to the seller through an encrypted method that's designed to ensure bitcoins can't be hacked or artificially created.").

²²⁸ *Id.*; see also Cameron Camp, *Bitcoin: P2P Underground Cyber Currency?*, ESET THREAT BLOG

proliferate on the margins of what is considered mainstream finance and secondary and tertiary investment vehicles develop in response to their growth. Ultimately, systemic banks and brokerages are transacting digital asset deals, presumably over heavily encrypted peer-to-peer networks, aggregating in the trillions of dollars per year until a trojan horse, designed to replicate the digital assets, activates and begins rapidly increasing the supply of the digital assets leading to the destruction of their value. Trading in the primary, secondary and tertiary investments ceases immediately when news of the problem goes public and market-wide panic grips the financial community. Once more, the government will step in to bail out the systemic firms affected by this scenario because the remaining participants simply will not have the capacity or the appetite to absorb the billions of dollars in assets of the failing systemic firms. Dodd-Frank seeks to resolve this by *preventing* the foregoing scenario from affecting systemic firms. Incidentally, *prevention* requires a government salaried regulator to have the willingness²²⁹ and support²³⁰ to quash *highly profitable* activity being conducted by the most powerful financiers in the

(June 6, 2011, 11:27 P.M.), <http://blog.eset.com/2011/06/06/bitcoin-p2p-underground-cyber-currency> ("What remains to be seen is the regulatory stance if the value and popularity continues to rise. We know in the U.S. the FBI has recently shutdown a ring of traditional currency being minted, traded and circulated, citing a law prohibiting the creation of legal tender outside of the Federal Reserve. Recently there has also been a rise in bitcoins being utilized in narcotic circles. There have been numerous attempts by the recording industry to curb P2P music sharing, an activity that still thrives despite myriad legal volleys. Will currency follow a similar P2P trajectory, or will fatal flaws in the architecture stop it short? One thing to note, when the original Napster failed due to legal challenge, dozens more popped up in its place, cementing P2P file sharing in the public mindset as a method of private exchange which proved both valuable to many, and difficult to stymie.").

²²⁹ See Christopher Cox, Chairman, Securities and Exchange Commission, *Keynote Address and Robert R. Glauber Lecture at the John F. Kennedy School of Government: The Role of Government in Markets* (Oct. 24, 2007) ("We've found that decentralized decision-making, in which millions of independent economic actors make judgments using their own money, results in the wisest allocation of scarce resources across our complex society. And we've found the market to be more reliable in heeding price signals and meting out discipline to failing enterprises than government could ever be.").

²³⁰ Simon Johnson, *The FDIC's Resolution Problem*, THE BASELINE SCENARIO (April 28, 2011, 9:04 A.M.), <http://baselinescenario.com/2011/04/28/the-fdics-resolution-problem/> ("At the political level, if you wish to engage in alternative or hypothetical history, you cannot ignore the presence of Hank Paulson, then Secretary of the Treasury. Mr. Paulson steadfastly refused, even in the aftermath of the near-collapse of Bear Stearns, to take any proactive or preemptive role with regard to strengthening the financial system - let alone intervening to break-up or otherwise deal firmly with a potentially vulnerable large firm. . . In this respect Mr. Paulson was not an outlier relative to Tim Geithner or other people who are likely to become Treasury Secretary. The operating philosophy of the US government with regard to the financial sector remains: hands-off and in favor of intervention only when absolutely necessary.").

world armed, in all likelihood, only with an explanation that the activity *could* lead to market instability. Given the history of regulatory deference to profit seeking—despite enormous risk-- in this country, this plan rings impracticable.²³¹

A better approach would be to break apart the banks which *currently* pose systemic threats, while tightening the regulatory fabric in a manner which does not single out participants for particular treatment.²³² By doing this, the threat posed by the *future* bad behavior of a major financial firm is reduced incidental to the limitation on that firm's total assets.²³³ The acknowledgement and institutionalization of "too big to fail" banks, however, will lead to further perversion of incentive structures, manipulated markets, and greater instances of moral hazard, requiring public bailouts.²³⁴ In addition to falling short on addressing the too big to fail paradigm, Dodd-Frank may result in unconstitutional delegations of power by overly aggrandizing the executive.

B. Article I Power Uncanalized

Congress' regulation-only approach may have delegated too much of its power to the Executive through the financial regulatory agencies.²³⁵ Given the massive delegation of power—particularly to the Board of Governors—resurrection of non-delegation does not seem fantastic or inappropriate.²³⁶ Considering that Dodd-Frank calls for the promulgation of 250 new rules, which effectively shift the authority to create an entire

²³¹ *Id.*

²³² DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 150, (2010).

²³³ See JOHNSON & KWAK, *supra* note 43.

²³⁴ SKEEL, *supra* note 232 at 150.

²³⁵ *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 472 (2001) (internal citations omitted) ("Article I, §1, of the Constitution vests '[a]ll legislative Powers herein granted . . . in a Congress of the United States.' This text permits no delegation of those powers, and so we repeatedly have said that when Congress confers decisionmaking authority upon agencies Congress must 'lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform.' We have never suggested that an agency can cure an unlawful delegation of legislative power by adopting in its discretion a limiting construction of the statute.").

²³⁶ See, e.g., Stephen Bainbridge, *Dodd-Frank and the Non-Delegation Doctrine*, PROFESSORBAINBRIDGE.COM (July 16, 2010 1:43 P.M.), <http://www.professorbainbridge.com/professorbainbridge.com/2010/07/doddfrank-and-the-nondelegation-doctrine.html> (asserting that Congress' assignment of between 240 and 500 rule-makings to the administrative state is both a violation of the non-delegation doctrine and better understood as Congress' abdication of its Constitutionally mandated duty.).

body of new law to the executive, a recommitment to a doctrine rooted in separation of powers seems imminently practical.²³⁷

The non-delegation doctrine has been used by the Supreme Court to invalidate Congressional legislation *very* sparingly.²³⁸ The doctrine developed as a tool to enforce the separation of powers critical to protect the tripartite architecture enshrined in the United States Constitution.²³⁹ Generally, non-delegation serves three purposes: it attempts to ensure that important and difficult choices are made by Congress because it is the branch of government most responsive to the popular will; it guarantees that, to the extent possible, an “intelligible principle” guides the recipient of the authority granted by Congress; and it ensures that a court reviewing the exercise of delegated legislative discretion will be able to test that exercise against ascertainable standards.²⁴⁰

In modern history, non-delegation challenges have succeeded only twice to invalidate congressional legislation.²⁴¹ But more recently, the doctrine has lurked just beneath the surface of the court’s reasoning, where it instead used its power of interpretation to limit the breadth of delegation to an agency.²⁴² In *Industrial Union v. American Petroleum Institute*, the American Petroleum Institute challenged the Occupational Safety and Health Administration’s (OSHA) interpretation of their organic statute, the Occupational Safety and Health Act of 1970 (Health Act).²⁴³ Under the Health Act, OSHA was charged with developing standards to promote occupational safety and health.²⁴⁴ Section 3(8) of the Health Act defined “occupational safety and health standard” as one “which requires conditions, or the adoption or use of one or more

²³⁷ *Id.*

²³⁸ *Id.*; *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935); *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935).

²³⁹ “That congress cannot delegate legislative power to the president is a principle universally recognized as vital to the integrity and maintenance of the system of government ordained by the constitution.” *Field v. Clark*, 143 U.S. 649, 692 (1892).

²⁴⁰ *Industrial Union Dep’t v. Am. Petroleum Inst.*, 448 U.S. 607, 685–86 (1980).

²⁴¹ See *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935); *Panama Ref. Co. v. Ryan*, 293 U.S. 388 (1935).

²⁴² *Industrial Union*, 448 U.S. at 646 (“If the Government was correct in arguing that neither § 3(8) nor § 6(b)(5) requires that the risk from a toxic substance be quantified sufficiently to enable the Secretary to characterize it as significant in an understandable way, the statute would make such a ‘sweeping delegation of legislative power’ that it might be unconstitutional under the Court’s reasoning in *A.L.A. Schechter Poultry Corp. v. United States*, and *Panama Refining Co. v. Ryan*. A construction of the statute that avoids this kind of open-ended grant should certainly be favored.”) (citations omitted).

²⁴³ Occupational Safety and Health Act of 1970, 29 U.S.C. § 651 (2011).

²⁴⁴ *Industrial Union*, 448 U.S. at 691–92 (Marshall, J., dissenting) (quoting 29 U.S.C. § 652(8) (2011)).

practices, means, methods, operations, or processes, reasonably necessary or appropriate to provide safe or healthful employment and places of employment.”²⁴⁵

The issue in *Industrial Union* arose when the Secretary, in keeping with the directive, promulgated a rule which set the exposure level to the chemical Benzene at “the lowest technologically feasible level that will not impair the viability of the industries regulated,” or one part Benzene per million air molecules.²⁴⁶ The regulated industries balked at the costs of compliance with such standard and challenged the rule.²⁴⁷

In a plurality decision, the Court interpreted the organic statute to require that the Secretary identify a health risk that exists at a particular threshold for a chemical substance, and then to decide whether to issue the *most* protective standard as it had done, or issue a standard after weighing its costs and benefits.²⁴⁸ By first determining that the Congress would not have provided the Secretary with the broad latitude to promulgate such a rule, three members of the plurality were able to avoid non-delegation in favor of a statutory interpretation that was constitutional.²⁴⁹ But Justice Rehnquist, in his concurrence, left no doubt

²⁴⁵ *Id.*

²⁴⁶ Section 6(b)5 of the statute provided the following guiding principle for promulgation of rules under the title: “The Secretary, in promulgating standards dealing with toxic materials or harmful physical agents under this subsection, shall set the standard which most adequately assures, to the extent feasible, on the basis of the best available evidence, that no employee will suffer material impairment of health or functional capacity even if such employee has regular exposure to the hazard dealt with by such standard for the period of his working life. Development of standards under this subsection shall be based upon research, demonstrations, experiments, and such other information as may be appropriate. In addition to the attainment of the highest degree of health and safety protection for the employee, other considerations shall be the latest available scientific data in the field, the feasibility of the standards, and experience gained under this and other health and safety laws.” *Id.* at 613 (majority opinion).

²⁴⁷ *See id.*

²⁴⁸ “If the Government was correct in arguing that neither §3(8) nor §6(b)(5) requires that the risk from a toxic substance be quantified sufficiently to enable the Secretary to characterize it as significant in an understandable way, the statute would make such a ‘sweeping delegation of legislative power’ that it might be unconstitutional under the Court’s reasoning in *A.L.A. Schechter and Panama Refining*.” *Id.* at 644.

²⁴⁹ Justice Stevens proclaimed, “[i]n the absence of a clear mandate in the Act, it is unreasonable to assume that Congress intended to give the Secretary the unprecedented power over American industry that would result from the Government’s view of §§ 3(8) and 6(b)(5), coupled with OSHA’s cancer policy. Expert testimony that a substance is probably a human carcinogen—either because it has caused cancer in animals or because individuals have contracted cancer following extremely high exposures—would justify the conclusion that the substance poses some risk of serious harm no matter how minute the exposure and no matter how many experts testified that they

that he viewed the legislation to be a violation of non-delegation, separation of powers, and an abdication of Congressional responsibility.²⁵⁰

Applying *Industrial Union* to Dodd-Frank, even prior to the promulgation of a great many agency rules, delegation challenges appear imminent. For example, with regard to the development of prudential standards, Congress provides:

The Board of Governors may establish additional prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a) that include . . . (vi) such other prudential standards as the Board of Governors, on its own or pursuant to a recommendation made by the Council in accordance with section 115, determines are appropriate.²⁵¹

Although the provisions immediately preceding 165(b)(1)(B) specify parameters for the implementation of the heightened prudential standards, the language of 165(b)(1)(B) grants the Board of Governors a blank check, effectively uncanalizing the power of Congress. These

regarded the risk as insignificant. That conclusion would in turn justify pervasive regulation limited only by the constraint of feasibility. In light of the fact that there are literally thousands of substances used in the workplace that have been identified as carcinogens or suspect carcinogens, the Government's theory would give OSHA power to impose enormous costs that might produce little, if any, discernible benefit." *Id.* at 634.

²⁵⁰ "As formulated and enforced by this Court, the nondelegation doctrine serves three important functions. . . I believe the legislation at issue here fails on all three counts. The decision whether the law of diminishing returns should have any place in the regulation of toxic substances is quintessentially one of legislative policy. For Congress to pass that decision on to the Secretary in the manner it did violates, in my mind, John Locke's caveat-reflected in the cases cited earlier in this opinion-that legislatures are to make laws, not legislators. Nor, as I think the prior discussion amply demonstrates, do the provisions at issue or their legislative history provide the Secretary with any guidance that might lead him to his somewhat tentative conclusion that he must eliminate exposure to benzene as far as technologically and economically possible. Finally, I would suggest that the standard of "feasibility" renders meaningful judicial review impossible. We ought not to shy away from our judicial duty to invalidate unconstitutional delegations of legislative authority solely out of concern that we should thereby reinvigorate discredited constitutional doctrines of the pre-New Deal era. If the nondelegation doctrine has fallen into the same desuetude as have substantive due process and restrictive interpretations of the Commerce Clause, it is, as one writer has phrased it, "a case of death by association." J. Ely, *Democracy and Distrust, A Theory of Judicial Review* 133 (1980). Indeed, a number of observers have suggested that this Court should once more take up its burden of ensuring that Congress does not unnecessarily delegate important choices of social policy to politically unresponsive administrators." *Id.* at 686-87.

²⁵¹ 12 U.S.C. § 5365(b)(1)(B) (2010).

“catch-all” provisions are necessitated by Congress’ inability to predict future innovation and its unwillingness to be held accountable for authoring the laws which will almost certainly stifle profitable activity.²⁵² However, the Constitution does not allow Congress to abdicate its duty by delegating excesses of its power to an agency to create law.²⁵³

In addition to the catch-all provisions that are used throughout the Act, Title II raises a host of Constitutional concerns besides non-delegation, including presentment and due process. In addressing whether a financial entity presents a systemic risk and requires dissolution, Section 203 of the Orderly Liquidation Authority vests the power to make that determination entirely in the Executive and *entirely in secret*.²⁵⁴ Congress, through enumerated personnel and committee,²⁵⁵ preserves only the right to notice of these actions within 24 hours *after* the decision to appoint the FDIC as receiver has been made by the President and Secretary of Treasury.²⁵⁶ Moreover, the Act does not require disclosure to the public until 60 days after the FDIC has been appointed receiver.²⁵⁷ The secrecy engendered in these provisions is clearly geared toward preventing bank runs in the midst of crisis, but does so at the expense of shareholder due process rights and the transparency necessary for markets to efficiently operate.²⁵⁸ Aside from the obvious market meddling that results as

²⁵² Bainbridge, *supra* note 199.

²⁵³ See generally, *id.*; *Panama Refining v. Ryan*, 293 U.S. 388 (1935); *A.L.A. Schechter Poultry v. United States*, 295 U.S. 495 (1935); see also JOHN LOCKE, *TWO TREATISES OF GOVERNMENT* 141 (Peter Laslett ed., Cambridge Univ. Press 1988) (1690) (“The legislative cannot transfer the power of making laws to any other hands: for it being but a delegated power from the people, they who have it cannot pass it over to others. The people alone can appoint the form of the common-wealth, which is by constituting the legislative, and appointing in whose hands that shall be. And when the people have said, We will submit to rules, and be governed by laws made by such men, and in such forms, no body else can say other men shall make laws for them; nor can the people be bound by any laws, but such as are enacted by those whom they have chosen, and authorized to make laws for them. The power of the legislative, being derived from the people by a positive voluntary grant and institution, can be no other than what that positive grant conveyed, which being only to make laws, and not to make legislators, the legislative can have no power to transfer their authority of making laws, and place it in other hands.”).

²⁵⁴ See *supra* Part III.B.

²⁵⁵ § 5383(c)(2) (“Majority leader and Minority Leader of the Senate and the Speaker and Minority Leader of the House of Representatives, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives.”).

²⁵⁶ *Id.* § 5383(c)(2).

²⁵⁷ *Id.* § 5383(c)(3)(A).

²⁵⁸ See, e.g., Joseph Gabai et al., *United States: Dodd-Frank, Title II: Where the FDIC and the “Orderly Liquidation Authority” Meet the Bankruptcy Code*, MONDAQ.COM (Sept. 10, 2010), <http://www.mondaq.com/unitedstates/article.asp?articleid=109616&tw=2> (advising clients that

envisaged by the drafters, these provisions work to aggrandize the Executive far beyond the limits of Constitutionality if non-delegation retains any gravity.

V. CONCLUSION

The financial crisis of 2008 forces acknowledgement that meaningful regulation of markets is required to prevent those who speculate and seek short-term gains regardless of future costs from jeopardizing the stability of the greater economy. What must also be acknowledged is that regulation cannot remove risk from the marketplace without disrupting markets. Somewhere between these known quantities, Congress must find a legislative solution while remaining within the directives of the Constitution. In its mixed ambition to solve the financial problems of yesterday, today, and tomorrow, while remaining in the good graces of the big banks, Congress simultaneously fell short and overshot its target. It failed to end “too big to fail” by not breaking the banks and, in its effort to avoid breaking the banks, likely ran afoul of the Constitutional principle of separation of powers.

“[b]ased on the OLA’s limited and expedited judicial review mechanism, parties transacting business with a financial company should assume that any FDIC receivership appointment will stand, despite the due process protections provided to the affected company to oppose such an appointment.”); Stephen J. Lubben, *Some Powers for Dealing With Failed Financial Firms*, NYTIMES.COM (May 10, 2011 4:43 P.M.), <http://dealbook.nytimes.com/2011/05/10/some-powers-for-dealing-with-failed-financial-firms/> (“While the bankruptcy code’s approach is consistent with general notions of due process, the liquidation authority approach probably better addresses the systemic nature of the problem.”); see also Harvey R. Miller & Maurice Horowitz, *One Way That Dodd-Frank’s Liquidation Authority Could Achieve Parity With the Bankruptcy Code*, 1 HARV. BUS. L. REV. ONLINE 1 (2010) (Noting that both transparency and creditor rights are a general concern with FDIC receiverships and providing examples which illustrate the point) <http://www.hblr.org/wp-content/uploads/2010/11/Miller-and-Horowitz-Liquidation-Authority.pdf>.

