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The Illegal Actions of the Federal Reserve: An Analysis of How the Nation’s Central Bank Has Acted Outside the Law in Responding to the Current Financial Crisis

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I. Introduction

In the Spring of 2008, the United States Federal Reserve Bank, under the Chairmanship of Ben Bernanke, took emergency measures in an attempt to forestall a national, if not international, economic meltdown. The actual effectiveness of these unprecedented measures has been hotly-debated. Unfortunately, regardless of their efficacy, the Federal Reserve acted outside the scope of its legal authority in taking several of these actions.

This essay will analyze how the Federal Reserve (the “Fed”) violated the law and, in doing so, will examine how these illegal actions have comprised the authority that Congress has granted to the Fed. In order to place this malfeasance into context, the essay will examine the origins of the Federal Reserve System and how this unique entity has dramatically (and often controversially) expanded the scope of its power.

Finally, the essay will analyze how the Fed’s willful violation of the law has critically undermined the United States economy in both the short and long-term. It will conclude by offering a proposed legislative reform that would begin to resolve this problem by placing the secretive maneuvers of the Fed into the full light of public scrutiny.

Ultimately, when viewed objectively and within historical context, it is clear that the Federal Reserve Bank has acted beyond the scope of its legislative authority and, by doing so, has harmed the financial interests of the United States both here and abroad. This warrants, at the very least, a full and independent audit of the Federal Reserve System to determine its compliance with existing law.

II. The Origins of the Federal Reserve System

A. Congressional Efforts Which Led to the Fed

The Federal Reserve Act of 1913 established the Fed as the central bank for the United States.\footnote{The Federal Reserve Board, \textit{The Structure of the Federal Reserve System}, http://www.federalreserve.gov/pubs/fseries/fsersi.htm, (last accessed Aug. 29, 2009).} Prior to that, several attempts to centralize banking efforts had come and gone. For instance, in 1908, Congress adopted the Aldrich-Vreeland Act as a stop-gap solution for several challenges facing the country’s banking and currency system.\footnote{Id.} One of the key issues of that time was whether creating a central bank would serve as a safeguard against economic crises.

Since the expiration of the charter of the Second National Bank of the United States in 1832, the country had been operating without a central bank.\footnote{Id.} In 1907, several bank
panics renewed the debate regarding the wisdom of establishing a central bank. Ultimately, several influential leaders of the nation’s financial community concluded that a central banking system was needed to remedy a lack of liquidity in the country’s economy.\(^4\)

Before the Aldrich-Vreeland Act was passed in 1908, existing law mandated that banks maintain only a small fraction of their overall deposits in reserve.\(^5\) The remaining reserves could be used to offer loans. Unfortunately, these low deposit reserve requirement often led to over-lending.\(^6\) Loans were being made that, in the short run, could only be converted into cash at a fraction of their value. This resulted in a “race to the bank” when liquidity problems arose.\(^7\)

The Aldrich-Vreeland Act established a short term liquidity mechanism for banks to mitigate this problem. The Act also created the National Monetary Commission whose primary responsibility was to propose a permanent solution to the problems of illiquidity and bank panics.\(^8\) It was the work of this commission that would ultimately lead to the creation of today’s Federal Reserve System.

### B. The Adoption of the 1913 Federal Reserve Act

Following the adoption of the 1908 Aldrich-Vreeland Act, the National Monetary Commission, headed by Senator Nelson Aldrich, began to research different banking and currency schemes.\(^9\) Aldrich and his team focused much of their research on the European banking system. In particular, the Senator consulted with influential banking leader Paul Warburg who convinced Aldrich that, in order to avoid future liquidity crises, the United States needed a central bank that was controlled by private bankers and financial experts.\(^10\) This would be patterned after the European system that utilized centralized banking and currency backed by commercial assets—a combination that the commission believed would allow for quick liquidity.\(^11\) Aldrich and Warburg also concluded that the mandatory reserve requirement should be increased to allow banks to transform a maximum amount of bank assets into cash without disturbing the general condition of the economy.\(^12\)

The influential American Bankers’ Association responded positively to the Aldrich plan. Doubts though remained in Congress, especially after Woodrow Wilson was elected as

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4 Id.
5 Id.
6 Id.
9 Id.
10 Id.
11 Id.
12 Id.
President of the United States. Progressive Democrats, including William Jennings Bryan, strongly opposed Aldrich’s plan to place the control of a central bank and monetary policy in the hands of private bankers rather than the federal government.

As an alternative to the Aldrich Plan, Representative Carter Glass of Virginia proposed a solution to add liquidity without utilizing a central bank. The Glass-Willis Plan called for twelve or more privately-owned regional banks which would perform central banking functions such as holding member banks’ reserves and issuing currency backed by commercial assets and gold. Basically, this was a decentralized version of the Aldrich Plan.

Ultimately, a compromise approach developed that included the addition of a central board that coordinated monetary policy through a series of regional reserve banks. Though Representative Glass still opposed the central bank idea, he eventually agreed to a plan drafted by William McAdoo, Wilson’s Secretary of State. This plan called for exclusive government control of the Federal Reserve Board and made currency printed by the Federal Reserve an obligation of the United States government. One problem though was that this compromise approach was strongly opposed by key leaders of the powerful banking industry who preferred a system that was controlled by private interests.

On June 20, 1913, President Wilson met with the House Committee on Banking and Currency to seek its support in advance of actually introducing his Federal Reserve Act in Congress. While his bill did not grant final control of the central bank to the federal government, the committee nevertheless promised its support after which President Wilson then presented the bill to Congress. Representative Carter Glass sponsored the bill in the House of Representatives and helped lobby for its passage.

Progressive Democrats, who sought federal supervision of the Federal Reserve, remained skeptical of the bill. However, the decision by Representative William Jennings Bryan, a

14 Id.
16 Id.
21 Id.
23 Id.
24 Id.
strong advocate of government control over the bank, to support the measure offered by his party’s leadership helped the bill pass the House of Representatives on September 18, 1913.25 Indeed, the Democratic Party’s decision to set aside their differences ultimately allowed for the bill to pass by a vote of 287 to 85—with only three democrats voting against the bill.26

The next hurdle for President Wilson and the Federal Reserve Act would be the Senate. Senator Robert Owen sponsored and helped guide the bill through the Senate.27 During its six months of debate on the bill, the Senate held numerous hearings from September 1st through October 25th before finally voting on the bill.28

During this time, Frank Vanderlip, a prominent New York banker, proposed yet another variation of a central banking plan.29 The Vanderlip Plan consisted of one Federal Reserve Bank with twelve branches of reserve banks around the country. The capital for the Federal Reserve Bank would come from the public, the government, and national banks, allowing for diversified interests.30 Control of the Federal Reserve Bank would lie with the federal government and currency would be issued against the bank’s currency and a 50% gold reserve.31 Though the Vanderlip Plan gained considerable support in the Senate and influenced debate on the issue, in the end it would lose out to another version that did not include final federal government control.32

On December 19, 1913, the Senate passed its version of the Federal Reserve Act with a vote of 54 to 34 that included full democratic support.33 However, since the House’s version of the Federal Reserve Act and the version passed by the Senate were somewhat different, the act was submitted to a conference committee composed of members of both chambers.34 One major difference between the two versions was that the House bill called for twelve or more regional reserve banks, while the Senate bill called for no less than eight and no more than twelve regional reserve banks.35

Ultimately, the conference committee incorporated much of the Senate version in the final bill.36 Two days after the conference committee resolved the differences between

25 Id.
26 50 Cong. Rec. 5127-5135 (1913).
28 Id.
30 Id.
31 Id.
32 Id.
33 51 Cong. Rec. 1230 (1913-1914).
35 Id.
36 Id.
the two bills, both the House of Representatives and the Senate approved the compromise version.\textsuperscript{37}

On December 23, 1913, President Woodrow Wilson signed the Federal Reserve Act into law.\textsuperscript{38}

\section*{C. The Organization of the Fed}

The 1913 Federal Reserve Act evidenced a belief during that time that a change in the banking and currency system was needed to bolster confidence and security in the minds of Americans. The disagreements centered on what kind of change. At the time, a major divide existed between the conservatives who advocated for as little government interference in the banking system as possible and the progressives who sought a central banking system controlled by the federal government.

In the end, the parties compromised and established a system where the central Federal Reserve Board is controlled by the federal government, but the regional reserve banks are more privately controlled. This mix limited both the private bankers’ and the federal government’s involvement to certain functions, making the Federal Reserve System “independent within the government.”\textsuperscript{39}

Today, the Federal Reserve is comprised of a seven-member Board of Governors, twelve regional Federal Reserve Banks, the Federal Open Market Committee (FOMC), the Federal Advisory Council, and numerous privately-owned, commercial banks.\textsuperscript{40} The function of the Federal Reserve System is to assist in achieving national economic goals through monetary policy.\textsuperscript{41}

The FOMC represents one of the key monetary policy tools at the Federal Reserve’s disposal.\textsuperscript{42} The FOMC is composed of the seven members of the Board of Governors and five representatives, who must be presidents or first vice-presidents, of the Federal Reserve Banks.\textsuperscript{43} The members of the Board of Governors are appointed by the President with the advice and consent of the Senate,\textsuperscript{44} while the representatives of the Federal Reserve Banks are elected annually by the board of directors of the Banks.\textsuperscript{45}

\section*{III. The Legislative Evolution of the Fed}

\textsuperscript{37} Id.
\textsuperscript{40} Id. See 12 U.S.C. §§ 221-522 (2006).
\textsuperscript{41} Reuss v. Balles, 584 F.2d 461, 462 (D.C. Cir. 1978).
\textsuperscript{42} Id. at 463.
\textsuperscript{43} Id. at 464.
\textsuperscript{45} Id. at § 263(a).
After its creation, the Fed continued to evolve through a series of Congressional acts that altered and, in many cases, expanded the Fed’s original scope of authority. The result was that this unique public/private hybrid entity began to engage in regulatory responsibilities that exceeded its original scope. Indeed, right up until 2008, the Fed continued to acquire increasingly expansive powers despite the fact that its quasi-private nature allowed the system to operate under a veil of opacity.

The following examples demonstrate several of the key pieces of legislation in the Fed’s evolution of power.46

A. The Banking Act of 1935

In 1935, Congress passed the Banking Act of 1935. In addition to creating the Federal Deposit Insurance Corporation (FDIC), the act also relocated the Federal Reserve’s location to Washington D.C.47 However, the most significant change that the 1935 Act made related to the Fed was to essentially assign control of national monetary policy to the Federal Reserve Board of Governors and the Federal Open Market Committee.48

To accomplish this, the act made several changes. First, it established that the Board of Governors would now be comprised of seven members which would be appointed by the President and subject to confirmation by the Senate.49 In addition, the board would no longer include the Comptroller of the Currency or the Secretary of the Treasury as members—a change that further moved authority over the banking system and monetary policy away from the federal government and concentrated it with the Fed.50

Another significant change involved the autonomy of the twelve individual Federal Reserve Banks. Prior to the 1935 act, these twelve banks were given broad discretion over whether to participate in open market activities.51 The 1935 Act changed this by requiring that the twelve banks engage in open market activities under the direction of the FOMC.52

46 This is not to say that every Congressional act since the 1913 Federal Reserve Act has further expanded the Fed’s powers or reduced its transparency. Indeed, though rare, Congress has on occasion passed legislation that did the opposite.

Take for instance the Federal Reserve Reform Act of 1977. The main purpose of this act was to make the Federal Reserve more accountable for its actions regarding economic and monetary policy. With this act, the Federal Reserve was now required to report its intentions for the future and the current status of the economy during monetary policy hearings before Congress. These hearings allowed Congress to have a more cohesive understanding of how the Federal Reserve’s monetary policy decisions and forecasts were affecting and would affect the United States economy. Ultimately, the Federal Reserve Reform Act of 1977 made the Federal Reserve more transparent.

48 Id.
49 Id.
50 Id.
51 Reuss, 584 F.2d at 463.
52 Id.
Ultimately, the Banking Act of 1935 expanded the Fed’s role as the central authority in overseeing the banking industry and established it as the lead monetary policymaker—a responsibility that was largely independent of the federal government.

B. Federal Reserve-Treasury Department Accord of 1951

The Federal Reserve- Treasury Department Accord (the “Accord”) of 1951 was an agreement between the two entities that restored independence to the Federal Reserve. In 1942, at the request of the Treasury Department, the Federal Reserve voluntarily agreed to maintain a low interest rate on government bonds so that the United States could cheaply finance the war debt. In order to maintain the low interest rate, the Federal Reserve gave up control of the size of its portfolio as well as the money supply.

After the war, President Truman and the Treasury wanted to keep the interest rate low to protect the public’s investment in war-time bonds. However, they also sought to contain inflationary measures as the Korean War ensued. This battle over control of interest rates and monetary policy in general led to the 1951 Accord.

In the end, the agreement expanded the Fed’s powers by eliminating its obligation to monetize Treasury Department debt at a fixed rate which, in turn, furthered the Fed’s independence from the federal government.

C. The Bank Holding Company Act of 1956

The Bank Holding Company Act of 1956 was implemented in response to banks that were forming bank holding companies in order to own both banking and non-banking businesses. This practice allowed banks to geographically expand into areas where branch banking was otherwise restricted. The 1956 Act prohibited a bank holding company from engaging in most non-banking activities or acquiring voting securities of certain companies that are not banks.

The act also served to increase the Fed’s power by requiring each bank holding company to register with the Board of Governors of the Federal Reserve. In doing so, it granted the Fed’s Board of Governors the responsibility of regulating and supervising bank holding company activities. In particular, the Board of Governors was given the power

54 Id.
55 Id.
56 Id.
57 Id.
59 Id.
60 Id.
61 Id.
to allow activities in the areas of banking, finance, or insurance if these activities were "so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto." Ultimately, the act afforded the Federal Reserve broad power and discretion over institutions that have any control or influence over banking, not just banks themselves.

D. The International Banking Act of 1978

The International Banking Act of 1978 was passed to bring foreign banks into the federal banking regulators framework. The act’s major objectives were to promote competitive equality between foreign and domestic banks, to improve Federal control over monetary policy, and to provide a Federal presence in the regulation and supervision of foreign bank activities inside the United States. In particular, the Act expanded the Federal Reserve’s power by placing foreign banks and domestic corporations that do business with foreign financial operations under the supervision of the Federal Reserve.

E. The Full Employment and Balanced Growth Act of 1978

Congress passed the Full Employment and Balanced Growth Act of 1978 in response to America’s fear of a recession due to high unemployment rates and high inflation. The act sets forth the economic goals of full employment, production growth, price stability, a trade balance, and a balanced budget as opposed to the singular goal of full employment set forth in the Employment Act of 1946.

Specifically, the act requires the Fed to establish a monetary policy that promotes the goals of long-run growth, minimizes inflation, and promotes price stability. It also integrates the monetary policy of the Fed with the economic policy of the president. Through these changes, Congress created a situation where the Federal Reserve was provided a more direct presence in and influence over the national economy and its long-term goals.

F. Depository Institutions Deregulation and Monetary Control Act of 1980

The Depository Institutions Deregulation and Monetary Control Act of 1980 affected the economy by changing the country’s monetary policy and deregulating the banking

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63 Id.
67 Id.
system.\textsuperscript{69} Related to the Fed’s powers, under the act, all banks, including credit unions and savings and loan companies, were allowed to access the Federal Reserve Discount Window to obtain credit advances.\textsuperscript{70} Through this act, all banking institutions in the United States were essentially required to abide by the Federal Reserve’s rules and policies. The end result was to expand the Federal Reserve’s power over both America’s banking industry and the economy in general.

G. The Federal Deposit Insurance Corporation Improvement Act of 1991

The Federal Deposit Insurance Corporation Improvement Act of 1991 was passed in response to the thrift industry crisis.\textsuperscript{71} This act significantly increased the powers and authority of the FDIC.\textsuperscript{72} In addition, the act included a subsection known as Foreign Bank Supervision Enhancement Act of 1991. This provision enhanced the authority of the Federal Reserve to supervise foreign banks entering into the United States banking system.\textsuperscript{73} Foreign banks could no longer establish a branch or agency in the United States banking system without first being approved by the Federal Reserve Board of Governors.\textsuperscript{74}

By requiring this approval, the act strengthened the Fed’s powers of examination and supervision over foreign banking, which, in turn, further expanded the Fed’s influence over the American banking industry and economy.

H. Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Act of 1999 was a far-reaching, complex law that covered many aspects of the banking industry from institution mergers to protection of private consumer information. It was passed under the auspices of modernizing the United States financial services industry.\textsuperscript{75} In furtherance of this, the act removed prohibitions on cross-ownership of banks, securities firms, and insurance companies established by the Banking Act of 1933.\textsuperscript{76} Under the act, commercial banks were allowed to underwrite securities and own insurance companies through federally regulated subsidiaries.\textsuperscript{77}

\textsuperscript{70} Id.
\textsuperscript{72} Id.
\textsuperscript{73} Id.
\textsuperscript{74} Id.
\textsuperscript{76} Id.
It also established the Federal Reserve as the regulator over these banks and their subsidiaries, known as financial holding institutions. In addition, the act gave both the Federal Reserve and the Treasury Department the right to veto each other’s decisions on newly acquired financial powers. However, more than anything, the Gramm-Leach-Bliley Act of 1999 significantly expanded the Fed’s power and authority from simply banking institutions to the larger category of financial holding institutions, which included banks, securities firms, and insurance companies.


Congress passed the Emergency Economic Stabilization Act of 2008 in response to the subprime mortgage crisis as an effort to bailout the United States financial system. The main purpose of the act was to allow the United States government to purchase and insure certain types of troubled assets for the purpose of providing stability and preventing disruption to the country’s economic growth.

The Secretary of the Treasury was allowed to establish the Troubled Assets Relief Program (TARP) to purchase troubled assets from any financial institution. In addition, the act directed the Federal Reserve Board and other housing and finance agencies to implement various measures to reduce the number of foreclosures, including modifying the terms of loans. The act also allowed the Federal Reserve to pay banks a high rate of interest on deposits held as reserve requirements beginning October 1, 2008 instead of 2011 as currently allowed by law.

The Congressional Budget Office estimated that over the next three years, the provision would reduce the Federal Reserve’s payments, which are classified as revenue in the federal budget, of its profits to the Treasury Department. Through the Emergency Economic Stabilization Act of 2008 the Federal Reserve was made an integral part of “rescuing” the United States economy from both its current and future instability.

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81 Id.
82 Id.
83 Id.
85 Id.
With the passage of this act, the Fed’s power was at its apex in terms of scope and authority. From its original role as a central bank primarily focused on monetary policy to becoming a gatekeeper over much of the nation’s financial system, the Fed was now one of the country’s most expansive economic regulators. However, even with these broad powers, the Fed did not possess unlimited authority.

Unfortunately, as the current economic crisis began to unfold, the Fed apparently did not understand this limitation. As a result, rather than operate within its legislative bounds, the Fed soon commenced a series of initiatives that fell squarely outside of its regulatory authority.

IV. The Federal Reserve Bank’s Role in the Ongoing Economic Crisis

On February 1, 2006, Ben Bernanke was sworn in to replace the retiring Alan Greenspan as Chairman of the Fed.86 Prior to that, Bernanke had served as a member of the Fed’s Board of Governors since 2002 after holding a variety of academic positions.87 Widely considered as a surprise choice by President Bush, Bernanke nevertheless was expected to continue many of the laissez faire, free market policies that had defined much of Alan Greenspan’s previous terms as Fed Chairman.88

Yet, this expectation should have been balanced by the fact that one of Bernanke’s most renowned areas of study was his analysis of the Great Depression. As part of his research into the depression, Bernanke concluded that the crisis had been exacerbated by the Fed’s adherence to orthodox policy in response to the situation.89

More than anything, Bernanke’s belief that extraordinary measures could have mitigated the Great Depression foreshadowed the extremely market-intrusive measures that the Fed would take as the current crisis unfolded. Indeed, in response to the crisis, the Bernanke-led Fed engaged in a series of unprecedented regulatory maneuvers. These have ranged from an adjustment of existing Fed programs to the creation of entirely new programs.

A. The Adjustment of Existing Programs

In early 2007, early indications of a subprime mortgage crisis began to percolate to the surface. One of the key indicators was the unanticipated increase, beginning in late 2006,

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87 Id.
89 Id.
of delinquencies in this segment of the mortgage industry.\textsuperscript{90} Despite the growing number of failed subprime mortgages, following the May 2007 bankruptcy of New Century Financial Corp. (a major subprime lender), Bernanke was continuing to argue that the problem of subprime mortgages did not represent a risk to the financial system as a whole:

> We believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.\textsuperscript{91}

Even as late as August 7, 2007, the Fed refused to reduce its federal funds rate, a key Fed program that promotes market liquidity through overnight inter-bank lending, from 5.25\%.\textsuperscript{92} The ability to influence interest rates was a significant power possessed by the Fed. While the Fed could not require banks to use specific interest rates when lending, it was able to influence lending rates by making central bank loans available at discounted rates. Depending how whether more liquidity or less liquidity was needed, the Fed could adjust rates to instigate expansion or contraction of available funds.

The Fed’s August 7\textsuperscript{th} refusal was very short-lived though. Indeed, only ten days later, the Fed reversed course and cut the Primary Credit Rate, another key interest rate, by ½ of a percentage.\textsuperscript{93} Through the fall of 2007, the Fed continued to reduce these rates, eventually cutting the federal funds rate to 4.25\% by December 2007.\textsuperscript{94}

Despite these rapid interest rate cuts, the threats facing the economy continued to grow rather than contract. It was becoming clear that the Fed would have to take more dramatic steps to increase liquidity into the financial system.\textsuperscript{95} The Fed’s next steps would be to establish a series of new liquidity programs.

**B. The Creation of New Programs**

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\textsuperscript{93} Id.
\textsuperscript{94} Id.
\textsuperscript{95} At the same time, the federal government through both the Treasury Department and Congress were implementing a variety of relief programs aimed at addressing the growing amount of mortgage defaults and the overall financial problems that these problems were causing. For more information on these programs see Chad D. Emerson, *A Troubled House of Cards: Examining How the “Housing and Economic Recovery Act of 2008” Fails to Resolve the Foreclosure Crisis*, 61 OKLA. L. REV. 561 (Fall 2008).
In December 2007, the Fed created the Term Auction Facility—one of its first new programs aimed at addressing the economic challenges. This program was designed to inject liquidity into the financial system by “auctioning” funds to qualified depository institutions with a broad array of assets being eligible to serve as collateral for these auctioned loans. At the same time, the FOMC announced plans to increase liquidity on an international scale through currency swap arrangements with the Swiss and European central banks.

These dramatic measures still failed to slow down the growing crisis so, on March 11, 2008, the Fed created another new program, the Term Securities Lending Facility, which would lend up to $200 billion worth of liquidity to approved recipients with a broad array of public and private securities qualifying as collateral for these loans. During this time, the Fed also continued to reduce its interest rates to promote lending and liquidity.

Even with these measures, the pervasive nature of the crisis was unrelenting. The scope of the problems continued to grow during March 2008 with the Fed forced to intercede to prevent the failure of Bear Stearns—a move that would ultimately serve as one of the clearest examples of the Fed acting outside the scope of its legislative authority.

Going forward, the Fed would continue to announce new and expanded programs designed to increase liquidity into the financial system. This would include lowering interest rates to essentially zero percent, accepting even more types of loan collateral, and ultimately providing a bailout for the American International Group (“AIG”).

Many of these actions, while unprecedented in nature, were still within the expanded authority that Congress had given the Fed over the last half-century. However, this was not uniformly the case.

V. The Federal Reserve Bank’s Illegal Expansion of its Economic Authority

With these new or expanded programs, the Fed has unquestionably implemented an aggressive series of actions in response to the current economic crisis. In many cases, while the effectiveness of these programs is subject to great debate, the actual legality is not. Indeed, the Fed has a broad array of powers, including a set of emergency powers that further increase its ability to expand existing programs and develop new programs in certain situations.

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98 *Id.*

99 *Id.*

100 The legally dubious nature of the Fed’s role in the Bear Stearns matter will be examined in detail in the following section.
However, even the powers of the Fed have limitations. Unfortunately, in responding to the current crisis, the Fed has exceeded those limitations. The net result is that the central bank has initiated several programs that fall outside even the broad scope of authority that Congress has granted to it. In doing so, the Fed has essentially broken the law. It has engaged in activities which are impermissible under the 1913 enabling act and subsequent amendments.

A. The Fed’s Very Limited Authority to Purchase Private Assets

To fully understand how the Fed has exceeded its authority in the current financial crisis, one must make a distinction between two types of assets: private assets versus public assets. Public assets are those either originating from the government or those fully guaranteed by it. This may come in the form of bonds issued by the government itself or, in some cases, through a bond or other obligation issued by a third-party that is nevertheless fully backed by the government.

In addition to this distinction, one must also distinguish between two types of transactions: a loan versus a purchase. The Federal Reserve Act gives the Fed the power to engage in both loans and purchases but does so in significantly different ways.

For instance, the Fed has the power to provide loans to private parties when those loans are backed by collateral. The Fed may also purchase certain obligations outright. However, the second power—the power to purchase—is much more limited in scope than the first. In particular, the Fed possesses the power to regularly provide loans to commercial banks (also known as “depository institutions”). It also has the power to provide loans to non-commercial banks in limited emergency situations.

The ability to purchase assets is much more limited. In particular, Section 14 of the Federal Reserve Act outlines the narrow scope of the Fed’s authority to make purchases. Section 14(b)(1) provides:

Notwithstanding any other provision of this chapter, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to the principal and interest may be bought and sold without regard to maturities but only in the open market.

In addition, Section 14(b)(2) permits the Fed to purchase assets backed or guaranteed by an agency of the United States (as opposed to the United States directly):

The Federal Reserve also may purchase any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States.\textsuperscript{104}

This means that all purchases made by the Fed (as opposed to loans issued by the Fed) are limited to those obligations whose full principal and interest are either owned by the United States or “fully” guaranteed by it or one of its agencies. Noticeably missing from this authority is the power of the Fed to purchase privately owned assets outright since privately owned assets are neither issued by the federal government nor generally guaranteed by the government.\textsuperscript{105}

The Act does provide the Fed with more expansive powers in certain emergency situations:

\begin{quote}
In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.\textsuperscript{106}
\end{quote}

However, a careful review of these emergency powers reveals that the Fed exceeded even this increased authority with its recent actions. For instance, the emergency section applies only to the discounting of notes, drafts, and bills of exchange in unusual and exigent circumstances. Nowhere does the section provide the Fed with authority to purchase private assets.

As a result, under the Federal Reserve Act, the Fed cannot purchase notes or drafts that do not comport with Section 14.\textsuperscript{107} Significantly, the Section 14 authority to purchase

\begin{footnotes}
\footnoteref{104}{Id. at § 355(2).}
\footnoteref{106}{12 U.S.C. § 343 (2006).}
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private bills of exchange in very limited scope and duration (generally less than 90 days) and does not apply to its interaction with Bear Stearns or AIG.\textsuperscript{108}

These clear limits to the Fed’s purchasing powers were succinctly stated by two Board of Governor economists: “There is no express provision in the Federal Reserve Act for the Federal Reserve to use its open-market authority to purchase private-sector promissory notes such as mortgages or corporate bonds or to purchase equities.”\textsuperscript{109}

Nevertheless, as the current economic crisis grew, the Fed apparently decided that the danger of the problems to the financial system as a whole warranted actions outside of the Fed’s actual authority. The clearest examples of this extra-legal conduct was the Fed’s actions in response to the looming failures of investment bank Bear Stearns and worldwide financial company American International Group (“AIG”)

**B. The Fed’s Improper Equity Interests in Private Entities**

In the case of Bear Stearns and AIG, the Fed acted outside the scope of its statutory authority by effectively purchasing assets from these companies that did not fall within the narrow purchase authority provided to it by the Federal Reserve Act. Essentially what the Fed attempted to do is use legal trickery to disguise its illegal purchases of private assets from these private companies. As one commentator described the situation:

[T]he Fed’s assistance in the Bear Stearns merger with JPMorgan Chase took a form that has some similarities to the TARP proposal. In the case of Bear Stearns, the Fed created a limited liability corporation called Maiden Lane, and lent Maiden Lane $28.82 billion. Maiden Lane used the proceeds of that loan and another loan from JPMorgan Chase to purchase mortgage-related assets from Bear Stearns. Thus, although the Fed created and controlled Maiden Lane, the assets were purchased and held by Maiden Lane, not the Fed. Similar to TARP, Maiden Lane plans to hold the assets until markets recover, and then sell the assets to repay its loans to the Fed and JPMorgan Chase.\textsuperscript{110}

The result of this obfuscation was that the Fed created a wholly-controlled limited liability company to engage in purchase activities that the Fed was barred from doing so by the Federal Reserve Act.\textsuperscript{111} In fact, the Fed implicitly admitted as much in later

\textsuperscript{111} Technically, the owner of the Maiden Lane entities was the New York Federal Reserve Bank rather than the Fed itself. However, that is a distinction without significance since both entities are subject to the private purchase restrictions of the Federal Reserve Act.
disclosures that were required by law: “Maiden Lane LLC (ML LLC) was formed to facilitate the merger of the Bear Stearns Companies, Inc. and JPMorgan Chase & Co.. The New York Fed extended credit to ML LLC to acquire certain assets of Bear Stearns.”

Despite this admission, the Fed strangely claims that, by “loaning” money to Maiden Lane to purchase Bear assets—rather than purchasing the assets directly from Bear Stearns—it is somehow in compliance with the Federal Reserve Act because the transaction constitutes a lending activity (for which the Fed has broad rights) rather than a purchasing activity. As one commentator has noted, this is not an accurate description of the actual transaction:

From an economic perspective, this complex arrangement is functionally identical to a purchase of the Bear portfolio by the Fed—one that's financed in small part by the subordinated $1 billion loan from JPMorgan.

Another problem facing the Fed in this scheme is that nowhere in the Federal Reserve Act did Congress provide authority for the Federal Reserve System to create subsidiary corporate entities as it did with the Maiden Lane entities. The reality is that the Fed cannot simply establish off the book, shadow companies to avoid its restrictions under the act. Thinking that the legislative power of Congress can be circumvented by merely creating a Delaware limited liability company is patently ridiculous.

In addition to the Bear Stearns transaction, the Fed also used two other Maiden Lane LLCs to divert Fed funds into impermissible AIG equity investments. Known as Maiden Lane II and Maiden Lane III, these LLCs were created by the Fed to purchase credit default swaps and mortgage securities from AIG whose diminished value was apparently burdening the company to the point that its continued ability to operate was in question. In both cases, while the Fed did not directly purchase the assets from AIG (in the sense that the Fed did not pay AIG directly), it was essentially doing that very thing since the Fed system was the true owner of the Maiden Lane entities.

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114 Whatever the Fed possesses in brazenness it apparently lacks in naming creativity as the term “Maiden Lane” appears to have been selected simply because that is the name of the street on which the New York Federal Reserve Bank is located.
116 Federal Reserve Bank of New York, Maiden Lane Transactions, http://www.newyorkfed.org/markets/maidenlane.html, (last accessed Aug. 29, 2009)(“The New York Fed has all material control rights over the Asset Portfolio and is the sole and managing member of ML LLC.”).
As with the Bear Stearns transaction, the Fed’s attempt to conceal an illegal purchase of AIG assets through the use of a wholly-controlled LLC is, at best, a surreptitious attempt to circumvent the meaning of the Federal Reserve Act and, at worst, an intentional and purposeful violation of the law.

C. The Fed’s Overall Ineffective Response to the Current Crisis

The impropriety of the Fed’s response to the current economic crisis is paralleled only by the Fed’s ineffective work leading up to the crisis. Indeed, the Fed’s decision to exceed its legislative authority was in large part the result of its failure to act proactively in preventing or at least mitigating the crisis in the first place. The scope of the Fed’s failure to comprehend the extent of the looming economic crisis is evidenced by a review of the actual public statements of the Fed, especially those by Chairman Bernanke, leading up to the crisis.

Considering the great amount of power that his office possesses, Chairman Bernanke is in a special position to inform the public as to the state of the economy. Moreover, when he speaks, his statements typically represent the official views of the Fed. In the present crisis, this has been problematic because he has repeatedly failed to comprehend the scope and extent of the crisis.

Consider the following statements made by Mr. Bernanke as the crisis unfolded.

**July 2005**

INTERVIEWER: Ben, there's been a lot of talk about a housing bubble, particularly, you know [inaudible] from all sorts of places. Can you give us your view as to whether or not there is a housing bubble out there?

BERNANKE: Well, unquestionably, housing prices are up quite a bit; I think it's important to note that fundamentals are also very strong. We've got a growing economy, jobs, incomes. We've got very low mortgage rates. We've got demographics supporting housing growth. We've got restricted supply in some places. So it's certainly understandable that prices would go up some. I don't know whether prices are exactly where they should be, but I think it's fair to say that much of what's happened is supported by the strength of the economy.

**July 2005**

118 The following quotes are taken from a transcript of a video compilation of statements by Ben Bernanke. The transcript can be found at: Mises Daily, *Ben Bernanke was Incredibly, Uncannily Wrong*, http://mises.org/story/3588, (last accessed Aug. 29, 2009). The original video can be found at: http://www.youtube.com/watch?v=HQ79Pt2GNJo
INTERVIEWER: Tell me, what is the worst-case scenario? Sir, we have so many economists coming on our air and saying, "Oh, this is a bubble, and it's going to burst, and this is going to be a real issue for the economy." Some say it could even cause a recession at some point. What is the worst-case scenario, if in fact we were to see prices come down substantially across the country?

BERNANKE: Well, I guess I don't buy your premise. It's a pretty unlikely possibility. We've never had a decline in house prices on a nationwide basis. So what I think is more likely is that house prices will slow, maybe stabilize: might slow consumption spending a bit. I don't think it's going to drive the economy too far from its full employment path, though.

INTERVIEWER: So would you agree with Alan Greenspan's comments recently that we've got some areas of the country that are seeing froth, not necessarily a national situation, but certainly froth in some areas?

BERNANKE: You can see some types of speculation: investors turning over condos quickly. Those sorts of things you see in some local areas. I'm hopeful — I'm confident, in fact, that the bank regulators will pay close attention to the kinds of loans that are being made, and make sure that underwriting is done right. But I do think this is mostly a localized problem, and not something that's going to affect the national economy.

November 2006

BERNANKE: This scenario envisions that consumer spending, supported by rising incomes and the recent decline in energy prices, will continue to grow near its trend rate and that the drag on the economy from the housing sector will gradually diminish. The motor vehicles sector may already be showing signs of strengthening. After having cut production significantly in recent months, in response to the rise in inventory of unsold vehicles, automakers appear to have boosted the assembly rate a bit in November, and they have scheduled further increases for December. The effects of the housing correction on real economic activity are likely to persist into next year, as I've already noted. But the rate of decline in home construction should slow as the inventory of unsold new homes is gradually worked down.

February 2007

BERNANKE: We expect moderate growth going forward. We believe that if the housing sector begins to stabilize, and if some of the inventory corrections still going on in manufacturing begin to be completed, that there's a reasonable possibility that we'll see some strengthening in the economy sometime during the middle of the new year.
Our assessment is that there's not much indication at this point that subprime mortgage issues have spread into the broader mortgage market, which still seems to be healthy. And the lending side of that still seems to be healthy.

**July 2007**

BERNANKE: The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending standards, and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment, as well as by mortgage rates that, despite the recent increase, remain fairly low relative to historical norms. However, even if demand stabilizes as we expect; the pace of construction will probably fall somewhat further, as builders work down the stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth in coming quarters, although the magnitude of the drag on growth should diminish over time. The global economy continues to be strong, supported by solid economic growth abroad. U.S. exports should expand further in coming quarters. Overall, the U.S. economy seems likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend.

Clearly, the Bernanke-led Fed repeatedly failed to recognize the severity and scope of the current economic crisis. This failure further indicates a lack of overall competence in the execution of its legislative authority—something that impugns any deference it might receive in expansively-interpreting its regulatory powers.

In no uncertain terms, the Fed failed both in its efforts to recognize and measure the crisis in advance, as well as, in its subsequent policy and programmatic responses to the crisis. Individually, these failures damage its efficacy. Taken together, it evidences a systemic failure of the central bank. At the very least, this should provoke Congress to vigorously investigate the extent to which the Fed itself was a contributor to the severity of this crisis.

Unfortunately, the opacity of the Fed’s actions is cloudy enough that it is able to prevent a comprehensive examination of these practices. The Fed’s ability to obscure an in-depth review of its illegal equity purchase activities provides the most convincing evidence in support of an initial but significant step toward resolving this obfuscation: a comprehensive Congressional audit of the Federal Reserve System.

**VI. The Need for a Comprehensive and Independent Audit of the Federal Reserve System**

Though the Fed’s illegal equity purchase activity is evident in a macro sense, the precise details of this malfeasance is difficult to expose since Congress currently does not
possess the power to comprehensively audit the Fed. This is true despite the fact that the Fed has the ability to control the monetary policy of the United States. It can essentially obligate the federal government to unlimited financial obligations through its loan and purchase powers.

At the same time, the Fed has historically been able to shield itself from complete and independent audits of its activities. From its inception in 1913 until 1933, the federal government maintained a limited authority to audit certain functions of the Federal Reserve Board. The 1933 Banking Act eliminated most of this authority leaving only a very narrow swath of audit authority.

It was not until the late 1970s that Congress restored the ability of the federal government to engage in broader audits of the Fed’s activities. This renewed authority arose out of the Federal Banking Agency Audit Act (the “FBA Act”) which Congress passed in 1978. The FBA Act is actually quite ironic in this sense because one of its main purposes was to expand Congressional oversight over the Fed. In particular, the act empowered the Government Accounting Office with authority to audit the Fed’s board of governors and reserve banks.

However, the act specifically excludes the GAO—or, for that matter, any independent entity—from auditing several other critical areas of Fed activity. The FBA Act provides:

> Audits of the Federal Reserve Board and Federal Reserve Banks may not include -
>   (1) transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization;
>   (2) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;
>   (3) transactions made under the direction of the Federal Open Market Committee; or
>   (4) a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to clauses (1)-(3) of this subsection.

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120 Id.
123 Id.
These exceptions are problematic because they represent the source of the Fed’s decision-making in the present response to the economic crisis, including its illegal equity purchases. The inability of any independent agency to audit the Fed’s monetary actions, transactions with most foreign entities, and activities of the FOMC prevents a detailed review of the Fed’s unprecedented actions in this matter, as those are the very areas from which most of these decisions are emanating.

The result is a glaring “blind spot” in the government’s ability to audit the agency which has the ability to bind it to near unlimited financial obligations.

In response, the Fed has pointed to the Inspector General Act of 1978, 124 which authorizes the Inspector General of the Federal Reserve System to engage in reviews of the areas that the FBA Act prevents the GAO from auditing. However, this authority is insufficient for two reasons. First, the Fed’s inspector general, while certainly professing independence, is nevertheless still a part of the Federal Reserve System. As such, no matter how the matter is structured, any audit by the Fed’s inspector general is in fact simply the organization auditing itself. This in no way equates to an independent audit.

Worse still, by the inspector general’s own admission, the power of that office to review the areas excluded from the GAO’s audit jurisdiction, is limited and subject to the final authority of the Fed itself:

The Board’s OIG is also authorized to audit and investigate the monetary policy programs and operations of the Board. However, this access can be limited, in part, by section 8G(g)(3) of the IG Act. These provisions state that the Board’s IG may be placed under the direction and control of the Chairman of the Federal Reserve Board, if such control is necessary to prevent the disclosure of any information concerning decisions or deliberations on policy matters, the disclosure of which could reasonably be expected to have a significant influence on the economy or market behavior, or if such disclosure would constitute a serious threat to national security. In these cases, the agency head has the ability to prohibit such an audit or investigation, if the agency head determines that such prohibition is necessary to prevent significant impairment to the national interests of the United States. 125 (emphasis added)

The acknowledgment that the Fed has final discretion over the auditing power given to the inspector general evidences the true inability for any entity—internal or external—to engage in an independent and comprehensive audit of the Fed’s full range of activities. The GAO has some limited authority while the Fed’s inspector general also has some limited authority. Neither entity has absolute auditing power though. This gap in auditing coverage allows the Fed to ultimately prevent a full review of the complete

details behind its current response to the financial crisis. This result is exacerbated by the fact that the Fed is engaging in equity purchases that violate the scope of authority that Congress afforded the central bank.

Ultimately, under the Fed’s conduct, the fundamental problem is that the federal government finds itself obligated to purchases for which Congress did not provide any appropriation. As one commentator has described the situation:

If this case proves anything, it’s that the Fed is ready to press the limits of its charter to keep the financial system afloat. Effectively acquiring the Bear assets at a bargain price and then liquidating them is similar to what Resolution Trust Corp. did when it shut down savings and loans and auctioned off their loan portfolios in the 1990s. The difference is that Congress set up the RTC but had nothing to do with the Fed’s moves.  

In response to the untenable situation, Representative Ron Paul of Texas has introduced the Federal Reserve Transparency Act\textsuperscript{127} and Senator Bernie Sanders of Vermont has introduced the Federal Reserve Sunshine Act of 2009.\textsuperscript{128} Both acts would provide the federal government with authority to engage in a comprehensive and independent audit of the Fed’s activities, including those related to the current financial crisis.

A significant indication of the importance of this authority is evidenced by the strong bi-Congressional support that both bills have received. Indeed, as of August 2009, Representative Paul’s bill had in excess of 280 co-sponsors—more than enough to pass a vote before the full 435 member House of Representatives.\textsuperscript{129} In addition, the legislation is broadly bi-partisan as over 100 of the co-sponsors of Republican Paul’s bill are Democrats.\textsuperscript{130} Senator Sanders’ bill has likewise generated bi-partisan support with 23 sponsors as of August 2009.\textsuperscript{131}

If Congress were to pass these bills, then the GAO could engage in a complete and independent audit of the Fed’s activities both generally and specifically related to its current, unprecedented programs. This would include a comprehensive review of the

details related to the Fed’s illegal equity purchases in transactions involving Bear Stearns and AIG.

The usefulness of such a review was succinctly explained by one commentator, “[t]he particular confluence of the ugly and the unknown ([Maiden Lane LLCs]), is exactly why we need an outside, independent audit of the Federal Reserve.”

Protests by the Fed and its supporters that such authority would impinge upon its independence are unfounded as the audits could be structured to narrowly review whether the Fed’s activities fall within the scope of authority granted to the central bank by Congress. There is simply no reasonable basis to argue that an investigation into the legality (or lack thereof) of specific Fed programs would compromise the central bank’s independence. Rather than serve as a threat, an audit would cause the Fed to more stridently act conform its activity to the law—a very useful requirement of an entity created by Congress with the ability to bind the federal government and United States citizens to a wide array of near unlimited financial obligations.

Yet, even a concern by the Fed that the review of details of this now-hidden activity would result in political gamesmanship, if proven valid, could be accommodated by limiting the disclosure of this information as is done related to national security information provided to Congress in its oversight role over the military and intelligence agencies. At the very least, elected members of Congress should be afforded the power to see the full details of transactions by the Federal Reserve.

Ultimately, the Fed’s illegal purchases of private assets from private companies provide the most striking rationale to date for Congress to authorize a comprehensive and independent audit into the central bank’s lending and purchase activities.

VII. Conclusion

The Federal Reserve Act of 1913 established a central banking system that was part private and part public in nature. Unfortunately, the Fed has used its partial private nature to circumvent the scope of authority that Congress provided to it through the Act.

This lack of transparency has enabled the Fed to engage in purchases of private assets that are impermissible under the law. As a result, Congress should authorize a comprehensive and independent audit of the Fed’s purchase and lending activities.

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Only through the exposure of the Fed’s opaque actions can the negative effects of those actions begin to be resolved and the current financial crisis addressed in a productive way.