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Of the two parts of the Volcker Rule,[2] one has hogged the spotlight. The prohibition on proprietary trading by banks has generated intense debate. Industry groups have criticized this rule for placing inordinate compliance burdens on banks, as well as for restricting their ability to diversify their portfolios, contribute to liquidity in financial markets, and (although rarely stated so bluntly) earn profits. Other commentators have criticized the proprietary trading ban for doing too little to constrain the systemic risks posed by banks. All this debate has meant that proprietary trading rule's forgotten stepsister has not received the attention it deserves.

The Volcker Rule's second half – the so called "covered funds rule" also circumscribes bank investments in the name of limiting their risk taking and mitigating their contribution to systemic risk. This article analyzes the choice by legislators and regulators in drafting the Volcker covered funds rule, in both the Dodd-Frank statute and subsequent regulation, to use Investment Company Act definitions to set the scope of their new rule. It also examines the broader implications of this choice for coordinating banking/prudential regulations and securities/disclosure-based regulations, as well as for the more general practice of one statute or legal regime cross-referencing another. Legislative efforts to borrow definitions from statute and transplant them to another have long drawn criticism from legal scholars.[3] More recently, scholars have focused on similar borrowing in the constitutional context.[4]

The borrowing (or "trans-statutory cross reference") in Volcker's covered fund rule presents a modern case study of statutory borrowing with several important lessons. One lesson is specific to the Volcker Rule. Prohibiting banks from investing in particular exempted funds does not necessarily mean that banks will move their money to safer locales. In fact, banks could move to other exempted funds or even restructure existing investments to fall under other Investment Company Act exemptions not covered by Volcker.

Another lesson is unique to financial regulation: the covered fund experience highlights the ways in which the Investment Company Act, in particular, and securities regulation, more broadly, can and cannot regulate the systemic risk posed by banks and other financial institutions. In other words, the tools of securities relation are in some was aligned and in some ways mismatched to perform the functions of prudential regulation. The trans-statutory cross references

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[1] Professor of Law, University of Colorado Law School. The author thanks William Birdthistle, Fred Bloom, and Anita Krug for comments.

[2] The statutory basis for the Volcker Rule is Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) (the "Dodd-Frank Act") (amending Section 13 of the Bank Holding Company Act of 1956 and codified at 12 U.S.C. § 1851).

[3] *E.g.*, R. Perry Sentell, Jr., *Reference Statutes--Borrow Now and Pay Later*, 10 GA. L. REV. 153 (1975).

[4] Nelson Tebbe and Robert L. Tsai, *Constitutional Borrowing*, 108 MICH. L. REV. 459 (2010).

in Volcker exacerbate problems of under- and over-inclusiveness in limiting the risk-taking of banks. The portions of the Investment Company Act most useful for systemic risk are its restrictions on leverage, which are somewhat unique in the pantheon of securities laws and function most similarly to banking rules.

Other lessons from Volcker's trans-statutory cross references may be of interest to a broader audience. By using a securities law to define the scope of a banking law, the covered funds rule effectively transfers critical policymaking functions from one group of agencies (banking regulators) to another (the SEC). This has potentially profound implications given the differing statutory missions, cultures, and personnel of those agencies. It also has political ramifications given the different interest groups and institutional pressure points affecting securities versus banking regulators.

According to a quick glance at the Dodd-Frank Act, the covered funds rule restricts the ability of banks to acquire or retain an ownership interest in or sponsor private equity or hedge funds. However, a closer inspection of the text of Dodd-Frank reveals that the covered funds rule covers much more than bank investments in private equity and hedge funds. This broad sweep stems from how the Dodd-Frank Act defines "hedge funds" and "private equity funds" and the way in which five federal agencies wrote the corresponding definitions in the Volcker Rule final regulation. Under the statute, "hedge funds" and "private equity funds" mean any issuer that would be an "investment company" under the Investment Company Act of 1940 but for two of the most commonly used exceptions to investment company status: Sections 3(c)(1) and 3(c)(7).[5] The definition in the final agency rule largely tracks this formulation.[6] Yet a wide range of entities, funds, and financing vehicles beyond private equity and hedge funds – ranging from many corporate acquisition vehicles used in mergers and acquisitions to many issuers of asset-backed securities (securitization vehicles) – rely on one of these two exemptions from the Investment Company Act.[7] Thanks to this trans-statutory cross reference to the Investment Company Act, the Volcker covered funds rule had the potential to sweep in a large number of entities and investments.

At first blush, it may seem odd for legislators and regulators to base a major prudential banking rule on a construct from another statute from a different area of law – in this case securities regulation – that has different policy objectives. As noted above, the entire Volcker Rule, including the covered funds provision, aims to address the safety and soundness of banking entities to mitigate systemic risk.[8] The seventy-five year old Investment Company Act, by contrast, seeks to protect investors who place their money in collective investment funds.[9] To accomplish this, it

[5] Dodd-Frank Section 619(a)(1)(B) (codified at 12 U.S.C. § 1851(a)(1)(B).

[6] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,535 (Jan. 31, 2014) (codified at 12 CFR Parts 44, 248, 351; 17 CFR Part 255).

[7] Investment Company Act of 1940, Pub. L. No. 76-768 (Aug. 22, 1940) (codified at 15 U.S.C. § 80a).

[8] Dodd-Frank Section 619 (b)(1) (codified at 12 U.S.C. § 1851(b)(1)). Jeff Merkeley & Carl Levin, *The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. LEGIS. 515, 546-48 (2011).

[9] Anita K. Krug, *Downstream Securities Regulation*, 94 B.U. L. REV. 1589, 1607-1609 (2014) (describing policy objectives and tools of Investment Company Act).

employs mandatory disclosure, corporate governance rules, borrowing limitations, and conflict of interest restrictions for managers of those funds.

There are some obvious administrative advantages to a new statute building off a well-developed legal regime. Policymakers can take comfort that existing definitions have been tested in courts and markets; well-settled expectations lowers legal uncertainty and the risk of gamesmanship. However, equally obvious questions arise when that regime has a different policy rationale. The drafters of the statutory provisions on covered funds likely used the following logic in defining the scope of their provisions:

> 'bank investments in private equity funds and hedge funds pose too much risk. We need to define what is a private equity and hedge fund. Fortunately, these funds use one of two exemptions in the Investment Company Act. We can then empower regulators to expand or narrow the scope of the rule to fix any over- or under-inclusiveness.'

This raises the question of whether regulators did in fact use their authority to tailor the covered fund rule appropriately. This is a more immediate policy question. A longer term and more interesting question, however, is how the covered fund rule might evolve over time. As with predicting the future course of any legal rule, the paramount question is "who is doing the revising?" It is here that the original choice in the covered funds provisions of Dodd-Frank to build off exemptions from a securities statute becomes critical. This decision gives enormous power to the SEC to define the future scope of the covered funds rules. If the covered fund rules prohibit only bank investments that rely on two exemptions to the Investment Company Act, the SEC has the power to enlarge or contract bank investments in funds by changing the terms of exemptions to a statute wholly within their regulatory domain. The battleground over a key banking provision may thus move into turf controlled by a securities regulator.

This article proceeds as follows. Part I explains the mechanics of the Volcker Rule's covered fund provision. Part II compares and contrasts the policy objectives of the Volcker Rule's covered fund provisions with those of the Investment Company Act and its 3(c)(1) and 3(c)(7) exceptions. It argues that using these two exceptions serve the Volcker Rule's purposes unevenly. In certain respects, the definitional and exemptive scheme in the Investment Company Act furthers policies to curb systemic risk. In other regards, the fit between securities definitions and prudential objectives is poor. Part III briefly looks at the practical effect of using these two exceptions as the touchstone of the covered fund rule, using the impact on bank investments in securitization as a brief case study. Part IV speculates on the next regulatory battlegrounds, as the structure of the covered fund rule places more pressure on the SEC as it considers changes to Investment Company Act exemptions, which would then have knock-on effects on the Volcker covered funds rule. Part IV then telescopes outward to consider the implications of the covered fund rule for future attempts to employ definitions or operative provisions from securities laws in the service of prudential regulation, as well as the general technique of one statute cross referencing definitions from another. The most profound implication may be political: one statute referencing another may transfer a large policymaking function to another agency with a different mission and institutional culture. Moreover, this other body may face different interest groups and pressure points.

I. The Mechanics of the Volcker Covered Funds Rule

A. A Thumbnail Sketch

The basic provision in the Dodd-Frank Act that contains the Volcker prohibition on bank investments in covered funds is simple and succinct. It reads as follows:

> Unless otherwise provided in this section, a banking entity shall not … acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.[10]

As noted above, in addition to defining critical terms such as "banking entity" and "sponsor," Section 619 of the Dodd-Frank Act also defines the terms "hedge fund" and "private equity fund" as issuers that would be an investment company under the Investment Company Act but for sections 3(c)(1) and 3(c)(7) of that statute "or such similar funds" as the five financial regulators with statutory responsibility determine by rule.

Those five regulators – the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission (together, the "Federal Agencies") – chose to wield this authority narrowly. In defining those funds to which their final rule would apply, these agencies chose to make the two Investment Company Act exemptions a ceiling rather than a floor. In other words, the final rule applies to funds that rely solely on the 3(c)(1) and 3(c)(7) provisions for exemption from the Investment Company Act. It then carves out certain types of entities that will not be subject to the covered fund restrictions.

The Investment Company Act's definition of "investment company" and its two exclusions from that definition in Sections 3(c)(1) and 3(c)(7) thus serve as the gateway to the Volcker covered fund provisions. Under the Investment Company Act, the term "investment company" sweeps in a broad range of entities in the business of investing or trading in securities beyond traditional collective investment vehicles like mutual funds.[11] Sections 3(c)(1) and 3(c)(7) provide exclusions from the definition of "investment company" for:

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[10] Dodd-Frank Act Section 619(a)(1)(B) (codified in 12 U.S.C. § 1851(a)(1)(B)).

[11] 'The statute defines "investment company'' as

> any issuer which— (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. 15 U.S.C § 80a-3(a)(1).

The following presents one example of a business that may unintentionally become an investment company. When operating companies conduct an initial public offering or raise substantial funds, they may invest in short term

> Section 3(c)(1): any issuer whose outstanding securities 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 (other than short-term paper); or
>
> Section 3(c)(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(§ 3(c((1)).[12]

The definition of "qualified purchaser," in turn, screens out retail investors; it includes only certain business entities and natural persons who own or have invested in a high dollar amount of securities.[13]

The Federal Agencies thus had to interpret statutory language that could potentially prohibit banks from investing in a wide range of entities. They used their rulemaking authority to exempt a number of entities that rely on those two exemptions to escape investment company status and the disclosure, governance, capital structure, and conflicts rules that come with it. The Federal Agencies drafted the final covered fund rule to exempt a host of entities on the grounds that they did not pose excessive risk to banks that invested in them.

B. Drafting Notes

Statutes or regulations that cross reference or piggyback off of definitions in other legal rules are nothing new. Notably, a host of U.S. financial regulations refer to the definition of "accredited investors" in Regulation D under the Securities Act of 1933. Very generally speaking, Regulation D provides that, offers and sales of securities limited to this category of investor need not be registered with the U.S. Securities and Exchange Commission. These accredited investor cross-references seek to take advantage of the population circumscribed by that term: a discrete subset of investors that may be more able to understand and bear the risk of certain investments. Admittedly, many of the criteria for accredited investors, such as income and net worth thresholds for individuals, serve as very crude proxies for financial sophistication. Nevertheless, a trans-statutory reference to accredited investors can serve to define a category of riskier investments and investors theoretically able to manage that risk

The Volcker covered funds rule also uses exemptions from securities law registration, however it does so with a conceptual drafting structure that operates in a manner reversed from how most accredited investor references work. The covered fund rule forbids rather than permits investments. Banks cannot invest or hold interests in funds that would otherwise be exempt from registration under the Investment Company Act. The definition of "covered funds" thus works more as an *inverted cross reference*. In other words, the covered fund rule definitions operate not by allowing investment in a product covered by regulation nor by permitting investment in an

securities before they can deploy that new capital for operational uses. *E.g.,* Applied Materials, Inc., Investment Company Act Rel. No. 27,114 (Oct. 12, 2005).

[12] See 15 U.S.C. 80a-3(c)(1) and (c)(7).
[13] 15 U.S. Code § 80a–2(a)(51)(A).

unregulated or exempted product. Rather it prohibits investment in a product exempted from another statutory scheme.

Why does diagramming this odd, gymnastic drafting move matter? As we will see in the next section, this definitional technique has policy implications. To preview: preventing banks from investing in products that might be less risky because they fall outside another statute's ambit does not mean banks will invest in products covered by that other statute or that are otherwise safer.

Any bright line definition or exemption from a statute's coverage may raise problems of under- and over-inclusiveness for the policy objectives of that statute. In the investment fund context, the definitions and exemptions in the Investment Company Act may mean too few or too many entities are covered by the statute's substantive provisions. A complex definitional scheme that weaves together definitions and exemptions deftly might remedy the under- and over-inclusiveness. However, the problems of under- and over-inclusiveness might be compounded when one statute's definitional and exemptive scheme is used for a different statute in a different field with different policy objectives.

II. Policy Match and Mismatch: Prudential Rules and Cross-Referencing Securities Laws

The drafting strategy of piggybacking off of these two Investment Company Act exemptions thus leads to the question of how well the policy objectives of the Investment Company Act provisions line up with the policy rationale of the Volcker Rule. Does reliance on the 3(c)(1) and 3(c)(7) exemptions serve to limit risk-taking by banks?

In answering this question it is helpful to first summarize the policies that animate the Investment Company Act, the tools that statute employs, and the rationale behind the 3(c)(1) and 3(c)(7) exemptions. Congress passed the Investment Company Act in 1940 to address the perception that widespread abuses and fraud by money managers caused massive investor losses.[14] In terms of market failure, the Investment Company Act aimed to mitigate the agency costs inherent in money managers investing enormous amounts of money on behalf of diffuse individuals and institutions. These clients face significant asymmetries of information and collective action challenges in seeking to monitor and discipline their agents. To address these agency costs, the statute and corresponding regulations first require "investment companies" to register with the SEC.[15] The statute and the SEC then subject registered investment companies to

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[14] _ LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION __ (__ ed. ___). *See also* 15 U.S.C. § 80a–1 (Findings and Declaration of Policy). For an alternative theory of the origin story of New Deal regulation of the investment fund industry, see John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 VA. L. & BUS. REV. 341 (2012) (arguing that legislation was driven by industry concern to protect brand for style of investing).

[15] H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777. 783-4 (2004). The statute contains the following definition of an investment company:

> any issuer which—
>
> (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

mandatory disclosure requirements, chiefly annual and other periodic reports to the SEC and fund investors.[16] The Investment Company Act regime also:

¶ mandates corporate governance rules, including that a registered investment company have a minimum number of disinterested directors on its board;[17]
¶ sets detailed rules on conflicts of interest and fiduciary duties that implicate not only the investment company, but its investment adviser and its affiliates as well;[18] and
¶ restricts the ability of an investment company to borrow.[19]

The statute also authorizes the SEC to limit the ability of investment companies to redeem shares unless they have sufficient liquidity[20] and to regulate the pricing of investment company shares;[21]

These two Investment Company Act exemptions stem from pragmatic decisions that certain investors did not need the protections the statute affords. Section 3(c)(1) exempts funds owned by fewer than 100 beneficial owners based on the belief that the benefits to investors were outweighed by the cost of regulating a large number of "private" investment pools.[22] On the benefit side of the ledger, a smaller number of investors could (at least theoretically) overcome collective action challenges more easily and negotiate for more information and substantive protections from managers. The 100 owner threshold, like any bright line rule, serves as only a rough estimate as to where regulatory costs exceed benefits.

In 1996, Congress added the 3(c)(7) exemption after heavy lobbying by hedge funds, which had felt constrained by the 100 beneficial owner cap. The 3(c)(7) exemption adapts the accredited investor framework from Regulation D of the Securities Act to the Investment Company Act. It exempts funds owned solely by "qualified purchasers," which are natural persons and various entities which has total investments over a threshold amount ($5 million or $25 million). As with the accredited investor definition, the amount invested serves as a rough proxy for ability to bear loss, financial sophistication and capacity to understand risk, and bargaining power to demand

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. 15 U.S.C. § 80a–3(a)(1).

The definition section of the statute then outlines several broad carve-outs from this definition (15 U.S.C. § 80a–3(b)) before turning to specific exemptions (such as 3(c)(1) and 3(c)(7) in subsection (c).

16 Knickle, *supra* note 15, at 783-4.

17 *Id.* at 786-7.

18 *Id.* at 786-7.

19 15 U.S.C. § 80a-18. *See* John Morley, *The Regulation of Mutual Fund Debt*, 30 YALE J. ON REG. 343 (2013).

20 15 U.S.C. § 80a-22. Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 332 (2007)

21 15 U.S.C. § 80a-22. Ordower, *supra* note 20, at 332.

22 Thomas P. Lemke & Gerald T. Lins, *Private Investment Companies Under Section 3(c)(1) of the Investment Company Act of 1940*, 44 BUS. LAW. 401, 402, 405-6 (1989).

information or substantive protections.[23] This second exemption employs yet another bright line rule, which again risks some over- and under-inclusiveness.

If the Investment Company Act belongs to the genus of investor protection, the Volcker Rule hunts with prudential regulations, which concern themselves with the systemic risk posed by banks. Prudential regulation aims to reduce the risk of bank runs and other financial crisis. (Securities laws might also reduce the risk of crisis, but they do so mainly by promoting investor confidence in capital markets and less by mitigating the risk that important institutions will fail.) Both the proprietary trading and covered fund restrictions aim to reduce the risk taking of banks because of concerns over the spillover effects that bank failures would have on financial markets and the economy as a whole. This systemic risk concern drives government bailouts of banks. Regulating the riskiness of bank investments thus serves to counter moral hazard. It also may remedy distortionary effects; banks may enjoy a lower cost of capital compared to other financial institutions thanks to implicit and explicit government guarantees. These guarantees also intensify the incentives of banks to finance themselves with debt. Excessive leverage, in turn, can fuel unsustainable credit booms and increase the probability and magnitude of financial crises. To stem the risk of spillover effects of bank failures and financial crises, prudential regulations typically take the form of capital requirements or leverage caps, liquidity rules, deposit insurance, or restrictions on bank activities, affiliations or investment restrictions. The Volcker provisions fall into this last category of prudential rule.

Widespread loss of investor confidence might also trigger or deepen financial crises. However, the traditional purposes and tools of the securities regulation, like the Investment Company Act, on the one hand, and prudential regulations, like Volcker's covered fund rule, on the other, remain distinct. The question becomes, when can one set of legal tools and concepts serve the purposes of the other? More particularly, when might it make sense for the covered fund rule to key of off 3(c)(1) and 3(c)(7)? More broadly, when might securities rules aid in the fight against systemic risk? Three potential ways in which the Investment Company Act exemptions might align with the policy objectives of the Volcker Rule are discussed below:

- these exemptions might serve as a rough proxy for risky investments;
- exempted funds are not subject to Investment Company Act protections that
    - lower agency costs;
    - improve disclosure and the pricing of risk; and
    - make investments more liquid; and
- restricting investments in exempt funds constrains the development of pyramids of leverage.

The first of these arguments has been the most repeated. The second of these three arguments, as we will see, is perhaps the most suspect, as there is no guarantee that a restriction on one class of investments will hydraulically drive banks to safer investments. The third argument is perhaps the most powerful one.

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[23] Ordower, *supra* note 20, at 341-2.

A. A Proxy for Riskiness

Most broadly, these two Investment Company Act exemptions may serve as crude proxies for the riskiness of investments. Legislators of course may need to use some proxies in writing laws. The question is how crude is too crude. In the proposing release, the Agencies cited this explanation – the trans-statutory definitions as proxies of risk -- as they struggled to rationalize why the Dodd-Frank and their proposed regulation of banks borrowed from a statute that addressed a very different set of market failures with very different regulatory tools.[24] According to this justification, funds that qualify under the 3(c)(1) (100 holders) or 3(c)(7) (qualified purchasers) exemptions involve a higher degree of investment volatility and risk. Indeed, there is empirical support for the proposition that exempted investment companies are subject to higher levels of risk.[25]

These proxies for risk, however, are both under-and over-inclusive. They are under-inclusive in the first instance because these two Investment Company exemptions themselves involved very crude proxies of risk. As with the category of "accredited investors" under other securities laws, qualified purchasers as defined by the Investment Company Act provides only a rough screen for ability of investors to demand information and evaluate investment risk. The numerical thresholds for qualified purchasers are higher than for accredited investors. This may screen out investors with smaller portfolios. However, the qualified purchaser definition may serve as a better and more direct proxy for ability to bear loss than for financial sophistication.

Second, these trans-statutory cross references are under-inclusive because, under Volcker's covered fund rule, banks may invest in funds that fall within other Investment Company Act exemptions (a topic discussed below at the end of Part III and again in Part IV.A.). Even SEC-registered funds may involve significant risk and suffer losses, as witnessed by the experience of many 401(k) investors during the global financial crisis. Indeed, the Investment Company Act's operative provisions on mandatory disclosure, corporate governance, capital structure, and conflicts of interest only address certain kinds of risk. Moreover, the risks targeted are risks to investors not systemic risks. Some categories of investment companies, like money market mutual funds, are subject to specialized and stringent restrictions on their investments.[26] However, even money market mutual funds, which regulations helped portray as super-safe, suffered in the crisis, with a few high-profile examples "breaking the buck."[27]

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24 Volcker Final Rule, *supra* note 6, at ___.

25 For empirical studies on the risk and return of hedge funds, which typically rely on 3(c)(7), *see, e.g.*, Ilia D. Dichev & Gwen Yu, *Higher Risk, Lower Returns: What Hedge Fund Investors Really Earn*, 100 J. Fin. Econ. 248 (2011) (comparing hedge fund returns to those of "buy-and-hold" funds); Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 Fin. Analysts J. 80 (Nov./Dec. 2005) (comparing returns of hedge funds to mutual funds, finding high levels of risk with hedge funds, but potential for diversification); Carl Ackermann, Richard McEnally, & David Ravenscraft, *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. Fin. 833 (1999). Empirical studies of the risk and returns of private equity funds have found they enjoy abnormal returns. *E.g.* Narasimhan Jegadeesh, Roman Kräussl, & Joshua Pollet, Risk and Return of Private Equity Investments: Evidence Based on Market Prices, Nat'l Bur. Econ. Res. Working Paper No. 15,335, Sept. 2009 *available at* http://www.nber.org/papers/w15335.

26 *E.g.*, 17 C.F.R. § 270.2a-7

27 William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WIS. L. REV. 1155.

B. Exempted Funds Could Suffer Suboptimal Agency Costs, Disclosure, and Liquidity Risk

The Volcker covered fund rule precludes banks from investing in funds not subject to the Investment Company Act's corporate governance, disclosure, and registration requirements. The absence of these rules could lead to funds suffering suboptimal levels of agency costs, disclosure, and liquidity risk. Whether banks would suffer from excessive risk in these regards presents difficult empirical questions, among them, what is the appropriate baseline to measure when risk becomes excessive and a flavor becomes a poison? This section attempts merely to sketch out how agency costs, and more interestingly, inadequate disclosure and illiquid investments might pose particular dangers for bank investments.

As noted above, the Investment Company Act was premised on the idea that conflicts of interest and manipulative behavior by fund managers caused massive investor losses and a loss of investor confidence. Indeed, concerns about agency costs and conflicts of interest animate prudential regulation, as well. The Supreme Court's famous articulation of the policy rationale behind the Glass-Steagall divisions in *Investment Company Institute v. Camp* included a discussion of the "subtle hazard" of conflicts of interest between investment and commercial bankers.[28] Were conflicts of interest either to cause losses for unregistered investment funds or to panic investors and trigger a stampede out of a fund, a bank might suffer investment losses or loss of liquidity. The extent of risk posed by agency costs, conflicts of interest and corporate governance failures in unregistered funds, however, remains the topic of heated debate.

The dearth of disclosure in unregistered funds poses clearer systemic risk concerns. Prudential regulation has long recognized the important role that market discipline plays. Market discipline, in turn, depends on the ability of investors to evaluate and compare risks. Mandatory disclosure can facilitate this and improve information efficiency. For market discipline to work for banks, disclosure should enable investors to assess troubling concentrations and correlations of risk on both the asset and liability sides of the balance sheet. If losses from a fund investment occur simultaneously with losses to other bank assets (for example commercial loans), a bank might find itself facing sudden and unexpected threats to its solvency. By contrast, private equity and hedge funds, which are not subject to the Investment Company Act's disclosure regime, continue to be criticized for their opacity.[29] It would be particularly troubling for banks to hold these investments given persistent criticisms about the complexity and opacity of bank balance sheets.[30] Opacity layered on opacity means potential errors in pricing risk can be magnified, just

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[28] 401 U.S. 617, 632-4. *Compare* William A. Birdthistle, *Investment Indiscipline: a Behavioral Approach to Mutual Fund Jurisprudence*, 2010 UNIV. ILL. L. REV. 61, 65. (analyzing conflicts within investment fund industry).

[29] Dodd-Frank requirements that hedge funds register with the SEC have increased their transparency somewhat. *See* Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. 243 (2013) (analyzing early data on registration and how much information it did and did not reveal).

[30] Frank Partnoy & Jesse Eisinger, *What's Inside America's Banks?*, THE ATLANTIC, (Jan./Feb. 2013) *available at* http://www.theatlantic.com/magazine/archive/2013/01/whats-inside-americas-banks/309196/.

as errors in pricing the risk of mortgages lead to larger errors as those assets were securitized and still larger errors upon resecuritization.[31]

The illiquidity of unregistered funds also poses particular prudential concerns for banks as investors given the asset-liability mismatch inherent in the business model of banks. Ownership interests in 3(c)(1) and 3(c)(7) funds can be illiquid not only because they face regulatory resale restrictions, but moreover, because their limited partnership agreements contractually limit redemptions and transfers. Redemption restrictions can vary by the type of fund.[32] For funds that limit redemptions for long periods, such as in venture capital, this problem becomes compounded when those funds cannot easily liquidate or "exit" their portfolio investments at the end of the funds' life cycle.[33]

So the covered fund rule restrictions reduce risk by addressing agency costs, improving disclosure and promoting liquidity. Not so fast. The problem is that restricting investment in risky, opaque, and illiquid assets does not ensure that banks will shift their money to safer, more transparent, and more liquid markets. Banks would seem unlikely to shift investments to registered investment companies[34] (which may have been criticized themselves for suffering from flawed corporate governance[35] and disclosure[36]). Regulators have warned that even many registered funds, such as certain exotic exchange traded-funds and alternative funds, can pose substantial risks.[37] The covered funds rules does not prevent banks from investing in funds that operate under other Investment Company Act exemptions, which might have their own problems with risk, opacity, and illiquidity. Banks could also shift their investments to other asset classes that offer

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[31] This disclosure and mispricing problem can occur with any derivative asset, in which the cash flows and risks associated with an asset stem from some other asset. Each layering of one asset on top of another magnifies the potential for misdescriptions and miscalculations of risk and risk correlation. *See* Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 163, 173 (2009)**,** Joshua Coval, Jakub Jurek, & Erik Stafford, *The Economics of Structured Finance*, 23 J. ECON. PERSP. 3 (2009).

On the other hand, some commentators have highlighted the ways in which market discipline can in certain circumstances govern hedge funds. SEBASTIAN MALLABY, MORE MONEY THAN GOD: HEDGE FUNDS AND THE MAKING OF A NEW ELITE (2011).

[32] There are differences among unregistered funds in the contractual ability of investors to exit, with some hedge funds allowing redemptions once per month or once per quarter, while private equity funds typically lock in investors for several years. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1235-6 (2014)

[33] Steven Davidoff Solomon, *A Venture Capital Giant Says: Bubble? What Bubble?*, N.Y. TIMES, July 1, 2015, at B5 (describing challenges venture capital firms face in exiting investments in current market).

[34] Banks could replicate the diversified portfolios of registered investment companies themselves without paying the fees. Banks also have become competitors of investment companies, offering retail investors their own fund products.

[35] *E.g.*, Jeff Schwartz, *Mutual Fund Conflicts of Interest in the Wake of the Short-Term Trading Scandals: Encouraging Structural Change through Shareholder Choice*, 2 N.Y.U. J. L. & BUS. 91 (2005)

[36] Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J.L. BUS. & FIN. 1 (2009).

[37] *E.g.*, SEC Investor Alert & Bulletin, Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors (Aug. 18, 2009) *available at* http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm. FINRA, Investor Alert, Alternative Funds Are Not Your Typical Mutual Funds (June 11, 2013) *available at* https://www.finra.org/investors/alerts/alternative-funds-are-not-your-typical-mutual-funds.

no improvement over 3(c)(1) and 3(c)(7) funds in these regards. The best retort, that prudential regulation has to start somewhere, is not entirely satisfying.

C. Pyramids of Leverage

A more satisfying rationale for using Investment Company Act exemptions in the service of prudential regulation would involve the restrictions that that statute places on investment companies financing themselves with debt. Some (but not all) unregistered funds take advantage of the Investment Company Act exemptions to lever up dramatically. The Investment Company Act's restrictions on debt financing are not part of the traditional arsenal of securities laws. However, they mesh well with prudential regulation given the systemic risk concerns with excessive leverage. By magnifying potential losses, leverage can threaten the solvency of financial institutions. Investing in unregistered funds could create pyramids of leverage; levered banks (with already heightened incentives to lever up thanks to government guarantees making their debt cheaper) investing in levered funds. Losses to funds could cascade back in tidal waves that sink financial institutions.

Pyramids of financial institution leverage can also create endogenous risk of financial crisis. A wave of post-crisis economic research has shown that financial institution leverage can act procyclically. Banks appear to lever up during boom times (including by via obtaining reduced haircuts on repo borrowings). This has the function of increasing the effective supply of money in the economy, which further fuels the boom and increases leverage. When a downturn begins, the feedback loop clangs abruptly into reverse: banks deleverage, which contracts the effective supply of money and deepens the economy's plunge. To square the circle, highly leveraged financial institutions are left badly exposed when the economy dips and investment losses widen. Financial institution leverage can thus sow the seeds for financial crises.[38]

Curiously, the piggybacking by the Volcker covered funds rule on the 3(c)(1) and 3(c)(7) exemptions restrictions may serve to rehabilitate Investment Company Act restrictions – at least in small part – against a trenchant critique newly levelled by Professor John Morley. Professor Morley questions the underlying policy rationales behind these restrictions, including the argument that they mitigate systemic risk. He argues that debt restrictions may be under inclusive in this regard, as they do not apply to unregistered investment funds, like hedge funds, that may pose more of a systemic threat than registered investment companies.[39] By prohibiting banks from investing in unregistered funds, the Volcker covered fund rule uses the coverage – or more precisely the exemptive structure – of the Investment Company Act for a more defensible systemic purpose.

However, this rehabilitation only goes so far. It does not challenge Professor Morley's criticism of debt restrictions as they apply to registered investment companies directly. Moreover, a more precisely tailored prudential rule – with less over- and under-inclusiveness – would restrict banks from investing in any leveraged fund or would key off the amount of leverage in that fund.

[38] ERIK F. GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION 382-5 (2013);
[39] Morley, *supra* note 19, at 17-8.

III. Practical Effects of Covered Funds on Securitizations: a Case Study of CLOs

One can make a rough and preliminary assessment of how the covered funds rule is working by looking at its impact on securitization. Asset-backed securities, after all, were the investment products at the epicenter of the U.S. financial crisis. However, the covered fund's impacts on securitization vary widely based on the exact type of asset-backed securities. Some securitization vehicles, for example, ones that own mortgages and other real estate interests, could rely on exemptions other than 3(c)(1) and 3(c)(7), a lacuna discussed in Part IV.A.

Other actively-managed investment vehicles that issue asset-backed securities generally used 3(c)(1) or 3(c)(7) to escape regulation under the Investment Company Act. Therefore, the covered funds rule threatened to prevent banks from investing in entire categories of asset-backed securities and to dry up a major source of demand in those securitization markets.[40] Collateralized Loan Obligations, asset-backed securities created by the cash flows from commercial loans, appeared particularly vulnerable when the Federal Agencies first proposed the covered fund regulations.[41] Concerted efforts by lawyers for banks and the securitization industry succeeded in changing aspects of the proposed rule. Nevertheless, the final rule still promised to prevent banks from investing in or holding CLO securities.[42] Smaller banks then complained that the implementation of the rule would force them to conduct fire sales. They succeeded in convincing the Federal Agencies to suspend implementation of the covered fund rules for certain collateralized debt obligations backed by small-bank securities.[43]

The scorecard reveals mixed results in the fight between proponents of a tough versus a liberal covered funds rule. The rule does clamp down on bank investments in CLOs, but the extension of time for compliance *vis a vis* certain CDOs did relax the rule. A larger, more troubling point remains: despite the intense fighting, the covered funds rule never covered various mortgage-backed and related asset-backed securities. These securities were at the eye of the financial crisis hurricane. Yet the decision in Dodd-Frank to focus on funds exempted under 3(c)(1) and 3(c)(7) all but guaranteed that these securities would never fall within Volcker's scope.

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[40] J. Paul Forrester et al., *The Final Volcker Rule—Impact on Securitization Transactions*, J. STRUCTURED FIN. 13 (Spr. 2014).

[41] *See* Stroock & Stroock & Lavan, Special Bulletin: Volcker's Rule's Impact on Securitization at 4 (Feb 12, 2014) (describing different securitization instruments and the Investment Company Act exemptions on which they relied) *available at* http://www.stroock.com/publications/pubsdetail_1447.

[42] Jody Sheen & Christopher Dereza, *CLOS that Volcker Rule Deems Bad for U.S. Banks Are Slumping*, Bloomberg Business (June 11, 2015) *available at* http://www.bloomberg.com/news/articles/2015-06-11/clos-deemed-bad-for-banks-in-volcker-rule-drop-as-deadline-nears.

[43] Matthew Goldstein, *Not So Fast on Volcker Rule, Regulators Tell Smaller Banks*, N.Y. Times DealBook Blog (Dec. 19, 2013) *available at* http://dealbook.nytimes.com/2013/12/19/not-so-fast-on-volcker-rule-regulators-tell-smaller-banks/?_r=0

Jesse Hamilton & Cheyenne Hopkins, *Volcker Rule Curbs on Banks Owning CDOs Eased in U.S.*, Bloomberg Business, (Jan. 14, 2014), *available at* http://www.bloomberg.com/news/articles/2014-01-14/u-s-regulators-said-ready-to-ease-volcker-cdo-limits-for-banks.

IV. Implications

A. The Next Battlefields in Covered Funds

Law firms are already advising clients on ways to restructure securitizations to qualify for exemptions from the Investment Company Act other than under 3(c)(1) and 3(c)(7).[44] Relying on other exemptions would mean securitization vehicles could issue asset-backed securities to banks without banks running afoul of the covered fund rule restrictions. Among the exemptions that law firms recommend securitization clients consider are:

Section 3(c)(5): this exemption covers issuers:

(a) purchasing or acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services;
(b) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and
(c) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate; and

Rule 3-a-7 under the Investment Company Act:[45] issuers of certain asset backed securities that hold only "eligible assets."[46]

Law firms have also advised clients to pay close attention to SEC rulemakings that could change the scope of these two exemptions.[47] Of particular concern to law firms representing clients in securitization, the SEC issued two separate notices in 2011 indicating an intention to revisit and possibly revise Rules under Section 3(c)(5) as well as Rule 3a-7.[48] Law firms are concerned that

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[44] *E.g.*, Stroock & Stroock & Lavan, Stroock Special Bulletin: Volcker Rule's Impact on Securitization at 4 (Feb. 12, 2014) *available at* http://www.stroock.com/siteFiles/Pub1447.pdf; Morgan Lewis, Final Volcker Rule Regulations: Securitizations and Other Structured Transactions at 4 (Jan. 13, 2014) *available at* https://www.morganlewis.com/~/media/files/handouts/volcker_rule_and_structured_transactions_handout.ashx (discussing Rule 3a-7); Cadwalader, Wickersham & Taft LLP, The Volcker Rule's Impact on Banking Entities' Ownership and Sponsorship of Structured Finance and Securitization Transactions (Dec. 17, 2013) *available at* http://www.cadwalader.com/resources/clients-friends-memos/the-volcker-rules-impact-on-banking-entities-ownership-and-sponsorship-of-structured-finance-and-securitization-transactions.

[45] 17 CFR § 270.3a-7.

[46] "Eligible assets" means the following:

> financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders. 17 CFR § 270.3a-7(b)(1).

[47] *E.g.*, Skadden, Arps, Slate, Meagher & Flom LLP, Structured Finance Alert: The Final Volcker Rule: Impact on Securitizations at 11 (Jan. 8, 2014) *available at* http://www.skadden.com/newsletters/Structured_Finance_Alert_The_Final_Volcker_Rule_Impact_on_Securitization.pdf.

[48] Advance Notice of Proposed Rulemaking: Treatment of Asset-Backed Issuers under the Investment Company Act, Investment Company Act Release 29,779 (Aug. 31, 2011) *available* at https://www.sec.gov/rules/concept/2011/ic-29779.pdf; Concept Release: Request for Comments: Companies Engaged in the Business of Acquiring Mortgages

the SEC might shrink the scope of these exemptions. Again, this would have the knock on effect of constraining the ability of banks to invest in asset-backed securities without violating the covered funds rule. Law firms representing banks and participants in securitization will surely resist any effort to shrink the exemptions and even push to expand them. The battle field has shifted from the domain of bank regulators to that of the SEC, and the fight may last decades.

B. Prudential and Securities Regulation: Alignments and Misalignments

Examining the policy match and mismatch between the covered funds rule and the Investment Company Act underscores several larger lessons about placing substantive securities laws in the service of prudential regulation. First, the weapons in the securities law arsenal that may be appropriate for regulating systemic risk are limited. Disclosure and, to a lesser extent, corporate governance represent the primary tools of securities regulation. It is the Investment Company Act's leverage provisions, which are somewhat atypical in the realm of securities regulation, that offer the tool for addressing systemic risk most directly.

1. Disclosure

As noted above, securities disclosure plays a crucial role in enabling market discipline of financial institutions. However, in the United States, securities disclosure rules are written primarily by securities regulators for the purposes of protecting investors, not to mitigate systemic risk. These investors with equity or bond stakes in a financial institution may care about the risk that the firm may fail. However, other counterparties of the firm – such as derivatives counterparties or repo lenders – might also exert disciplining effects on firms. Indeed, their exposures may be larger and even shorter term than traditional investors. Moreover, the disciplining mechanisms they enjoy – such as the ability to demand more collateral or not to relend in overnight repo markets– may be swifter, nimbler, and more effective than remedies available to shareholders (such as the proxy) or bondholders (covenant rights). For market discipline to work, disclosure rules must also be written for these parties. This might mean more timely disclosure; short term exposures mean that risks may metastasize in the intervals between quarterly or annual reports.

They might also need more granular disclosure to understand the risks on financial firm balance sheets. When financial firms invest in funds or derivatives, investors might need to understand the composition of assets in the fund's portfolio or the derivative's underlying assets. If these assets do not themselves trade on efficient markets, their pricing may not adequately reflect the risks they pose to the bank. As noted above, the potential for mispricing of risk is compounded with each layering of a fund on top a fund or a derivative based on another derivative.[49]

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and Mortgage-Related Instruments, Investment Company Act Release 29,778 (Aug. 31, 2011) *available at* https://www.sec.gov/rules/concept/2011/ic-29778.pdf.

[49] *Supra* note 31, and accompanying text.

Market discipline of financial institution depends on disclosure tailored to the unique risks faced by banks and other financial institutions, including details on credit, concentration, and liquidity risk. The off-the-rack disclosure rules applicable to non-bank issuers would be inadequate for investors, counterparties, and regulators to evaluate these special risks. Recognizing this need, the SEC did create special supplemental disclosure rules for banks called Guide 3. However, calls to rewrite Guide 3 are intensifying in Washington, D.C., as part of a broader push for "regulatory relief."[50] Policymakers cannot forget the special requirements for securities disclosure to be effective as a tool for reinforcing market discipline. Moreover, as explored more below, questions remain as to whether the SEC will think enough about market discipline, prudential regulation, and systemic risk when rewriting these rules.

2. *Corporate Governance.*

Corporate governance can also play a vital role in prudential regulation with several provisos. First, traditional corporate governance concerns revolve around aligning the interests of management with shareholders. However, this focus exists in tension with the focus of prudential regulation, which cares about externalities that financial institutions impose on financial markets, taxpayers, and the broader economy. Indeed, serving shareholder interests (such as taking excessive risks if the firm is close to failure) may run counter to the interests of the parties on whom these costs are externalized.[51]

Corporate governance in service of prudential regulation might be more effective when it focuses on the bank or financial institution itself rather than on the governance of entities in which the bank invests. If the banks interests are not aligned with shareholders or stakeholders affected by systemic risk, it is unlikely to wield its own rights as a shareholder appropriately if at all. Furthermore, the particular corporate governance mechanisms in the Investment Company Act provide a cautionary tale. They have come under sustained attack for focusing too much on formal distinctions between entities. More concretely, the Investment Company Act appears to have tough corporate governance rules, but these rules apply to the board of the investment company. The real investment management decisions and the capacity for abuse lies with a separate investment adviser firm.[52]

3. Leverage Regulations.

The discussion above concluded that the most effective alignment between the covered funds rule and the Investment Company Act came in the area of the latter's restrictions on debt financing by

[50] *See* SEC Commissioner Michael S. Piwowar, Remarks before the Exchequer Club of Washington, D.C. (May 20, 2015) *available at* http://www.sec.gov/news/speech/remarks-before-exchequer-club-washington-dc.html#_ftnref24.

[51] *See generally* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEG. ANALY. 35 (2014).

[52] Anita K. Krug, *Escaping Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039 (2013). For a critique that analyzes how formalistic legal rules as applied to investment companies might insulate the real managers (*i.e.* advisers) from liability for manipulative behavior, see *Janus Capital Group, Inc.*, *et al. v. First Derivative Traders*, 131 S. Ct. 2296, 2310, 2312 (2011) (Breyer, J., dissenting)(criticizing a narrow rule of who might be liable for an investment company's misleading disclosure: "The possibility of guilty management and innocent board is the 13th stroke of the new rule's clock.")

investment companies. This should not surprise given prudential regulation's concerns with the contributions of financial institution leverage to systemic risk. To recap: financial institution risk renders financial institutions more vulnerable to failure, and the collective leverage of financial institutions can create conditions for financial crises. Since leverage packs this one-two punch, the other (somewhat atypical) securities regulations that address leverage, such as margin requirements, represent some of the most potentially powerful weapons in fighting systemic risk. The question is whether securities regulators will see and use these rules for that purpose, or whether they conceive of them more as tools to protect investors and ensure the smooth functioning of capital markets.[53]

C. The Tradeoffs of Trans-statutory Cross References

The covered funds rule also provides lessons for trans-statutory cross references used in any field whether financial regulatory or otherwise. A new statute piggybacking off definitions or provisions in an older one offers several practical advantages. Existing definitions and provisions may enjoy well-developed boundaries, tested in courts and markets. Interpretative practice may have settled the expectations of market participants, as well as of courts, agencies, and private sector lawyers. This reduces legal uncertainty, as well as hampers regulatory arbitrage that flows from aggressive legal interpretation.

However, trans-statutory cross references also has significant downsides. Industry groups may attempt to exploit the importation of one statute in another. The immense sums at stake sharpens legal creativity. Lawyers may even seek to import on their own one statutory concept to game another statute in the same field. For example, Facebook faced potential SEC registration as a public company under the Securities and Exchange Act of 1934 because the number of its investors was about to pass a statutory threshold. To avoid this, the company and its advisors sought to borrow structures from the securities law regimes applicable to investment funds by placing groups of investors under one fund.[54]

Furthermore, in a complex contract in which multiple provisions refer to the same defined term, changes to that definition have cascading effects throughout the agreement. Using the same definitional term in different legal rules – be they different parts of a contract or different statutes – complicates any effort to revise rules. For any change, policymakers must consider policy implications along not just one but multiple dimensions. In the case of changes to another Investment Company Act exemption, such as Rule 3a-7, the SEC must now consider both the potential effect on investor protection, as well as the possible impact on bank investments and prudential regulation. It is quite possible the two sets of consideration may point to opposite conclusions. For example, the SEC may determine that enlarging an Investment Company Act exemption would pose little risk to investors, as few unsophisticated retail investors would purchase the investment products implicated. However, enlarging the exception may allow banks

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[53] Erik F. Gerding, *Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension*, 8 BERKELEY BUS. L.J. 29 (2011).
[54] Goldman Sachs Investment in Facebook May Draw SEC Scrutiny, BloombergBusiness (Jan. 3, 2011) *available at* http://www.bloomberg.com/news/articles/2011-01-03/goldman-sachs-investment-in-facebook-may-draw-sec-scrutiny-on-disclosure.

to make a wider range of investments and take on massive amounts of risk, much of which they could externalize onto taxpayers or financial markets. What should the SEC do in this case?

What would the SEC do? Politicos would be advised to bet on the SEC enlarging the exemption. The SEC's statutory mission and organizational culture revolve around investor protection not prudential regulation. The training and professional ethos of its leadership and staff have been infused with safeguarding shareholders and bondholders. When other factors enter the policymaking equation, they are typically about promoting the efficient operations of capital markets, not lowering systemic risk. Recent fights within the Beltway provide evidence of the SEC's reluctance to see systemic risk regulation as among its core missions. The SEC engaged in a protracted fight both internally and with the Financial Stability Oversight Council over reforms to the money-market mutual fund sector. Resistance to reform occurred even though these funds suffered "runs" during the financial crisis that threatened financial stability and prompted unprecedented emergency actions by the Federal Reserve to inject liquidity into the sector. Then the SEC Chair and other commissioners protested suggestions that asset managers, traditionally in the SEC's regulatory domain, be regulated because of systemic significance. Much of this might be attributed to age old political battles over regulatory turf. However, the SEC's conception of its fiefdom and organizational mission also reflects deep underlying political dynamics. In short, the SEC responds to different industries and interest groups than do prudential bank regulators. The debate over money-market mutual fund reform reflected a fight between the banking and investment fund industries and their respective regulators over where trillions of dollars of investor capital should be stored.

This points to lessons for policymakers considering using trans-statutory cross references in the future. Trans-statutory references may take power from one regulatory body and give it to another. In the case of the covered fund rules, power over prudential rules was, perhaps unintentionally, delegated to a securities regulator. This works well if the statutory drafters trust the agency from whom power was taken less or trust the agency to whom power was given more. It works if the concern is to check potential overzealous pursuit of policy objectives by the traditional regulator or to remedy potential shirking by a captured body. However, trans-statutory cross references may fail if the newly empowered regulator works at cross purposes to the statute it now has authority over. Trans-statutory cross references reflect a lesson that is old but one that bears repeating nonetheless: technical drafting decisions can have outsized and unintended political consequences, particularly with respect to the most important question of all – who decides policy going forward.