Financial Crises in the United States and the European Union: Policy Responses, Successes and Failures and the Need for Further, Cross-national Reform

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Abstract

This paper examines the causes of the global financial crisis of 2008-2009 and explores the major financial reforms in the United States and the EU, offers comparisons of the legislation and recommends changes to the legislations that are aimed at minimizing the burden on taxpayers, and balancing the necessary intervention of governments in financial markets and the economy with capitalistic ideals. The lack of government oversight, predatory lending practices, and an overall environment of deregulation leading up to the financial crisis ultimately led to its collapse in late 2008. In response to the collapse of the global financial system, the United States began working on the largest reform of the United States economy since the Great Depression—the European Union began work on their reform shortly thereafter. The Dodd Frank Financial Reform bill aims to bring stability to the United States' financial markets and confidence to its individual and institutional investors. While the bill addresses some of the causes of the financial crisis, it leaves much of the legislation up to future congresses, ignores Fannie Mae and Freddie Mac, and delegates broad discretion of power to relatively small, and independent advisory boards within the United States government.

In the European Union, regulators have taken a piece meal approach to reforming their financial system, and are addressing issues one bill at a time, instead of in a single piece of legislation. However, because the United States has fallen short on issues of mortgage reform, hedge funds, bailouts, and capital requirements, among others, in its own reform, it has left the door open for the European Union to pave the way on such issues. A cross Atlantic Divide between the United States and European Union on financial reform will necessarily shrink the global economy, and create a need for further financial reform.
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I. Introduction

“A congressman said to me, 'Mr. Chairman, you know, I'm talking to bankers in my town. I'm talking to shopkeepers in my town. And they say things are normal. Nothing's going on. We don't see any problem.' And I turned to him and I said, 'You will.'”1 – Chairman of the Federal Reserve, Ben Bernanke, to a congressman as the financial crisis was taking shape.

Founded on ideals of integrity and the American Dream, the recent financial crisis has sent the United States, the European Union (“EU”) and the global marketplace into the worst recession since the Great Depression. The crisis reached every town and every market across the world. The contagion effect quickly spread to and throughout Europe, and now, the EU is in the midst of revamping their financial system in an attempt, along with the United States, to prevent another worldwide financial crisis. This paper explores the major financial reforms in the United States and in the EU, offers comparisons of the legislations, and recommends changes to the legislations that are aimed at minimizing the burden on taxpayers, and balancing the necessary intervention of governments in financial markets and the economy with capitalistic ideals.

As home prices skyrocketed from 2000 through 2006, the American Dream, for everyone from investment bankers to blue collar middle Americans, gave way to American greed as American’s took out mortgages for amounts well in excess of what they could actually afford, lenders leant the money without conducting much, if any, due diligence, and investment bankers bundled these high risk mortgages in mortgage backed securities. What ensued was a game of high stakes hot potato, as

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investment banks and financial institutions passed around mortgage backed securities filled with subprime mortgages, hoping that they were not the ones left holding them when the homeowners behind the mortgages that, by and large, were too outlandish for the homeowners to afford, defaulted on the mortgage.

As financial strongholds of the American economy like Bear Stearns, Lehman Brothers and AIG were brought to their knees by defaulting mortgages and frozen credit, the financial industry began to crumble.\(^2\) The domestic crisis had wide reaching effects throughout the European Union as well, as Greece and other member nations underwent sovereign debt crises, and financial institutions across the EU began to fail. Because financial giants like Lehman Brothers and Bear Stearns are so intertwined with the world economy, many of the factors that led to the domestic financial crisis also led to the financial crisis in Europe.\(^3\) As the downturn in housing prices took hold in the United States, European banks and financial institutions that were holding mortgage backed securities, or maintained subsidiaries that were holding mortgage backed securities, were forced to borrow money or seek government financing.\(^4\) The British government was forced to nationalize a housing lender, and other EU countries, including France and Belgium were forced to loan money to municipal lenders and banking and insurance institutions.\(^5\)

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\(^4\) Id. at 9.

\(^5\) Id.
As a result of the crisis, and the $700 billion bailout by the Federal government, Congress began work on the largest reform of the American financial system since the Great Depression.\(^6\)

After the stock market crashed in October of 1929, Congress adopted the Uniform Sale of Securities Act in an attempt to “harmonize securities regulations across states.”\(^7\) The Uniform Sale of Securities Act, however, was narrowly adopted.\(^8\) In 1933, Congress passed the Glass-Steagall Act, in response to 5,000 bank failures during the Great Depression, which effectively separated the roles of commercial and investment banks.\(^9\) Then, the 1934 Securities and Exchange Act promulgated broad reaching financial and regulatory reform in light of the Great Depression. The Act was designed to “protect interstate commerce, the national credit, the Federal taxing power . . . and [to] make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.”\(^10\) Combined, the Glass-Steagall Act of 1933 and Securities and Exchange Act of 1934 served as Congress’s major response to the Great Depression.

The next major reform of American financial institutions arguably played a large role in the financial crisis of 2008. In 1999, congress passed the Gramm-Leach-Bliley Act that eliminated the firewall between investment and commercial

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\(^8\) Id.


banks, allowing banks to invest with their depositors’ money. And finally, in the aftermath of Enron, Arthur Anderson and other financial oversight disasters, Congress passed the Sarbanes-Oxley Act in 2002. The Act was “the most far reaching [reform] of American business practices since the time of [FDR]” and mandated certain business practices to hold accountable corporate managers and eliminate corporate fraud. Despite American’s long and evolving history of financial reform, no financial crisis, or subsequent bill, has had as profound effect on both domestic and international business as the Financial Crisis of 2008, and subsequent Dodd-Frank Wall Street Reform and Consumer Protection Act, since the Securities and Exchange Act of 1934.

This paper explores the content of the Dodd-Frank bill and compares it with the EU’s financial reform measures and current financial reform proposals. Reforming financial systems and enacting legislations is a necessary part of protecting the global markets. The World Bank has identified 112 instances of systemic bank failures or crises since 1970. Most occur quickly, and require some form of bailout, bankruptcy, or legislative response in order to provide a resolution. The financial crisis of 2008, however, was the deepest, and most widespread failure of the financial system since the Great Depression. Part II of this paper addresses the factors that led to the financial crisis of 2008, and the contagion effect that the domestic crisis had on the EU. Part III examines the Dodd Frank financial reform bill and compares portions of the bill to its counterpart financial reform legislation.

13 Id.
15 Id.
16 Id.
in the EU. This part also analyzes areas where legislative and regulatory improvement is needed in order to prevent future financial crises. Part IV concludes by encouraging lawmakers in the United States and European Union to continue moving forward with financial reform, and encourages regulatory regimes that will promote cross border, and cross continental business. Without cooperation between the United States and EU on financial reform, especially with regards to capital and liquidity, deposit and investor guarantee schemes, hedge funds, and executive compensation, the United States and the EU will force multinational enterprises and other businesses out of their territories because the costs and burdens of compliance with two conflicting regulations would be crippling, if not impossible to achieve.

II. A Lack of Financial Oversight and Responsibility in the United States Leads to the Global Financial Crises

The financial crisis of 2008 was spurred, in large part, by a decade of foreign investment into the United States.\(^{17}\) As emerging markets in Asia and the Middle East grew as a result of rising consumption and Western dependence on oil, these emerging markets total investments equaled 6% of the United States’ total output in 2006.\(^{18}\) American financial giants, like Lehman Brothers and Bear Stearns, and smaller financial institutions, however, were not conservative in their investments of the aforementioned foreign funds. The vast influx of foreign investment, coupled with decreasing interest rates on traditionally safe investments like treasury bills and bonds, due in part to the dot-com bust and the terrorist attacks of September 11,


\(^{18}\) Id.
2001, led to intense competition for lending in the financial world. From 1996 until 2004, the investment rate in the United States stayed at approximately 19% of GDP, while the United States savings rate dropped to under 14% of GDP. Obviously, the investment rate cannot stay constant while the savings rate decreases without significant foreign investment propping up the investment rate.

However, the “significant decline in long-term real interest rates” made borrowing money on Wall Street easy. In the mid 2000’s, mortgage bankers were making fortunes from mortgage lending and, because of the low cost of capital, bankers were heavily leveraged (sometimes as much as a ratio of 40:1).

Smaller United States banks were subject to local leverage regulations, requiring them to maintain a sufficient amount of leverage for regulators to consider them “well capitalized,” but not so much leverage that they posed a risk to the market. Larger investment banks, however, are governed by the SEC, and prior to the Financial Crisis of 2008, were not subjected to leverage regulation. With a leverage ratio of 30:1, “a drop in asset prices of 3.3% will basically wipe [a company]

\[ \text{id} \]
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In 2008, that is exactly what happened to Lehman Brothers, Bear Stearns and the like as the housing bubble burst.\(^\text{27}\)

With low interest rates and little oversight by the SEC with regards to leverage, Wall Street investment banks borrowed money at an unprecedented rate, generating enormous returns on a “slim equity base.”\(^\text{28}\) The low interest rates and “easy money” on Wall Street led to a change in the investment banking business model.\(^\text{29}\) As the trading and underwriting practices that built Wall Street became commoditized, Wall Street investment banks turned to higher-margin products and became less dependent on steady client business.\(^\text{30}\) Instead, Wall Street investment banks began trading exotic mortgage backed securities and engaged in proprietary trading—that is, buying and selling investments with their own deposits, for their own accounts.\(^\text{31}\)


\(^{30}\) Id.

\(^{31}\) Stephen Gandel, *Is Proprietary Trading Too Wild for Wall Street*, Time, in Partnership with CNN, Feb. 5, 2010, http://www.time.com/time/business/article/0,8599,1960565,00.html (recounting the story of Lehman Brothers bond trader, Lawrence McDonald. In 2006, Lawrence McDonald asked an intern how he spent his winter break at Lehman Brothers. The intern told McDonald that he was trading derivatives for the firm. Taken aback by the interns role, McDonald asked him how much he was able to trade. The intern responded with an outrageous dollar figure of $150 million. “This kid didn’t even have a college degree,” McDonald said.).
Wall Street investment banks created complex mortgage backed securities and collateralized debt obligations, and then traded on them with the firm’s own, highly leveraged capital.

Housing values rose consistently in the United States from 1990 through 2005, and investment banks, commercial banks, lenders and homebuyers viewed real estate as the one investment that would always increase in value.\(^{32}\) However, historical data reveals that over the last 100 years, that was not necessarily the case.\(^{33}\) The housing price spike from the late 1990’s until the housing bubble burst in 2006 is exponentially greater than any housing price change in the United States since 1890.\(^{34}\) Historically, homes were never thought of as a mechanism to make Americans rich.\(^{35}\) However, from about 1998 through 2006 homes, were in fact, making Americans, and Wall Street investment bankers, rich.\(^{36}\)

As housing prices boomed in the early 2000’s, the mortgage market created complicated, and profitable mortgage agreements.\(^{37}\) These mortgages are classified as prime, jumbo, and subprime.\(^{38}\) Prime mortgages are sold to borrowers with good credit and who are able to fully document and disclose their income and jumbo mortgage borrowers have the same good credit and documentation, but they “exceed the $417,000 ceiling for mortgages that can be bought and guaranteed by government-sponsored enterprises” like Fannie Mae and Freddie Mac.\(^{39}\) Subprime


\(^{33}\) Id.

\(^{34}\) Id.

\(^{35}\) Id.

\(^{36}\) Id.


\(^{38}\) Id.

\(^{39}\) Id.
mortgages, the ones at the heart of the financial crisis, are “extended to applicants deemed the least creditworthy because of low credit scores or poor, or non-existent income documentation.” By 2006, subprime mortgages totaled 40% of all newly originated mortgages. The introduction of subprime lending made it easier for American’s to buy homes, and in 2004, a record 69.2% of Americans owned a home.

Fannie Mae and Freddie Mac were at the heart of the financial crisis--each government sponsored entity (“GSE’s”) bought billions of dollars worth of risky mortgages from lenders, allowed the lenders to originate even more subprime loans since the GSE’s were creating a demand for the mortgages, and then required a substantial government bailout when the housing bubble collapsed.

Presumably, investment bankers on Wall Street realized that the housing boom provided an opportunity. They began investing heavily, and creating exotic financial instruments to capitalize on the mortgage market. Investment bankers began purchasing mortgages, pooling them together, and then selling them as collateralized debt obligations (CDO’s).

CDO’s during the housing boom were comprised of mortgage-backed securities, often filled with subprime mortgages. Investment banks divided the CDO’s into categories, based on the riskiness, as rated by credit agencies, of the underling assets. However, as addressed by the U.S. and EU reforms of credit rating agency regulations, many credit rating agencies did not accurately and

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40 Id.
41 Id.
42 Morgenson, infra note 47.
44 Morgenson, infra, note 47.
46 Id.
responsibly rate the CDO’s and did not recognize that the housing bubble could collapse.\textsuperscript{47} It is apparent that credit rating agencies did not understand the complex nature or inherent risk of investment bank CDO’s filled with mortgage backed securities. Similarly, rating agencies and investment banks figured that, worst-case scenario, in the case of a default, they would receive a home with a relatively stable value as an asset.

Wall Street investment banks continued to leverage up, purchase subprime mortgages, and package and sell the mortgages as CDO’s while credit rating agencies continued to overrate the debt as AAA or BBB, and GSE’s continued to buy the securities. CDO’s “divide the streams of income . . . from the underlying mortgages into tranches that absorb default losses according to a preset priority.”\textsuperscript{48} The lowest rated tranches, usually not rated by the credit rating agency, contained the highest risk mortgages and were the first to absorb any losses from defaults.\textsuperscript{49} The middle tranch, usually BBB rated, would absorb the losses once the lowest rated tranch was empty, and the highest rated tranch, usually AAA, would absorb losses only if the two lower tranches totally defaulted.\textsuperscript{50}

However, in 2006, as the housing bubble began to collapse, investors, and investment bankers realized these securities were not as risk-free as once thought.\textsuperscript{51} If home values were stable, and homeowners were simply defaulting, the consequences of the housing collapse would have been far less drastic. However, the

\begin{footnotesize}
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\item\textsuperscript{48} DiMartino and Duca, \textit{supra} note 37.
\item\textsuperscript{49} \textit{Id}.
\item\textsuperscript{50} \textit{Id}.
\item\textsuperscript{51} \textit{Id}.
\end{itemize}
\end{footnotesize}
combination of defaulting homeowners, and decreasing home prices (now becoming bank assets) caused significant turmoil.

As the housing supply increased, and demand decreased, housing prices began to fall. Homeowners defaulted on their mortgages, largely due to adjustable rate terms as a result of less strict lending standards. As these foreclosed homes went up for sale in great quantities, neighboring homes also lost value because potential homebuyers did not want to purchase a home in a neighborhood where adjacent houses were also being foreclosed. “In the absence of home-price appreciation, many households [were] finding it difficult to refinance their way out of adjustable rate mortgages.” At this point, investment bankers, who leveraged millions of dollars to purchase mortgages from a mortgage broker, were stuck holding mortgages, or more often homes, that the investment bank could no longer sell the to the investor as a CDO. Similarly, when mortgage lender’s now tried to sell more mortgages to the investment banker, the banker had to turn the lender away because he could not sell the mortgages he was already holding.

As a result of the frozen housing market, and investment banks now stuck with worthless mortgages, investors “began to pull back from a wide range of credit markets, and financial institutions, reeling from severe losses on mortgages and other loans, cut back their lending.” As a result, many large financial institutions, now unable to borrow capital because of the increasingly frozen credit markets and their holdings of worthless houses, began to fail in September of 2008. Stock prices tumbled and obtaining any credit became nearly impossible, as lenders were afraid

52 Id.
53 Id.
54 Id.
55 Bernanke, supra note 17.
56 Id.
to lend money after the subprime mortgage disaster.\textsuperscript{57} “A rapid and deep contraction in global economic activity and employment resulted,” posing the question of how to reform America’s financial system, and restore economic stability to the U.S., EU, and world markets.\textsuperscript{58}

**III. The United States and European Union Respond to the Crises with Expansive, but Incomplete and Partially Competing Legislations**

On Thursday, July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter, “the bill”)—the most broad, wide reaching reform of the American financial system since the Great Depression.\textsuperscript{59} On July 21, 2010, President Obama signed the bill into law.\textsuperscript{60} The bill purports “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail,” to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices.”\textsuperscript{61} The bill is divided into sixteen titles, regulating everything from the size of a firm to the severance packages of directors.\textsuperscript{62}

Much like the United States, Europe is beginning to recover from their worst recession since the great depression in the 1930’s.\textsuperscript{63} The bursting of the United States housing bubble, and the EU’s exposure to the United States subprime

\textsuperscript{57} Id.
\textsuperscript{58} Id.
\textsuperscript{62} Lee, *supra* note 60.
mortgage market led to the failure of EU banks, including Northern Rock and Landesbank Sachsen, indicating that the crisis would not just threaten individual entities, but may pose a systemic risk to the entire EU economy.\textsuperscript{64} The combined real GDP of the 27 European Union nations grew just .5\% in 2008, and shrunk by 4.2\% in 2009.\textsuperscript{65} The European Commission forecasts a meager 1\% increase in the member states real GDP in 2010.\textsuperscript{66}

Much like in the United States, the credit markets in the EU dried up quickly, and consumer confidence quickly declined—leading to a significant decrease in demand for consumer durables and housing.\textsuperscript{67} Highly leveraged institutions that borrowed at a low rate, in part because of the savings surpluses of China, Japan and the Middle East, were now struggling to stay afloat.\textsuperscript{68} The crisis quickly spread across European Union member states because of the lack of business boundaries within the EU.\textsuperscript{69}

As a result of the contagion effect taking hold in the EU, the European Commission began work on an overhaul of their financial system and, with the United State’s policy response to the crisis in mind, began to develop their own financial legislation. Like the United States, a lack of transparency, oversight, regulation and responsibility exaggerated the effects of the EU’s financial crisis, as it dealt with the fallout from the bursting housing bubble, and with member nations,

\textsuperscript{64} Id. at 9-10.
\textsuperscript{66} European Commission, \textit{infra}, note 147, at 9-10.
\textsuperscript{67} Id.
\textsuperscript{68} Id.
\textsuperscript{69} Id.
such as Greece, who found themselves on the brink of bankruptcy because of excessive government spending and leverage.\textsuperscript{70}

\textbf{A. Financial Stability Oversight Council and the European Supervisory Authority}

\textit{a. Financial Stability Oversight Council}

Title I of the Dodd Frank bill creates the Financial Stability Oversight Council and the Office of Financial Research, both of which are created within the Department of the Treasury and Under the Secretary of the Treasury.\textsuperscript{71} The Financial Stability Oversight Council will “identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.”\textsuperscript{72} Similarly, the Council will eliminate the expectation that the government, in the event of a large company or multinational enterprise failure, will bailout the company and “shield” the stakeholders from losses.\textsuperscript{73} The council’s first and foremost duty is to “enhance the integrity, efficiency, competitiveness, and stability of the U.S financial markets” by identifying systemic risks and monitoring financial activity domestically and internationally.\textsuperscript{74} The council, as defined in Title I of the bill, is meant to identify and address the risk posed by multinational enterprises such as AIG, long before the government is forced to purchase, or bailout


\textsuperscript{71} Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §§111, 153 (2010) (enacted).

\textsuperscript{72} Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §112 (2010) (enacted).

\textsuperscript{73} Id.

\textsuperscript{74} Id.
the company. AIG, for example, received $85 billion dollars worth of federal funds because allowing AIG, whose stock was held by hedge funds and investment institutions all over the world, and was one of the major providers of credit default swaps, to fail, would have been “catastrophic.”

If the council deems by a 2/3 vote that a company poses a systemic risk to the financial system and requires increased supervision, the council may determine that the Board of Governors of the council shall supervise the company. The determining factors governing supervision of a company give the council broad discretion, allowing them to justify supervision based on leverage, interconnectedness, or “any other risk related factors that the council deems appropriate.” The council also has the authority to limit the continuation and scope of business activities for bank holding companies with assets in excess of

76 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 113(2)(a-k) (2010) (enacted) (considerations in determining what companies the council shall supervise include: “(A) the extent of the leverage of the company; (B) the extent and nature of the off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies; (I) the amount and nature of the financial assets of the company; (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (K) any other risk-related factors that the Council deems appropriate.”).
77 Id. at § 113(2)(k).
$50,000,000,000, if it determines that the company poses a “grave threat” to the United States financial system and stability.\textsuperscript{78}

To assist with the enormous task of monitoring the nation’s, and world’s, financial institutions, the bill creates the Office of Financial Research. The Office is to “support the Council in fulfilling the purposes and duties of the Council” by “collecting data,” “performing research,” and developing risk management and measurement tools to further the purpose of the Council.\textsuperscript{79}

Prior to the adoption of the bill, government did indeed have the power to prevent, or at least curb, the severity of the crisis. However, a lack of corporate governance in the private sector, coupled with a lack of government oversight in the public sector, led to the perfect storm of micro and macro economic factors to cause a global financial crisis. The New York Federal Reserve had the power to monitor and regulate financial institution lending practices, and had the manpower and information to do so—yet, they did not step in to stop the questionable loaning practices of many of the United States’ financial institutions.\textsuperscript{80} Similarly, the Securities and Exchange Commissions’ lack of regulation on liquidity standards, coupled with the case by case, “on again off again” bailout policy of the federal

\textsuperscript{78} Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. § 121(a) (2010) (enacted).

\textsuperscript{79} Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §153(a)(1-7) (2010) (enacted) (Noting that “the purpose of the Office is to support the Council in fulfilling the purposes and duties of the Council, as set forth in subtitle A, and to support member agencies, by— (1) collecting data on behalf of the Council, and providing such data to the Council and member agencies; (2) standardizing the types and formats of data reported and collected; (3) performing applied research and essential long-term research; (4) developing tools for risk measurement and monitoring; (5) performing other related services; (6) making the results of the activities of the Office available to financial regulatory agencies; and (7) assisting such member agencies in determining the types and formats of data authorized by this Act to be collected by such member agencies.”).

\textsuperscript{80} John B, Taylor, The Dodd-Frank Financial Fiasco The bill all but guarantees bailouts as far as the eye can see, while failing to address real problems like Fan and Fred and our outdated bankruptcy code, The Wall Street Journal, July 1, 2010, http://online.wsj.com/article/SB1000142405274870342600457538732174405398.html.
reserve, led to a lack of consumer and investor confidence, and inconsistent policy that “spooked” the financial sector and ultimately led to its collapse.\textsuperscript{81}

The new bill, however, vastly ignores issuing improvement mandates to existing government entities, and grants extreme, autonomous authority to the newly created committees and oversight boards. On numerous occasions, the bill authorizes a committee to act as it “determines necessary” for the best interest of the investors, but such power leaves the implementation of the goals of the bill up to the individual committee.\textsuperscript{82} Moving forward, future legislation should seek to remedy the already established financial oversight institutions in order to promote consistency and curb government spending, instead of creating new agencies, and new expenditures to enforce governance that should already be implemented by current government and federal agencies.\textsuperscript{83}

Title I of the bill grants broad discretion and little guidance to the government in supervising companies. What the council deems a “grave threat” or an appropriate “risk related factor” is yet to be decided. However, Title I certainly makes it difficult for companies to become “too big to fail” and helps the government disband large, complex companies that are deeply intertwined with the global economy.\textsuperscript{84}

\textit{b. European Supervisory Authority}

Many EU banks are owned and operated by a country other than the one in which the bank is located and, thus, in order to protect depositors and detect unsafe

\textsuperscript{81} Id.

\textsuperscript{82} See, e.g, Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §§342(f)(6), 408(2) (2010) (enacted).

\textsuperscript{83} See Taylor, \textit{supra} note 80, (noting that the Bureau is in charge of drafting rules for all financial services, many of which have no tie to the financial crisis.).

business practices, the European Commission has established a EU-wide
Supervisory Authority. The European Commission established a Supervisory
Authority to “protect the public interest by contributing to the short, medium and
long-term stability and effectiveness of the financial system.” The Authority shall
focus on improving the functioning of the EU markets and promote consistent,
effective, regulation and encourage transparency.

The Supervisory Authority has the power to draft regulatory standards,
develop guidelines and recommendations, and collect information necessary for the
Authority to promote its purposes.

The Authority also has the duty to protect consumers across financial
markets not only by collecting and disseminating financial information, but by
providing widespread, unsolicited public warnings regarding EU financial threats.

Like the power granted to the Financial Stability Oversight Council in the
Dodd Frank bill, the Authority may identify financial dealings that pose a systemic
risk to the EU economy and prohibit or restrict such activity in the EU. The
Authority’s power, unlike that of the Financial Stability Oversight Council, however,
is limited strictly to developing and protecting technical standards—it may not
implement strategic decision or policy changes. Uniquely, the authority is to serve

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87 Id. at Article 1(4)(i, iii).
88 Id. at Article 1(a)(i)
89 Id.
90 Id.
as the liaison between member states if there is a disagreement on the actions of another authority in a member state.\textsuperscript{92}

\textit{B. U.S' Orderly Liquidation Authority}

Title II of the bill creates the Orderly Liquidation Authority to “liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.”\textsuperscript{93} The Authority is to exercise its power to assure that, in the event of liquidation, creditors and shareholders bear the loss, that “management responsible for the condition of the financial company will not be retained,” and that all parties contributing to the losses of the company bear losses in proportion to their relative responsibility.\textsuperscript{94}

Title II sets out guidelines for the liquidation of a corporation and places an emphasis of the appropriate parties, managers or shareholders, bearing losses in proportion to their responsibility or investment in the company.\textsuperscript{95}

\textit{C. Enhancing Financial Institution Safety and Soundness Act and Improving EU Investor Confidence}

\textsuperscript{92}\textit{Id.}
\textsuperscript{93}Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §204(a) (2010) (enacted).
\textsuperscript{94}\textit{Id.}
\textsuperscript{95}Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §206(1-6) (2010) (enacted) (discussing the mandatory terms for liquidation. “In taking action under this title, the Corporation shall— (1) determine that such action is necessary for purposes of the financial stability of the United States, and not for the purpose of preserving the covered financial company; (2) ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid; (3) ensure that unsecured creditors bear losses in accordance with the priority of claim provisions in section 210; (4) ensure that management responsible for the failed condition of the covered financial company is removed (if such management has not already been removed at the time at which the Corporation is appointed receiver); (5) ensure that the members of the board of directors (or body performing similar functions) responsible for the failed condition of the covered financial company are removed, if such members have not already been removed at the time the Corporation is appointed as receiver; and (6) not take an equity interest in or become a shareholder of any covered financial company or any covered subsidiary.”).
a. Enhancing Financial Institution Safety and Soundness

Title III of the bill, the “Enhancing Financial Institution Safety and Soundness Act of 2010,” provides for the “safe and sound operation of the banking system of the United States.” The Act streamlines the supervision of commercial banks and transfers the old duties of the Office of Thrift Supervision to the Board of Governors of the Federal Reserve. Most notably, however, the Act increases the maximum amount insured under the Federal Deposit Insurance Act from $100,000 to $250,000.

b. Investor Confidence in the EU

FDIC insurance serves to protect bank depositors, and helps give those depositors a sense of confidence and security in their bank, even during a crisis. However, investor confidence fell sharply in the United States in late 2008 and through early 2009. European Union investor confidence followed suit, with the decline amongst EU member states reaching its lowest point in March, 2009. The following regulations and initiatives, are aimed at controlling the investments of financial institutions, multinational enterprises, and individual investors, and at “building] an atmosphere of mutual confidence and predictability between business, labor and governments.” Institutional investors and individual investors need to

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have confidence that the investment “game is fair and equitable for all.”\textsuperscript{101} If multinational enterprises cannot convince institutional and individual investors that the enterprises’ incentives are aligned with the investors, and the government cannot convince these investors that the new regulations will help align those incentives, investment into multinational enterprises, and thus the economy as a whole, will slow.

\textit{i. Deposit Guarantee Schemes}

In order to prevent bank runs in the wake of the current and any future financial crises, the EU Commission has proposed reforms to deposit guarantee schemes to raise the coverage level, reduce the time of the payout, and ensure that consumer banks are appropriately and sufficiently financed.\textsuperscript{102} As the crisis of 2008 developed, the European Commission acted quickly in order to insure depositors.\textsuperscript{103} The EU’s deposit guarantee schemes are essentially the European version of United States FDIC insured banks,\textsuperscript{104} and work as a deterrent against bank runs and catastrophic financial failure, but do not serve as a total safe haven for depositors with more accounts worth more than 100,000 euros in the EU, or $250,000 in the United States.

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The EU commission has now proposed, to be effective by 2012, new legislation regarding deposit guarantee schemes in order to provide better coverage, faster payouts, less red tape, better consumer information and promote long term and responsible financing.\textsuperscript{105} The EU’s plans to promote responsible financing by banks revolve around a four step plan that includes the allowance of ex ante and ex post contributions to failing banks, and permits “mutual borrowing” between banks.\textsuperscript{106}

The European Commission states that “not only will Europeans have better protection for their savings, but they can now also choose the best savings product in any EU country without worrying about differences in protection.”\textsuperscript{107} However, the proposed solutions for more responsible funding will inevitably lead to increased taxes on the banks, if the government is forced to provide ex post or ex ante funds. Similarly, and despite the saving benefits and increase protections of a pan-European Deposit Guarantee Scheme, the EU has no plans to implement such a scheme and, despite breaking down some barriers to banking trade in the EU, will still isolate each country with its own deposit guarantee scheme.\textsuperscript{108}

Similarly, as we saw in the United States during the financial crisis, interbank lending is unlikely in a frozen credit market. Upon the failure of a small bank during non-recessory times, large lending and depository institutions will be able to come to the rescue without government intervention. However, upon the failure of a systemically important consumer bank, or upon the failure or any bank

\textsuperscript{105} Id.
\textsuperscript{106} Id.
\textsuperscript{107} Id.
during recessory times, the ability or inclination of other banks to lend is unlikely, when those banks are struggling to meet their own obligations.

**ii. Investor Compensation Schemes**

In 1997, the EU Commission adopted the Investor Compensation Schemes Directive that allowed for investors using investment services, be it individual investors, institutional investors, or multinational enterprises with an investment portfolio with an investment service, to be compensated where an investment firm or credit institution, under certain circumstances, failed to return money or financial instruments to the investor.\(^\text{109}\) However, the Directive failed during the 2008 financial crisis, as the inconsistency of its implementation across member states led to diverse results on similar investor claims.\(^\text{110}\) As a result, the EU Commission is amending the directive to provide a single market for investor services, increase investor protection and in turn, increase investor confidence.\(^\text{111}\) The amended directive leaves the implementation of the directive up to the member states, and provides that “member states shall ensure that the schemes provide coverage where financial instruments or monies are held, administered or managed for or on behalf of an investor.”\(^\text{112}\) The proposal provides for better coverage, increasing the minimum level of compensation from 20,000 to 100,000 Euros per investor by the end of 2010, faster payouts, requiring investment banks to distribute compensation within 9 months, and reducing the payout period for non investment banks from 3 months to 4-6 weeks, improved information transfer to investors regarding the

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\(^{110}\) *Id.*

\(^{111}\) *Id.*

\(^{112}\) *Id.* at 11(c).
ability of the bank to cover their investment, wider coverage, made to include
coverage on defaulting third parties so that frauds such as the Bernie Madoff ponzi
scheme will be covered, and again, provide for long term and responsible financing
that includes mutual borrowing provisions.113

D. The Private Fund Investment Advisers Registration Act and Hedge Fund
Regulations in the U.S. and the EU

a. Private Fund Investment Advisers Registration Act

Known as the “Private Fund Investment Advisers Registration Act of 2010,”
Title IV of the bill requires “hedge funds and private equity advisors to register with
the SEC as investment advisers and provide information about their trades and
portfolios necessary to assess systemic risk.”114 The registration and regulations
requirements, however, are far less stringent than their European Union
counterparts, and are unlikely to restrict investment in United States.115 Title IV
also provides for greater state supervision of hedge funds by raising the minimum
amount of assets necessary for federal regulation from $30,000,000 to
$100,000,000.116 By increasing the minimum asset requirement, the bill gives states
more leeway to regulate smaller hedge funds, and allows the SEC to “focus its
resources on newly registered, high risk hedge funds.117

113 Europa.eu, infra note 180; EC.Europa.eu, EU-US Comparison on Financial Regulation
(G20 Commitments Progress Table), 1, http://ec.europa.eu/commission_2010-
Dec. 10, 2010).
114 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
115 See Europa.eu, supra note 113.
116 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong.
117 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
Title IV significantly increases the mandatory reporting requirements for high net worth hedge funds and individuals, but provides an exception for investment advisers acting only as advisors to private funds with less than $150,000,000 in assets in the United States.\textsuperscript{118} In such a scenario, however, the Act requires the advisor to maintain accurate and relevant records and to provide reports to the SEC at least annually, or as the SEC “determines necessary or appropriate in the public interest or for the protection of investors.”\textsuperscript{119} Again, the Act gives the SEC substantial discretionary power in determining which hedge funds and private equity funds necessarily must disclose information to the SEC.

\textit{b. Hedge Fund and Private Equity Regulation in the EU}

The proposed legislation creates the European Securities and Markets Authority to regulate hedge funds and private equity, and gives the authority the power to limit the amount of leverage used by hedge funds if the authority sees the leverage as posing a risk to financial markets or the economy.\textsuperscript{120} The proposed EU rules will require hedge funds and private equity funds to register with financial authorities in the EU in order to operate.\textsuperscript{121} Hedge fund managers must seek approval from their supervisors with regards to how much leverage and risk they can operate with.\textsuperscript{122}

The proposal will pose a significant burden for U.S hedge funds when it is passed. The new rules create a “passport” that allows hedge funds to operate in all

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\item \textsuperscript{118} Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §408(m)(1) (2010) (enacted).
\item \textsuperscript{119} Id.
\item \textsuperscript{120} Matthew Dalton and Nicholas Winning, \textit{Hedge Funds Get Tougher Rules in EU}, Oct. 20, 2010, \texttt{available at}, http://online.wsj.com/article/SB10001424052702304510704575561912232031020.html?KEYWORDS=eu+hedge+fund+and+private+equity.
\item \textsuperscript{121} Id.
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27 member states. However, in order to get a passport, a hedge fund manager will have to show that they are in full compliance with the EU directive; for U.S based hedge funds, that means that they would have to follow EU law in the U.S. Similarly, the regulation requires that all private equity groups disclose their investment strategy—a regulation aimed at eliminating “asset stripping.” The asset stripping provisions will force the private equity investor who takes over a company to develop a more long-term strategy for management, instead of “stripping” value out of the firms assets in the short term.

The EU hedge fund regulations make it difficult, if not impossible for United States based hedge funds to operate in the European Union. The British Private Equity and Venture Capital Association warned that the EU’s “excessive administrative burden” on hedge funds and private equity would drive profitable business out of the EU and to other leading financial markets such as Duabi, Zurich and New York City. The rules requiring full compliance with EU hedge fund law and requiring the obtainment of a passport to operate in the EU will place significant costs on foreign hedge funds. Similarly, such stringent regulation for domestically run EU hedge funds will limit the funds ability to compete in the global

124 Id. (The directive includes a provision on hedge fund manager and employee pay that can require managers to defer up to half of their compensation for 3 years. The hedge fund model in the U.S is dependent on big bonuses to retain employees, thus making compliance with EU law very difficult.).
125 Jones, infra, note 200.
market, as their requirements for full disclosure of their assets, securities and investment measures will hamper the funds’ relative competitiveness.

E. Federal Insurance Office Act of 2010 and Insurance Guarantee Schemes in the EU

a. Federal Insurance Office

Title V of the bill, the “Federal Insurance Office Act of 2010,” establishes the Federal Insurance Office within the Department of the Treasury. The office may “monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States,” monitor the availability of insurance to low and moderate income families, recommend an insurer to the Financial Stability Oversight Council for supervision, and serve as a national representative for the United States on global insurance issues. Similarly, the Office has broad power to require an insurance group, or any affiliate thereof, to submit information as the “Office may reasonably require” in fulfilling the duties and functions set forth in the Act. Once again, the Act sets forth broad language and does not explicitly define the scope of the Office’s power, leaving the amount of government intervention and oversight up to the discretion of the office.

130 Id.
b. Insurance Guarantee Schemes

If the deposit guarantee and investor guarantee schemes fail because of insufficient private funding, or the collapse of the insuring institution, the EU’s proposal on Insurance Guarantee Schemes will provide a last line of protection to consumers.\textsuperscript{131} Despite the commonality of the deposit and investor guarantee schemes throughout the EU, there is no such common scheme in the insurance sector.\textsuperscript{132} The legislation seeks to unify the insurance guarantee schemes across the EU, ensure that no more than 1 in 200 insurance providers go bankrupt in a single year, and protect insurers who purchase policies across international borders.\textsuperscript{133}

\textit{F. Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act and EU Capital and Liquidity Requirements}

\textit{a. Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act}

Title VI, entitled the “Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010,” implements the highly controversial Volcker rule that curbs proprietary trading and reinstates the firewall between investment and commercial banks.\textsuperscript{134} Proprietary trading is when a bank trades with its own funds, and was a major cause of the financial crisis, as banking institutions held billions of dollars worth of mortgage backed securities.\textsuperscript{135} Section 603 of the bill states that the FDIC may “not approve an application for deposit insurance . . . for an industrial bank, a credit card bank, or a trust bank that

\textsuperscript{132} \textit{Id.}
\textsuperscript{133} \textit{Id.} at 3-4, 8.
\textsuperscript{134} Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111\textsuperscript{th} Cong. §§601, 603(a) (2010) (enacted); see also, Gramm-Leach Bliley supra note 11, repealing the firewall between commercial and investment banks.
\textsuperscript{135} See Gandel, \textit{supra} note 31.
is directly or indirectly controlled by a commercial firm.”¹³⁶ The Act is aimed to promote the stability of commercial and investment banks, and replaces the firewall between commercial and investment banks that was removed when Glass-Steagall was repealed.

b. Capital Requirements for Financial Institutions

The EU is set to transpose the Basel framework into EU law by the end of 2010. The regulation imposes new capital quality, capital requirement, leverage ratio requirements and liquidity requirements on EU member banks.¹³⁷ Similarly, the legislation imposes additional requirements regarding compliance, processes, discretionary powers, and introduces the possibility of counter cyclical hedging measures.¹³⁸

The new legislation in the Capital Requirements Directive require that banks hold 4.5% of tier 1 capital in the next 5 years, and 7% after eight years.¹³⁹ The capital requirement will help financial institutions better meet the new leverage ratio requirements of the Basel legislation. During the crisis, leverage ratios in excess of 40:1 led to an accelerated and exaggerated world-wide credit crunch. The new tier 1 leverage requirements limit banks to a leverage ratio of 33:1 on tier one capital.¹⁴⁰

The European Commission has conducted a public consultation regarding possible countercyclical buffer requirements that would require banking institutions

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¹³⁷ *Id.* at 6.
¹³⁸ *Id.*
to build up reserves during good economic times to support the bank when economic conditions worsen.\textsuperscript{141} The need for a public consultation on such a proposal is obvious, since enforcing countercyclical measures would force banks to pass up positive return on investment projects during good economic times in favor of building reserves for poor economic times. Thus, shareholders would give up potential gains during economic booms to protect against losses during contractions. But, such a countercyclical requirement should be left to the sole determination of multinational banks boards and shareholders, and should not be mandated by the government. Despite the necessity of some government intervention in financial institutions, mandating countercyclical buffers while sacrificing shareholder returns entails the government entering the management of the multinational enterprise, not just regulating it.

\textit{G. The Wall Street Transparency and Accountability Act and Crisis Management Measures in the EU}

\textit{a. The Wall Street Transparency and Accountability Act}

The “Wall Street Transparency and Accountability Act of 2010” gives the Securities and Exchange commission, and the Commodity Futures Trading Commission the authority to oversee derivative trading and swaps, such as the credit default swaps that led to the demise of many of America’s financial institutions, and ensures that any excessive risk taken on by banks is regulated.\textsuperscript{142} The Act also creates a central clearing house for the review of derivate trading and collection of information regarding derivatives trading, and gives the SEC the authority to prohibit corporations not domiciled in the United States from engaging

\textsuperscript{142} See Brief Summary of Dodd Frank Financial Reform Bill, \textit{supra} note 84.
in risky swaps in the United States. The Act establishes regulations to protect pensions, endowments, or public funds and adds safeguards to ensure that swap dealers have the adequate financial capital to meet their obligations.

b. Banking Sector - Crisis Management Measures in the EU

During the financial crisis of 2008, numerous EU member state governments had to step in to save failing banks. However, the governments acted under their domestic law, as there was not EU framework for managing banking crises. As a result, the EU is in the midst of developing legislation to regulate the financial industry, both in its member states and across borders. Much like the United States, the EU wants to avoid future bailouts of their member state’s private banks. The goal of the legislation is to be able to allow financial institutions, even systemically important ones, to fail without posing devastating risks to the financial system as a whole, and without placing a burden of repayment on taxpayers.

The European Commission does not have plans to appoint a EU-wide governing body, but rather, will mandate that each member state appoints a board to carry out the legislation, thus, allowing the member states to retain some of their own regulations. However, the challenge lies in implementing arrangements that ensure that the supervisory authority has the power to unwind failing banks across

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144 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
146 Id.
148 Id. at 2.
149 Id. at 4, 12.
borders. The proposal, to be enacted in 2011, should ensure that the European Banking Authority has the role of “coordination and support in crisis situations, without impinging on the fiscal responsibilities of the member states.” However, without an EU wide governing body, conflicts of interests between the member state’s governing bodies, who want to protect their domestic economy, and the European Banking Authority, who wants to protect the interest of the EU as a whole, are inevitable.

Like the United States, the EU commission’s goal is to not have to respond to a systemic crisis, but rather, to be able to curb a financial crisis before it begins through monitoring and preparation. The new legislation will reinforce supervision of financial institutions and require each institution to present an annual risk assessment report, and require “greater and more systematic use of on-site supervisory examinations.”

Similarly, the commission will require detailed recovery and resolution plans from all credit institutions and financial firms covered by the legislation in the event that a financial firm began to fail. The plans are to be detailed and realistic, and are not to “assume access to any support from public funds.” However, the Commission leaves the breadth and depth of the plans relatively undefined, stating that the requirement to prepare such a plan is only proportional to the size of the firm, the nature of its funding, and the systemic risk it would pose to the market.

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151 Id.
152 Id.
153 Id. at 6.
Such a lose requirement will undoubtedly dampen the effect of the asset-unwinding legislation, as it provides for inconsistent and unquantifiable standards for asset unwinding a corporation.

Like the Dodd-Frank Financial Reform Bill, the EU Commission will implement a supervisory board that has the power to intervene with the operations of a financial institution that is likely to fail. The board will be able to prohibit dividend payments, require the replacement or dismissal of managers or directors, and require a financial institution to disclose activities that pose a systemic risk to the financial system.155 In the event of the failure or a financial institution, the EU commission will implement a set of “resolution tools” that will “enable authorities to effect a sale of the credit institution or parts of its business to one or more purchasers without the consent of shareholders.”156 The tools will also allow the transfer of the entire failing institution’s business to a “bridge bank” in order to manage the failure of the bank without totally disrupting the banks services.157

While the preventatory framwork of the EU legislation mirrors the Dodd Frank bill in some respects, the EU Commissions has proposed that a national fund be established to support future bank resolutions,158 which is, in essence, a public bailout fund. The Commission acknowledges that while creditors and shareholders will be the first source of funding, it is unlikely that such bailout financing will be sufficient.159 Thus, the creation of a specified bailout fund is necessary to “ensure that resolution is a credible option.”160 While the Dodd Frank financial reform bill leaves open the possibility of a bailout, in the event that a systemically important

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155 Id at 8.
156 Id. at 9-10.
157 Analytica, infra note 167.
158 H.R 4173, infra note 166, at 14.
159 Id.
160 Id.
institution began to fail, the burden on taxpayers would be ex post, and would be
deependent upon the amount of money received from shareholders and creditors. The
European Commission’s legislation on bailout funds, however, is an ex ante
collection of taxpayer dollars that will exist indefinitely in the short term, effectively
insuring systemically risky institutions with already collected European taxpayer
dollars. Despite the European Commissions efforts to make it clear that the funds
are not insurance against failure, moral hazard problems undoubtedly still exist.161
While the Dodd Frank bill does not completely eliminate the possibility of publicly
funded bailouts, it at least disincentivizes grave risk taking by financial institutions
because the taxpayer bailout funding will have to be collected ex post of the failure.
Thus, there is some possibility that the failing institution will not be saved.
However, the ex ante collection of taxpayer dollars for bailouts in the EU serves to
place an unnecessary burden on taxpayers, and to incentivize risk taking by
financial institutions and multi national enterprises.

A public bailout fund provides little incentive for large financial institutions
and multinational enterprises to avoid the need for a bailout. Although an
institution that receives bailout funds will have to repay the loan, and the damage to
its shareholders and goodwill may be substantial. Knowing that the EU has the
public bailout fund as a backstop, should the company encounter financial trouble,
will disincentivize managers from avoiding risks with possible substantial returns.
Thus, a large financial institution, or multinational enterprises that does not protect
against the need for a public bailout will still be capable of causing global credit and

161 European Commission, *Communication from the Commission to the European
Parliament, the Council, the European Economic and Social Committee and the European
Central Bank-Bank Resolution Funds*, 4 May 26, 2010, available at
http://ec.europa.eu/internal_market/bank/docs/crisis-
transactional markets to contract, hampering business and profitability across national boundaries.

H. The Payment, Clearing and Settlement Supervision Act

The “Payment, Clearing, and Settlement Supervision Act of 2010” is designed to reduce systemic risk and increase the financial stability of the system by creating and promoting uniform standards for risk management and payment activities of financial entities.162

I. Investor Protection and Securities Reform Act, EU Executive Pay, and U.S. and EU Credit Rating Agency Reform

a. Investor Protection

The “Investor Protection and Securities Reform Act of 2010” aims to increase investor protection, increase regulatory enforcement, improve the regulation of credit rating agencies, improve the asset backed securitization process, and improve accountability and executive compensation standards.163 The Act establishes an Investor Advisory Committee whose sole purpose is to advise and consult the SEC on regulatory priorities of the SEC and issues and initiatives designed to “protect investor interest” and “promote investor confidence” in the securities market.164 Subtitle B creates protections and incentives for whistleblowers, and offers significant compensation, up to 30% of funds recovered, to the reporting person.165 The subtitle also provides that an employer may not “discharge, suspend, threaten, harass . . . or discriminate against a whistleblower because of any lawful act done by

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the whistleblower.” However, it is unlikely that this provision generates any significant increase in the number of whistleblower claims because, despite the prohibition against retaliation, enforcing such a remedy is difficult to monitor and detect.

b. EU Executive Pay

As part of the adopted legislation on capital requirements, the EU has adopted a directive that places stringent compensation and bonus requirements on financial executives in the EU. The requirements limits cash bonuses to 30% of the overall bonus, and limits cash bonuses even further, to 20%, for large bonuses. The directive also mandates that half of the bonuses are paid in contingent capital or shares, and that at least 40% is deferred for three to 5 years. Similarly, the directive allows for a hedge fund manager to take back bonuses if “the future performance of the individuals transactions turns out to be weaker than predicted.” Unlike much of the financial reform legislation in the EU, the regulation of hedge funds will be left to the state. However, the U.S is not taking similar action with regard to hedge funds and executive pay, and such a schism in the cross-Atlantic legislation will place EU hedge funds and banks at a disadvantage. The U.S has adopted a supervisory approach to executive compensation, instead of the regulatory approach adopted in the EU.

168 Id.
169 Id.
170 Id.
171 Id.
172 EC.Europa.eu, EU-US Comparison on Financial Regulation (G20 Commitments Progress Table), 3, http://ec.europa.eu/commission_2010-
Because of the reliance on credit rating agencies in the financial world, Subtitle C addresses improving the regulation of credit rating agencies in order to prevent overrating of financial institution assets and debt instruments. The Act requires that nationally recognized rating agencies “establish, maintain, enforce and document” internal controls governing the determination of their ratings. Similarly, these rating agencies must disclose their methodologies, third party relationships, and track records so the government and investment institutions may better assess the validity of the agency ratings.

The Act, in the interest of investor protection, will now allow investors to bring private actions against rating agencies for “a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source.” In furtherance of investor interest, the Act forces the SEC to create a mechanism to prevent ratings shopping, whereby firms issuing securities choose the rating agency willing to give their assets the highest rating.

The EU adopted a Regulation on Credit Rating Agencies on September 16, 2009. Prior to the adopted regulation, many credit rating agencies were not regulated by the member states, despite their vitality to the financial system. The goal, much like in the United States, is to insure independence amongst and

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175 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
176 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
177 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
reliability in the credit rating agencies, so to enforce the necessary due diligence and separation of interests amongst the credit rating agencies, investors, and financial institutions.

d. Compensation and Corporate Governance in the United States

Subtitle E of the act establishes regulations for executive compensation and corporate governance. Most notably, subtitle E requires shareholder approval of executive compensation by proxy or consent or authorization of shareholders.\(^{179}\) However, while requiring shareholder approval, the act also states that this vote is not binding on the issuer of the securities or on the board of directors, and does not overrule the decisions of the issuer or board, imply any additional liability or fiduciary duty.\(^ {180}\) Even with the illusion of shareholder power in determining executive, the act does require that public companies take away executive compensation if the compensation was based on inaccurate financial information.\(^ {181}\)

J. The Bureau of Consumer Financial Protection

Title X creates the Bureau of Consumer Financial Protection, and places a $500 million dollar annual budget, that does not require approval from congress, in the hands of the Bureau’s director.\(^ {182}\) The head of the Bureau is appointed by the President, and confirmed by the advice and consent of the senate.\(^ {183}\) The Act grants the Bureau a wide range of power, authorizing it to “establish the general policies of


\(^{181}\) See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.


the Bureau with respect to all executive and administrative functions.” The Bureau has the authority to examine and enforce regulation on banks and credit unions with assets over $10 billion dollars, and establishes a committee who offers guidance and assistance to consumers purchasing financial products that are typically underserved by their local regulatory agencies. The “Bureau shall seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.” In essence, the Bureau will serve as a national better business bureau for consumer financial products and serve as a liaison between government and financial institutions, large or small. However, the large budget and extraordinary power granted to the director of the Bureau could allow a single person to greatly influence the state of the American financial system.

**K. Federal Reserve Reform**

Title XI, entitled the Federal Reserve System Provisions, redefines the scope of the Federal Reserve. The title prohibits emergency lending to an individual entity and, thereby, makes it more difficult for the government to loan large sums of money to failing institutions and multinational enterprises. The Secretary of the

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187 See Brief Summary of Dodd Frank Financial Reform Bill, supra note 84.
Treasury must approve all such 13(3) lending programs. However, even if the Fed lends money to a firm, the collateral must be “sufficient to protect taxpayers from losses.” But, the bill authorizes emergency lending “for the purpose of providing liquidity to the financial system” as a whole. Thus, for firms that pose systemic risks to the financial system, the bill would authorize government bailouts since injecting capital into such a firm would provide liquidity to the financial system as whole. This provision is designed to end “too big to fail” bailouts and ensure there is appropriate accountability within the fed, and appropriate elimination of conflicts of interests between the Fed, its directors, and private entities.

Despite the bill’s advocacy against any future government bailouts, the bill leaves open the possibility that firms, once again, deemed to big to fail would be bailed out by the government. Title XI authorizes emergency lending “for the purpose of providing liquidity to the financial system,” and, because of the interconnectivity of the banking and financial system, such a provision will undoubtedly lead to the qualification of the country’s largest investment banks. Under Title XI, the Treasury is given the authority to determine the “policies and procedures governing emergency lending.”

It is difficult to imagine that, when faced with a single failing institution with the capability of bringing down the entire financial system and causing chaos in the global markets, that the Treasury would allow that institution to fail. The bill does

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188 Id.
189 Id.
190 Id.
191 Id.
not prohibit such a bailout, if the Treasury and Federal Reserve classify it as providing liquidity to the financial system. The argument, in essence, would be based around a trickle down effect, whereby providing large amounts of capital to large, failing banks, the banks subsidiaries and counterparts would benefit from the capital injected into the economy.

Rather than focus on the ability of the Federal Reserve, FDIC, and Treasury to react to a failing institution, the bill should emphasize corporate governance and preventative measures to keep financial institutions from falling into bankruptcy as abruptly as they did in 2008. Failing to bail out a largely intertwined financial institution, such as AIG, would have had devastating effects on the American economy.\(^{194}\) It was, and still is, unrealistic to expect the legislature to take away the governments ability to bail out a single institution when the value of that institutions assets reach into the tens of billions, and its failure would send the financial markets spiraling towards extinction. The catch 22 lies in that, in order to prevent a single institution from becoming “to big to fail,” the government has to limit the institutions size, beyond the scope of the limitations provided by anti-monopoly law.\(^{195}\) By providing bailouts to the firms that are “to big to fail,” the government perpetuates the firm’s existence, while allowing smaller firms, who do not pose an equal systemic risk, to fail.\(^{196}\) Having a to big to fail provision, or any provision that authorizes the government to bail out institutions, leads to an


\(^{195}\) See Sharon E. Foster, \textit{Too Big to Fail – Too Small to Compete: Systemic Risk Should be Addressed Through Antitrust Law but such a Solution Will Only Work if it is Applied on an International Basis}, 22 Fla. J. Int’l L. 31, 32-64 (2010) (discussing the need to international antitrust law to govern companies that pose a systemic risk to the financial sector).

\(^{196}\) \textit{Id.} at 54.
elimination of competition at the margins. Similarly, the simple knowledge for large institutions that the government will bail them out in the event of failure perpetuates the risk taking measures that led to the collapse of the financial system to begin with. With no real threat of failing for institutions that know they are systemically intertwined so that their failure would cause a near collapse of the financial system, the government has few mechanisms, other than the threat of allowing the institution to fail, to curb risky bets and investments. Once the government identifies a firm as being too big to fail, it automatically protects the investor’s money, and encourages both institutional and non-institutional investors to funnel funds into the company that is, basically, insured by the government. Thus, the ultimate outcome is that small firms are allowed to fail, and the big firms get bigger because of investors inclination to invest in firms that are essentially, government insured.

L. Improving Access to Financial Institutions

The “Improving Access to Mainstream Financial Institutions Act of 2010” aims to incorporate millions of low and moderate income Americans who are typically not a part of financial institutions and investments into the financial system. The act encourages investment by low and moderate-income families and individuals into FDIC insured financial institutions. The Act also issues a loan loss reserve fund provision designed to help smaller institutions establish low dollar loan provisions and defray some of the costs of the new regulations.

M. The Pay it Back Act

197 Id. at 56.
198 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. §1202, 1204(a-b) (enacted).
199 Id.
The “Pay it Back Act” ensures that any money acquired by the Treasury from the sale of troubled assets purchased with the $700 billion issued in the 2008 bailout are dedicated to deficit reduction and prohibited from offsetting other spending increases by government.201

**N. Mortgage Reform and Predatory Lending**

The “Mortgage Reform and Anti Predatory Lending Act” establishes that all lending institutions must ensure that their borrowers can repay the loans they are issued.202 The act prohibits the kind of lending that led to many foreclosures, and caused other homeowners to walk away from their underwater homes, during the financial crisis by eliminating incentives for such subprime loans.203 Lenders who do issue subprime loans in violation of the act will be subject to significant penalties, including up to three years of interest payments plus attorneys fees.204

Leading up to the financial crisis, many homeowners were led into adjustable rate mortgages that left them unable to pay their mortgage as housing prices decreased. This Act requires lenders to disclose the maximum a borrower could end up paying on an adjustable rate mortgage, and conduct due diligence in determining the suitability of the borrower.205 No longer will mortgage brokers be able to issue no document loans. However, the financial burden the regulation places on smaller lending institutions could cause significant contraction within the lending industry, and small lenders will be unable to bear the costs to come into compliance with the legislation. As a result, the prospect of shrinking the size of the GSE’s or creating more competition in the lending industry is bleak.

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201 Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. §1304(a) (enacted).
202 *See* Brief Summary of Dodd Frank Financial Reform Bill, *supra* note 84.
203 *See* Brief Summary of Dodd Frank Financial Reform Bill, *supra* note 84.
204 *See* Brief Summary of Dodd Frank Financial Reform Bill, *supra* note 84.
205 *See* Brief Summary of Dodd Frank Financial Reform Bill, *supra* note 84.
O. What about Fannie Mae and Freddie Mac?

The most significant oversight of either the Dodd Frank bill or the European Union’s legislation is the failure to mention Fannie Mae and Freddie Mac, the two government sponsored entities that guaranteed approximately $6 trillion in home loans at the time of the financial crisis (totaling about 50% of the mortgage market.)\textsuperscript{206} To date, the government has spent $135 billion to bail out Fannie Mae and Freddie Mac, and could spend approximately $19 billion more if the economic recovery continues at its current pace.\textsuperscript{207} Politicians and lawmakers have argued that Fannie Mae and Freddie Mac will be reformed in a separate piece of legislation, and that the government is waiting for the housing market to show consistent signs of recovery before it reforms the two GSE’s.\textsuperscript{208} However, housing market reform is a necessary piece to promote a domestic and worldwide economic recovery.\textsuperscript{209}

The Dodd Frank bill requires that financial firms that package mortgage backed securities retain 5% of the securities risk.\textsuperscript{210} The goal is to encourage financial institutions to take more caution, and monitor more closely, the mortgages that they package.\textsuperscript{211} However, mortgages currently guaranteed by the Federal Housing Authority are not required to retain 5% of the risk, and it is expected that when the legislature reforms Fannie Mae and Freddie Mac, they will receive a similar exemption.\textsuperscript{212} The exemption of Fannie and Freddie from the risk


\textsuperscript{209} \textit{Id}.

\textsuperscript{210} \textit{Id}.

\textsuperscript{211} \textit{Id}.

\textsuperscript{212} \textit{Id}.
management standard will squeeze out competition in the private sector of the mortgage market, since the GSE’s are able to borrow at a lower interest rate, and, eventually, the two entities largely responsible for buying and supporting subprime mortgage backed securities will be two of the largest mortgage brokers in the world, with little incentive to manage and control their risk.213

Thus, the best way to eliminate the systemic risk of the GSE’s, and promote efficient, risk managed lending by the private sector, is to shrink the size of Fannie Mae and Freddie Mac. The GSE’s were created by congress to “serve the public policy goal of reducing mortgage costs,” but because they are publicly traded companies, the GSE’s are also “driven by shareholder returns.”214 Such a conflict of interest “between public purpose and private ownership” was “destabilizing to the GSE’s.”215 Limiting the subsidized mortgages provided by the GSE’s to low income or smaller mortgages would help shrink the size of the GSE’s, and ensuring that the rate charged by the GSE’s is high enough to promote and encourage private sector mortgage lending would help develop a competitive market for individuals and institutions that do not qualify for a GSE loan.216

IV. Conclusion

The Dodd Frank Financial reform bill was a necessary step as a result of the systemic crisis and subsequent collapse of the American financial system. However, despite the ingenuity of the bill, and the sheer magnitude of its content, it falls noticeably short on some issues, and intrudes on the free market in other respects. Similarly, the European financial and debt crisis also precipitated the need for

213 Id.
215 Id.
216 Id.
European Union financial reform, but such cross border reform will hamper the EU’s global financial competitiveness. Historically, the American financial system has been so strong because American firms are able to operate around the world. However, differing legislative responses by world markets to the financial crisis jeopardize the continuance of America’s dominance, as a failure by the United States to enact meaningful, enforceable and effective financial reform will cause other countries not to follow our lead and, in effect, eliminate some American firms from foreign economies. Regardless of the initiatives taken in other countries to regulate their financial sector, United States based companies and multinational enterprises operating in the United States will be forced to follow the legislation set forth in the Dodd Frank bill, and in other United States securities laws. Thus, if other countries enact legislation that conflicts with the United State's, either because of differing incentives or because they believe the United States regulation to be inadequate, the foreign countries will effectively eliminate United States enterprises from operating within their bounds because it would be costly, if not impossible, for the United States multinational enterprise to compete and simultaneously comply with both sets of laws. The theory also works in the reverse—whereby multinational enterprises not based in or operating in the United States would find it difficult and costly to move foreign investment into the United States and come into compliance with two sets of conflicting regulations. In such a scenario, where other countries decide to take their own initiative in financial reform, “the American financial system will have to live with the risk . . . of


218 Id.
inconsistent, different, competitively weaker standards for financial oversight around the world." It is necessary that regulation of financial institutions and financial markets does not occur in the vacuum of individual sovereigns. Because of the interconnectedness of global markets, and the vast size, scope, and number of countries in which many enterprises operate, it is necessary that financial reform be a joint effort by the world’s leading economies, including the United States and the EU. Without a joint effort, the segregation and contraction of economies and multinational enterprises discussed above will occur, and the global economy will contract.

The worldwide financial and regulatory reform was a necessary action to prevent the total collapse of world financial markets. However, the Dodd Frank financial reform appears to perpetuate the existence of the United States’ largest firms, and shrink the size of those firms deemed not to pose a systemic risk by being too big to fail. Similarly, the European Union legislation will effectively drive foreign financial institutions out of their borders because of the passport requirements. The legislation in the United States and the European Union is not perfect, and some will argue that anything short of total self-regulation in the financial sector is anti-capitalistic, but certainly, both the United States and the EU have shown that complete self-regulation is inefficient and ineffective. Thus, the necessary step is to continue to mold the current reforms to develop the proper balance of government and the free market, and promote, not constrict, cross national cooperation between policy makers and businesses.

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219 Id.
The United States and European Union bailouts of their nations banks were necessary because of the contagious nature of their failures, and because every other business relies on banks and financing to operate.\textsuperscript{221} The volatile combination of contagion and necessity means that major banks cannot be allowed to fail\textsuperscript{222}, and thus, the governments in the both the U.S and the E.U were correct in providing capital, even at great expense, to the nations largest banks. While the legislation in both the U.S and the E.U promotes protecting the largest banks, it fails to “align competition and welfare, bringing sustainable low prices for banking services and safe, innovative product development.”\textsuperscript{223} The legislations jointly promote and perpetuate the existence of the U.S and EU’s largest banks, by insuring against risk for depositors and investors\textsuperscript{224} while simultaneously increasing regulatory costs for smaller banks and making it more difficult for them to compete.

While the legislations succeed partially with regards to bailouts of the financial system, the under-qualified bailout allowances in the Dodd Frank bill, and the public bailout fund in the EU, leave open the possibility that other sectors not exhibiting the characteristics of contagion and reliance will receive public financing, and that the legislations other regulations regarding capital, liquidity, insurance and the like will actually decrease competition in the markets, as the usual stronghold strategies of sound investment, customer service, and competitive prices will give way to a single requirement—the sheer size of the firm.\textsuperscript{225}

In conclusions, the Dodd Frank bill and the E.U financial reform response took the necessary steps to prevent a complete collapse of the world’s financial

\textsuperscript{221} Bruce Lyons, \textit{A Symposium on Antitrust and the Global Economic Crisis: Competition Policy, Bailouts and the Economic Crisis}, 5 Competition Pol’y Int’l 25, 34 (2009).
\textsuperscript{222} Id.
\textsuperscript{223} Id.
\textsuperscript{224} Id.
\textsuperscript{225} Id. at 35.
system. However, the legislations fail to eliminate the need for future action, and expand to role and scope of government beyond what is best for the free market by not limiting bailouts and subsequent government intervention only to banks, but by offering the possibility of a bailout to any company, regardless of size, that poses a systemic risk to the U.S or E.U’s economy and by imposing restricting regulations on multinational enterprises that will limit their scope and ability to move and grow internationally.