February 23, 2011

Capture in Financial Regulation: Can We Channel It Toward the Common Good?

Lawrence G. Baxter, Duke University School of Law
Capture in Financial Regulation:
Can We Channel It Toward the Common Good?

Lawrence G. Baxter

Table of Contents

Unpacking “Capture” .................................................................................................................. 3
Surface Capture .......................................................................................................................... 3
Structural Capture ...................................................................................................................... 7

Creative Turbulence and Balancing Structures ................................................................. 12
“Tripartism” .............................................................................................................................. 15
Limiting the influence of the industry players ....................................................................... 16
Properly structured and resourced agencies ........................................................................... 17
Better institutional roles for regulators .................................................................................... 18
Transference, Appearances and Disclosures .......................................................................... 18
The Revolving Door ................................................................................................................ 19
Independent Reviews ............................................................................................................... 20

Abstract

“Regulatory capture” is central to regulatory analysis yet is a troublesome concept. It is difficult to prove and sometimes seems refuted by outcomes unfavorable to powerful interests. Nevertheless, the process of bank regulation and supervision fosters a closeness between regulator and regulated that would seem to be conducive to “capture” or at least to fostering undue sympathy by regulators for the companies they oversee. The influence of very large financial institutions has also become so great that financial regulation appears to have become excessively distorted in favor of these entities and to the detriment of many other legitimate interests, including those of taxpayers, smaller financial institutions, and the promotion of general economic growth. So “deep capture” by the larger elements of the financial industry of the regulatory process might well have become a very significant problem.

At the same time, it is unrealistic to assume that participants in the policy making and policy implementation process will not be trying to exert influence on the outcome of any regulation that impacts them. Attempts to maximize influence are surely an inevitable element of the ongoing regulatory process. And it is unrealistic to try to avoid extensive industry input altogether. Regulators and regulations depend on frequent and sometimes intense interaction with various sectors of the industry.

To promote sound regulatory policy, we should renew efforts to shape the environmental conditions in which the competition for regulatory outcomes takes place, so that policy more favorable to the general public interest becomes more likely. This involves a

* © Lawrence G. Baxter. Paper originally prepared as background for panelist remarks at the Fordham Journal of Corporate & Financial Law Symposium, Fordham Law School, New York, Mon. Feb. 7, 2011. I would like to thank Rebecca Dunning, Ed Balleisen and Anat Admati for valuable general suggestions, Ron Backus of the MITRE Corporation for his guidance regarding the organization, and the participants of the Symposium, from whom I learned a lot about the nuances of capture theory. This is a draft; please do not cite or quote without the author’s permission.
combination of measures, many of which are quite traditional but some of which are too often neglected. Such measures might include: strengthening "tripartism," advocated by Ayres and Braithwaite, by facilitating broader interest group participation in the regulatory process; limiting the influence of dominant participants by reducing their scale; properly structuring, resourcing and supporting regulatory agencies and regulators; "rotating" regulators so that they are less likely to develop unduly empathic relationships with the institutions they regulate; tightening the rules governing the "revolving door;" and making greater use of independent consultative and review bodies.

Regulatory capture could not be more central to regulatory theory and the economic analysis of regulation. It lies at the heart of public and social choice theory and is a concept adopted by conservative and liberal theorists alike. Indeed, capture theory has, from the 1960s onwards, influenced the development of two entirely opposing approaches to regulation: on the one hand it provided impetus to the deregulation movement because markets were considered to be less susceptible to undue influence than regulatory agencies; and on the other it led to attempts to pinpoint faithful implementation of legislative policy through the creation of single executive (and therefore directly accountable) agencies designed to implement social policies.

The concept of capture is morally satisfying because it conveys a sense of illegitimate expropriation by one power group over others of the resources we might have thought were provided for general social benefit. Moreover, because of frequently professed motivations and intense overt political engagement by the most organized and best funded interest groups involved, incidences of "capture" seem to leap out at us from their statements, funding and action. Depending on the direction of the outcomes of particular policies it is easy to attribute the result to the

---


excessive influence of the group or groups whose views seemed most to support that result.

**Unpacking “Capture”**

**Surface Capture**

Attractive though it might be, the concept of capture is not very reliable, either as a descriptive or normative tool for understanding regulatory dysfunction. Though usually used quite simplistically in economic modeling, “capture” might take many forms and is likely to be a matter of degree, and this leaves much room for differences of opinion as to whether it has even occurred. And “capture” is notoriously difficult to define. As a working definition, this paper regards regulatory capture to be present *whenever a particular sector of the industry subject to the regulatory regime has acquired persistent influence disproportionate to the balance of interests envisaged when the regulatory system was established*. Yet this definition immediately begs questions, such as when influence is “persistent”?, or what the “balance of interests envisaged” really is? It is almost certain that some individuals or groups will have more influence than others for a number of reasons, good and bad, so another important question is which groups *should* have greater influence, and when greater influence represents a distortion of the process.

There is often another complicating and more fundamental factor at play: it might be that the regulatory regime appears “captured” because the legislature that created it was *itself* captured by “special interests” and, as a result, produced a regime predestined to “captured” results favoring those interests.³ Figuring out where “capture” begins is itself both an empirical and a political question. Do we treat democratic legislative results as a given and therefore *prior* to regulatory capture analysis because the legislative process itself was democratic? If so, and if regulators are merely carrying out legislative will, then the rest of the capture inquiry would be little more than a waste of time.⁴

⁴ *See infra* note 11 (likely views of state banks in reaction to passage of the National Bank Act of 1863).
Regulatory capture as an analytical concept has also been shown to be both indeterminate and sometimes not supported by the facts.\(^5\) It is indeterminate because a particular policy may well have been adopted \textit{because it is the right one} and not because it might have been \textit{bought and paid for} (even if it was). Just because the result is supported by a powerful and organized group does not necessarily imply that it is wrong. This highlights the fundamental causal problem that capture theory does not satisfactorily address.\(^6\)

The concept is also unsupported in significant situations where policies appear to have been adopted in the face of powerful opposition that would, under capture theory, have suggested a different result.\(^7\) Of course in such situations it might be argued that other powerful “interests” have prevailed, but once one starts making this kind of concession the concept becomes so diluted that it quickly loses analytical value.

“Capture” can also be unhelpful, even counterproductive, because it is hurled back and forth between competing interest groups (“factions”\(^8\)) as an accusation—sometimes little more than an insult\(^9\)—rather than a constructive diagnosis. This in turn generates adversarial responses. Such controversy is not surprising given that regulatory capture is an idea borne out of the flat rhetorical rejection of any objective “public interest:” after all, if policy is simply the product of a zero sum

\(^{5}\) For critiques, see, e.g., Steven Croley, \textit{Interest groups and public choice}, in \textit{RESEARCH HANDBOOK ON PUBLIC CHOICE AND PUBLIC LAW} 49 at 56-58 (Daniel A. Farber & Anne Joseph O’Connell eds. 2010); Daniel Carpenter, \textit{Confidence Games: How Does Regulation Constitute Markets}, in \textit{GOVERNMENT AND MARKETS: TOWARD A NEW THEORY OF REGULATION} 164 at 165, 170-73 (Edward J. Balleisen & David A. Moss eds. 2010); Jessica Leight, \textit{Public Choice: A Critical Reassessment}, in id. 213, at 230-38. For a rich exploration of the dimensions and deficiencies of both public interest and capture theory, and an attempt to develop a more complex model for understanding the process of sound policy formation, see Michael E. Levine & Jennifer L. Forrence, \textit{Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis}, 6 \textit{J. L & ECON.} 167 (Special Issue 1990). The author, Kim Krawiec and Maciej Borowicz, have posted some thoughts on capture in the blog entitled \textit{www.theParetoCommons.com} (posts attached to the blog extracts accompanying this paper).

\(^{6}\) See the powerful general critique by DANIEL CARPENTER, \textit{REPUTATION AND POWER: ORGANIZATIONAL IMAGE AND PHARMACEUTICAL REGULATION AT THE FDA} at 35-43 (2010).

\(^{7}\) See, e.g., David A. Moss & Mary Oey, \textit{The Paranoid Style in the Study of American Politics}, in \textit{GOVERNMENT AND MARKETS}, supra note 5, 256 (describing three major examples [voting rights, Medicare and Superfund] in which “special interests appear to have given way to the general interest in the policymaking process”). See also David B. Spence & Frank Cross, \textit{A Public Choice Case for the Administrative State}, 89 \textit{GEO. L. J.} 97, 122-23 (discussing the ongoing “influence battle” that does not end with the passage of legislation, precisely because that legislation is itself often contrary to industry interests—which should not be the case if the capture theory of legislation was resilient).

\(^{8}\) See infra note 40.

game in which there are only winners and losers, then public policy can be no more than the spoils of victory. Losers are left only to lament the capture of the prize by others. Under this view, capture is a concept embedded in an adversary model not only of politics but of policy itself.

There are more problems. “Capture” is offered as an antidote to the supposed political naïveté of the “public interest” theory of policy formation. Yet the notion of an opposing, “public interest” theory is itself largely a straw man set up by capture theorists to advance their models. There is no simplistic “public interest” school of public policy: as Daniel Carpenter has observed, “[t]he term is much more commonly used by capture and rent-seeking theorists” and “‘public interest’ is less a body of theory and more a descriptive label used by critics of an earlier era’s scholarship.”

Indeed, to make useful assessments on whether something like “capture” has in fact occurred, we have to make much more precise distinctions about “regulation” and “regulators” than public choice economists seem to have been inclined to make. This is very evident in the world of financial regulation, where there are many dimensions of “regulation.”

For example, what is the purpose of the legislation creating the regulatory framework? Sometimes the legislation under which the regulators act expressly authorizes favorable treatment of one group over another. The National Bank Act provides a good example in that it was specifically enacted to promote the development of a national banking system for the sake of the public interest. As Justice Strong famously declared in a case favoring national banks over state banks, “National banks have been National favorites.” Sometimes it is perfectly appropriate, even and statutorily required, for the Comptroller of the Currency (OCC), who is charged with applying the Act, to promote the interests of national banks over competing interests. Yet this does not mean that the Comptroller is

---

10 CARPENTER, supra note 6, at 37.
11 Tiffany v. National Bank of Missouri, 85 U.S. (18 Wall.) 409, 413 (1874). The opponents of a national banking system, of which there were many, would no doubt have argued that Congress had been “captured” by special interests when it enacted the legislation in the first place.
therefore “captured” by the national banking industry and not acting in the “public interest.”

Furthermore, there are many kinds of regulators with many kinds of missions. In the financial word there are regulators who, like the OCC and state banking commissions, are primarily established to create and promote an industry. There are others, like the SEC and the newly created Consumer Financial Protection Bureau,12 whose mission is to regulate the business conduct of those industries. Others, like the FDIC and even the chartering agencies such as the OCC, have the important “microprudential” mission of preventing institutional failure, to protect depositors, shareholders or even the general public. There are “macroprudential” regulators, such as the Federal Reserve and the new Financial Stability Oversight Council, whose mission, among others, is financial stability. And some, such as the FDIC, play the role of undertaker in ensuring “orderly liquidation” of financial companies that have become insolvent.13 Such distinctions are important if we are to attain any degree of precision when talking about “capture.”

Except perhaps in some extreme situations, the surface concept of capture does not even plausibly describe the overall process of policy formation. This is not only because, as aptly observed by Richard Whitt, “influence is not quite the same thing as control,”14 but also because the direct focus on capture theory inconsistently and wrongly presupposes simple linear influences on the emergence of policy. Yet many fluctuating and buffeting forces interact to determine results that are seldom the “logical” result of the inputs involved. Policy, as much as market prices, is the result of a process in which, to use the language of complexity theory, the result is an emergence from the process, not the linear sum of its parts.15

13 See id., Title II. For a general discussion of financial agency types, see, e.g., HEIDI MANDANIS SCHOONER & MICHAEL W. TAYLOR, GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES ch 15 (2010).
15 “Emergence” is a complicated concept connoting a condition, state or quality that evolves from the systemic interaction by diverse agents within a complex system and it is not the linear sum of those inputs. For example, the “wetness” of water is not the mere sum of H2O molecules, nor is “mind” just the accumulation of brain tissue powered by electrical impulses between neural connections. See, e.g., JOHN H. MILLER & SCOTT E. PAGE, COMPLEX ADAPTIVE SYSTEMS: AN INTRODUCTION TO COMPUTATIONAL MODELS OF SOCIAL LIFE ch. 4 ("On
Finally, there is a strange irony to the position of some capture theorists. Capture is a central tenet for adherents of the rational choice school of economics and is a basis for preferring market discipline to regulation in most circumstances. Market forces, supposedly less susceptible to capture themselves are under this model likely to provide a more reliable means of generating efficient results. “Efficiency,” under the rational choice model, has become a substitute for “public interest.” But here is the irony: market discipline theorists celebrate the efficient results of properly functioning markets by tirelessly reiterating Adam Smith’s overworked metaphor\textsuperscript{16} of the “invisible hand:” the efficient result is mysteriously generated by the collective energy of myriads of selfishly motivated market participants.\textsuperscript{17} Yet public and social choice theorists seem implicitly to deny the possibility that any analogous “public interest” might similarly emerge through the process of policy formation. Why is regulation, a product of competing forces, not also an “efficient” result?

**Structural Capture**

So “capture” seems at first to be rather deficient as a tool for analyzing the performance of regulators. It turns out, however, to be very relevant in the context of contemporary financial regulation for two distinct reasons. First, the overt conduct of the industry and various high regulatory officials appears to demonstrate the kind of extreme situation in which one of the regulated interests, namely the very large financial institutions, have secured such dominant influence that it might be said that they have “captured” the regulators, the regulatory process, and the regulatory outcomes, to the disregard of many other important interests. In a world of degree, financial regulation might well have come to reflect just the kind of extreme situation in which capture accurately describes the result of our regulatory policy.


\textsuperscript{17} Indeed this itself is not an unreasonable claim, as countless highly efficient, diverse markets illustrate.
Secondly, when one turns from the shallow concept of visible capture that has been the focus of the earlier discussion to the “deep capture”\(^\text{18}\) that might be embedded within the financial regulatory system, the evidence seems to accumulate even more rapidly, suggesting that our public policy process is very detrimentally captured by large scale financial interests. The leading exponents of the theory of “deep capture” have described their use of the term as follows:\(^\text{19}\)

By ‘deep capture,’ ... we ... [refer] to the disproportionate and self-serving influence that the relatively powerful tend to exert over all the *exterior* and *interior* situational features that materially influence the maintenance and extension of that power— including those features that purport to be, and that we experience as, independent, volitional, and benign. Because the situation generally tends to be invisible (or nearly so) to us, deep capture tends to be as well.

To understand “capture” from this perspective we are required to reach beyond surface connections that suggest causality and the attribution of outcomes to obvious inputs, and we would have to take into consideration the implicit assumptions, shapes and channels of information, that ultimately, notwithstanding professed views and objectives, drive perceptions and decisions.\(^\text{20}\) There could be various dimensions of this type of capture, including “cultural”\(^\text{21}\) and “social”\(^\text{22}\) capture in which the entire language of the policy debate is shaped by an elite that


\(^{19}\) Id. at 218. See also Simon Johnson, *The Quiet Coup* (ATLANTIC MAG. May 2009), [http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/](http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/) (developing a case that our financial regulators and policy have become victim to a pervasive “cultural capture” that promotes the interests of large financial institutions to the detriment of financial stability).

\(^{20}\) See Hanson & Yosifon, supra note 18, at 177–79 (discussing how and why our surface assumptions do not reliably reflect the basis for decisions and action and can lead to inaccurate attribution of cause and effect).

\(^{21}\) See, e.g., Johnson & Kwak, *13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN*, 89-90 (2010); Johnson, supra note 19 (describing the “cultural capital” amassed by the financial industry, creating a network that ensures massive influence among colleagues, former colleagues and other socially and vocationally connected individuals who collectively control the levers of government decisionmaking in matters relating to the financial system).

has gained dominance in promoting and controlling policy outcomes, and in which
the language of regulation is shaped by the common backgrounds, education,
experience and intermingling of the more powerful players in the policy formation
process.

Perhaps even more insidious are the subtle conflicts of interest created by
the role of academics dependent on industry sponsored research, or deriving
income from industry associations such as directorships. A recent study on the
activities of academic economists suggests that the conflicts are sufficiently real as
to require a code of ethics, including fuller disclosures when economists take public
positions on policy issues.23 Such industry/academic relationship might well
significantly distort our understanding of what the relationship between industry
and the regulators even is.

This environment nurtures a kind of “consanguinity” among the captains of
industry, the heads of political and regulatory departments, from which lesser
committees, officials and corporate officers continuously take their lead,24 and even
many academic thought leaders. This in turn may generate a collective cognitive
bias that has been called “intellectual hazard,”25 which would lead to a cognitive bias
in which different views are not even perceived, let alone recognized and properly
analyzed.

Delving into the “situational” context of financial regulation, focusing on the
deep structures that shape and influence regulatory outcomes, it seems more than
possible that the financial regulatory system is suffering from “deep capture.” From

---

23 See Gerald Epstein & Jessica Carrick-Hangenbarth, Financial Economists, Financial Interests And Dark Corners
economists between 2005 and 2009).

24 Consider, for example, the recent criticism of the IMF for its “group think” and being “overly influenced” and
“in awe of” the reputation and expertise in larger nations.” Sandrine Rastello, IMF ‘In Awe’ of Rich Nations Missed
Coming Crisis, Audit Says, BLOOMBERG Feb 9, 2011, online at http://www.bloomberg.com/news/print/2011-
02-09/imf-economists-in-awe-of-rich-nations-missed-coming-crisis-audit-finds.html. See INDEPENDENT
EVALUATION OFFICE OF THE INTERNATIONAL MONETARY FUND, IMF PERFORMANCE IN THE RUN-UP TO
THE FINANCIAL AND ECONOMIC CRISIS: IMF SURVEILLANCE IN 2004-07 (Jan. 10, 2011), online at http://imf-
ieo.org/eval/complete/eval 01102011.html.

25 See Geoffrey Miller & Gerald Rosenfeld, Intellectual Hazard: How Conceptual Biases in Complex Organizations
Contributed to the Crisis, 33 HARV. J. L & PUB. POL’Y 807 (2010).
the phone logs of current and former Treasury Secretaries to the very visible revolving doors between regulators and industry, from the origin and composition of the Federal Reserve Banks to statements by the new Chairman of the House Financial Services Committee, and from the opposition by the Treasury Department and other senior members of the Administration to the imposition of concentration limits on an unstable and publicly subsidized industry to the inexplicable disregard of powerful economic studies to the contrary by the same Treasury Department as it favors allowing continued growth by gargantuan, highly risky financial conglomerates, the power of the financial industry, particularly that

26 See, e.g., WILLIAM M. ISAAC, SENSELESS PANIC ch. 13 (2010) (describing the almost exclusive engagement by Treasury Secretary Paulsen with the large financial institutions, including and average of ten calls per day with Goldman Sachs, and the then-President of the New York Federal Reserve Bank, Timothy Geithner, to the virtual exclusion of other participants in the political process who represented major stakes in the financial collapse). Compare the articles by Jackie Calmes, At Treasury, Geithner Struggles to Escape a Past He Never Had (N.Y. TIMES Aug 19, 2010), http://www.nytimes.com/2010/08/20/business/20tax.html?r=1&dbk (describing how Secretary Geithner is perceived to be a Wall Street Insider); and Jo Becker & Gretchen Morgenson, Geithner, Member and Overseer of Finance Club (N.Y. TIMES Apr. 26, 2010), http://www.nytimes.com/2009/04/27/business/27geithner.html?pagewanted=all (describing Mr. Geithner’s very close relationship with Wall Street).


28 From their inception, the Federal Reserve Banks have been owned and under the strong influence of the member banks. There are interesting parallels in the current environment to that which existed during the original creation of the federal reserve system following the Panic of 1907: at that time progressive reforms were met by a backlash from the industry leading to a much less radical set of reforms than outrage generated by the Panic would have created. The past Congress that enacted the Dodd Frank Act appeared particularly in the Senate, to strip away many of the powers of the Federal Reserve System. Although the ultimate result was to eliminate the role of member banks in electing the individual reserve bank presidents, see the Dodd-Frank Act, supra note 12, § 1107, the Fed has in fact come out much stronger than ever before, and its membership is likely to continue to promote very strong industry influence over its actions. For a discussion of the aftermath of the Panic, leading to the eventual enactment of the Federal Reserve Act in 1913, see ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907: LESSONS LEARNED FROM THE MARTET’S PERFECT STORM 141-50 (2007).

29 See infra note at note 38.

30 See, e.g., Ryan Grim & Shahien Asniripour, Senate Votes for Wall Street; Megabanks to Remain Behemoths (HUFF June 17, 2010), http://www.huffingtonpost.com/2010/05/06/senate-votes-for-wall-st_n_567063.html (describing opposition by Administration to an amendment that would have required megabanks to be broken down in size).

of the large banking conglomerates, looms large in the shaping of general public policy and specific regulatory action. Political spending by the nation’s largest banks alone dwarfs the lobbying efforts of most other sectors and spending influence does not end there: deep capture may well be nourished by collateral institutional interests. For example, the “deregulatory” position of the financial industry has been heavily supported with allied lobbying by groups such as the US Chamber of Commerce.

Furthermore, the particular processes involved in financial regulation suggest that the opportunity for “capture” might be greater than ever in financial services, particularly in relation to large scale financial institutions, which have very deep engagements with the regulators. Banks are subject not only to rules that govern their structure, operations and activities in advance but also to ongoing monitoring in a manner that involves broad regulatory discretion. One need not be totally cynical to recognize that the highly discretionary and continuous nature of bank regulation is dependent on and nurtures an environment in which the


33 Compare Hanson & Yosifon, supra note 18, 219-33 (discussing the development of extensive institutional, political and cultural support for corporate interests).

34 See, e.g., Eric Lipton, Mike McIntyre & Don Van Natta, Jr., Top Corporations Ai U.S. Chamber of Commerce Campaign, (N.Y. TIMES Oct. 21, 2010), dhttp://www.nytimes.com/2010/10/22/us/politics/22chamber.html?_r=2 (describing the extensive mutual financing support between the Chamber, owner of the Wall Street Journal, and major financiers and financial institutions, and the anti-financial regulatory stance of the Chamber).

35 Cf. Christoph Knill & Andrea Lenschow, Modes of regulation in the governance of the European Union: towards a comprehensive evaluation, in THE POLITICS OF REGULATION: INSTITUTIONS AND REGULATORY REFORMS FOR AN AGE OF GOVERNANCE 218 at 231 (Jacint Jordana & David Levi-Faur eds. 2004) (“Generally, capture is more likely in cases of highly detailed regulation. In such constellations, regulators require a large amount of information in order to carry out their task. As the regulated industry itself is the best source of such information, this gives the industry a degree of leverage over regulatory arrangements which, in the extreme case, might lead to capture.”)

36 See, e.g., Steve Randy Waldman, Discretion and financial regulation, INTERFLUIDITY (Nov. 2009), http://www.interfluidity.com/v2/date/2009/11 (“[a]n enduring truth about financial regulation is this: Given the discretion to do so, financial regulators will always do the wrong thing”). Waldman’s lugubrious view is based on the political and resource pressures that drive the institutional dynamics of regulator-industry interaction.)
regulators and the regulated are engaged in such close, daily relationships as to nurture intense mutual empathy—perhaps even a kind of “transference”\textsuperscript{37}—between the two sides. This codependence might seem inevitably to lead to a mutual identification of interests and a manifestation of deep, if not surface, capture. Worse, it might even lead to the kind of lop-sided relationship so baldly asserted by incoming House Financial Services Committee Chairman Bachus in his recent remarks to the Birmingham newspaper, that “the regulators are there to serve the banks.”\textsuperscript{38} In other words, bank supervision provides even more opportunity for the kind of influence that leads to capture than might traditional regulation itself.

Yet these are all facts of our political life. What can one do to try to counteract the massive dominance of the financial industry in our public life?

**Creative Turbulence and Balancing Structures**

One technique for promoting effective and rejuvenating policy in the complex financial world would be to maintain a constant, creative and constructive turbulence through transparency, debate and deliberation. We do not always do this very well. We also to be least successful when our theories of government are themselves “captured” by simplistic doctrines purporting to explain as “capture” policy results that appear to favor one interest group over another, or using dichotomous juxtapositions that pit “regulatory failure” against “market failure” as if these must be mutually exclusive results.\textsuperscript{39} Yet our inveterate frailty and frequent failure to achieve good results does also not mean we should abandon the

\textsuperscript{37} The reference is to the Freudian notion that in psychoanalysis a patient redirects feelings for an important person to the analyst. See http://www.freudfile.org/psychoanalysis/transference.html. Of course I use the term metaphorically.

\textsuperscript{38} Quoted by Mary Orndorff, *Spencer Bachus finally gets his chairmanship*, BIRMINGHAM NEWS Dec. 9, 2010. The full statement is “In Washington, the view is that the banks are to be regulated, and my view is that Washington and the regulators are there to serve the banks.” The report goes on to state that “[Rep. Bachus] later clarified his comment to say that regulators should set the parameters in which banks operate but should not micromanage them.”

\textsuperscript{39} Compare the discussion by Hanson & Yosifon, *supra* note 18, at 177 et seq. (discussing how we “get ourselves wrong”). See also, e.g., Joseph Heath, *An Adversarial Ethic for Business: or When Sun-Tzu Met the Stakeholder*, 72 J. BUS. ETHICS 359 (2007) (exploring the interesting implications of the sports analogy for healthy competition and regulation).
Madisonian ambition\(^{40}\) of striving to structure a framework conducive to the common good and channeling the process of policy formulation toward better social results.

I would submit that we gain a better understanding of the problems of financial regulation by treating “capture” as an expected, and in the right context sometimes even healthy,\(^{41}\) tactic of policy participants that is to be channeled through institutions and practices designed to balance the impact of this tactic. In this respect it can be helpful to adopt a complexity view of the process of policy formation and the techniques for promoting the best policy over time. Viewed from a complexity perspective, policy formation is a continuous process and not a static end result.\(^{42}\)

One of the most perplexing challenges of regulatory policy formation is reconciling the important disposition toward other-regarding (i.e. “public”)\(^{43}\) action by regulators with the necessity of informed policy. One can hardly demand that regulators be free of industrial influence. For example, would we really want totally “impartial” outsiders to design and set the rules for such complicated infrastructures as derivatives exchanges, uninformed by the heavy input industry participants? Surely the derivatives industry itself should have deep influence on this process? At the same time, how do we prevent the regulators from being overwhelmed by high paid lobbyists and “liaison organizations” whose purpose is aggressively to persuade that their point of view is the only correct one? How do we

\(^{40}\) James Madison, The Federalist No. 10 (1787) (addressing the challenge for republican government in addressing the problem of “faction”).

\(^{41}\) This appears to be the argument of Susan E. Woodward, Regulatory Capture at the U.S. Securities and Exchange Commission, paper presented to the Milken Institute Conference on Capital Markets, Mar. 16, 1998, online at http://www.sandhillecon.com/pdf/RegulatoryCapture.pdf.

\(^{42}\) See, e.g., Whitt, supra note 14; Richard S. Whitt & Stephen J. Schultz, The New “Emergence Economics” of Innovation and Growth, and What it Means for Communications Policy, 7 J. TELECOMM. & HIGH TECH. LAW 217 (2009), describing the need for adaptive regulation in the rapidly evolving field of telecommunications. I would submit that a similar approach applies to the world of financial services. For the author’s attempt to apply complexity theory to general regulatory technique, see, e.g., Lawrence G. Baxter, Adaptive Regulation in the Amoral Bazaar (Oliver Schreiner Mem. Lecture) forthcoming 128 S.A.L.J. [8] (2011).

\(^{43}\) For a much more sophisticated analysis of the distinction between “public” and private action, and between “general” and “special interests”—important to disentangle—see Levine & Forrence, supra note 5, 174-82.
encourage independent thinking on the part of regulators? We cannot rely on the cacophony of competing, often one-sided and partisan comment alone.

Some solutions might actually be more traditional than narrow models of economic analysis, using stylized frameworks, would suggest. Like any complex process, stability depends on the interaction of a diverse range of forces, many of which we have instinctively nurtured for decades, even centuries. Unfortunately resilient solutions to each problem tend toward obsolescence as competing agents learn how to game the structures and processes. So constant adaptation is needed to sustain a process that seeks to promote the greatest social welfare.

Combining various dimensions of reform is probably a prerequisite, although the combination would be difficult to achieve in the current environment. There is no simple formula. A real solution would have to be complex and multidimensional and would require a more serious attitude toward regulation than we have culturally been willing to display. The Dodd-Frank Act\textsuperscript{44} addressed a few dimensions but the regulatory reform agenda has still been left with gaping omissions.\textsuperscript{45}

Which are the most important areas for reform? On the one hand, we should accept the reality (and even the virtue) of influence by all affected agents, whether industry or consumer or taxpayer. On the other, we should be trying to avoid disproportionate or undue influence by any one sector over the others, while recognizing that all agents will be trying to impose that influence. Essentially, we would be seeking to establish and preserve a system that is resilient over time, one that ebbs and flows but does not swing so far in one direction that it ends up excluding or disregarding other legitimate interests and leads to an end result of real capture. Perhaps in an age of corporatocracy it is already too late for us to succeed. But assuming it is still worth trying, the following dimensions seem most relevant:

\textsuperscript{44} Dodd-Frank Act, \textit{supra} note 12.

\textsuperscript{45} For some public choice/capture reflections on the passage of the Dodd-Frank Act, \textit{supra} note 12, see Kim Krawiec, \textit{dodd-frank: “I’ll have the meatless entrée, please”} (THEPARETOCOMMONS July 20, 2011), \texttt{http://www.theparetocommons.com/2010/07/dodd-frank-%E2%80%9Ci%E2%80%99ll-have-the-meatless-entree-please%E2%80%9D/}.
“Tripartism”

Robert Dahl coined the term “economic democracy” in advocating that the principles of participatory democracy be extended into the realm of economic activity as a means of maintaining a balance within corporate capitalism between liberty and equality.46 The notion is relevant for current purposes because one of the factors that create a climate ripe for capture is the exclusion of important stakeholders (consumers, taxpayers, smaller financial institutions, other diffuse interests) from the policymaking process because very large institutions have the financial and political power to secure preferential access. Very large corporations can and, in the case of the financial industry do, distort the democratic process through their lobbying power, disproportionate access to high level government decision-makers, and the fact that government tends to recruit directly from their executive layers. Charles Lindblom described this phenomenon as “the privileged position of business.”47

In an attempt to restore balance to the process, scholars have advocated empowering or strengthening the weaker interest groups within the “iron triangle”48 of policy making, so that they can act as a kind of counterweight to these powerful forces, thereby reducing the likelihood of capture. Ian Ayres and John Braithwaite are among the most prominent in proposing this method of remediying the problem of collective action on the part of diffuse and poorly organized groups, such as consumers and other sectors of the industry.49 They propose a model of “tripartism,” which they define as a “regulatory policy that fosters the participation of [public interest groups] in the regulatory process.” Under tripartism such groups would be given full access to all the information available to the regulator, a “seat at

46 ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY (1985).
48 The term is used to refer to the political interaction between “three key participants in a clearly delineated area of policy-making: the Federal bureaucracy, the key committees and members of Congress, and the private interest.” GORDON ADAMS, THE POLITICS OF DEFENSE CONTRACTING: THE IRON TRIANGLE 24 (1981).
the negotiating table when deals are done,” and “the same standing to sue or prosecute under the regulatory statute as the regulator.”

In providing for a continued role on the part of state attorney generals in the enforcement of consumer protection laws against financial institutions, Dodd-Frank has made a step toward something analogous to tripartism. But this preservation of state enforcement power is still dependent on state action and it is confined to consumer protection issues. There are also organized interest groups for various and diverse financial interest groups, but they are fragmented and far outgunned by the spending power of the large financial organizations. Without greater funding for such groups and a revival of the “private attorney general,” it is unlikely that individuals or organizations other than the very largest will be able effectively to understand and act on fuller access to information, let alone influence unsympathetic regulators or successfully combat the large-scale industry in ensuing legal battles.

Limiting the influence of the industry players

One obvious way to contain the degree of influence some participants could play in the process would be to limit their size and power. The large financial institutions are in effect an oligarchy possessed of unprecedented power.

Numerous commentators, and even very senior regulators, have proposed limitations on the size and complexity of financial institutions, or even that they be

---

50 Id. at 441.
51 Dodd-Frank Act, supra note 12, § 1042 (clarifying the power of states attorneys general to bring actions against national banks and federal savings associations to enforce consumer protection provisions in the Act, notwithstanding the creation of a new federal enforcement agency).
52 See, e.g., the Center for Responsible Lending, http://www.responsiblelending.org/. There are of course numerous examples across a very diverse industry.
54 See esp. SIMON JOHNSON & JAMES KWAK, supra note 21, ch. 7.
55 For a convenient review of the large number of experts who have advocated breaking up the banks, see, e.g., “George,” Virtually All Independent Financial Experts Say That the Size of Big Banks is Hurting the Economy (WASHINGTON’S BLOG Jan. 11, 2011), http://www.washingtongblog.com/2011/01/virtually-all-of-leading-financial.html. This view is shared at the highest levels of the Bank of England and it is held across the political spectrum. See Johnson, supra note 31 and the links at his posts. See also Arnold Kling, Break Up the Banks, NATIONAL REVIEW Apr. 5, 2010, http://www.nationalreview.com/articles/229442/break-banks/arnold-kling (conservative viewpoint); Lawrence Baxter, financial macrophilia and shrinking the banks (THEPARETOCOMMONS Sept. 24, 2010), http://www.theparetocommons.com/2010/09/financial-macrophilia-
broken into smaller components. Yet all of these proposals have met with fierce industry and Administration opposition and have so far been to no avail. Dodd-Frank did expand the concentration cap on such institutions but so far the Financial Stability Oversight Council and the Treasury Department shows little inclination to give meaning to the limits.

**Properly structured and resourced agencies**

The failure by Dodd-Frank to address regulatory restructuring has been widely discussed. It seems inevitable that we will have multiple regulators. It might also be that the FSOC/Fed structure for addressing systemic and other risks posed by large financial institutions is a promising advance. The Federal Reserve Banks have also been partly reformed. But concerns linger about the degree of influence over, and blatantly privileged access to, senior regulators that the industry seems still to enjoy. Mistaken though this would surely be, it is hardly surprising that eliminating the Federal Reserve System, perceived as a secretive, pro-industry agency, has so much political support. So recent efforts to promote greater transparency in the way in which the Fed operates, such as audits and delayed disclosures regarding the provision of financial assistance to ailing institutions, help to promote an accountability that might reduce the danger of undue influence, inappropriate allocations of public support, or decisions that are just plain wrong.

---

and-shrinking-the-banks/ (providing a further link to an important Bank of England study that indicates that the large financial institutions may well be detrimental for economic growth.)

56 Dodd-Frank Act, supra note 12, § 622 (imposing a cap on consolidated, risk-weighted liabilities of a financial institution of 10% of the aggregate consolidated liabilities of all financial companies). The liability cap, initially imposed in the Riegle-Neal Act of 2004, was formerly limited to 10% of insured deposits.

57 See Johnson, supra note 31 (commenting on the neglect by the Treasury Department of all the economic evidence in support of breaking up the banks); and Nasiripour, supra note 31 (noting that the concentration limits themselves are being applied in an apparently manipulative fashion).

58 Dodd-Frank Act, supra note 12, Title I (Financial Stability Act of 2010).

59 Id, § 1107 (eliminating the voting power of member bank representatives on the board—Class A directors—from elections of individual reserve bank presidents).

60 Former presidential candidate and author of the New York Times best seller attacking the Federal Reserve System, see RON PAUL, END THE FED (2009), is now chairman of the House Financial Services Committee’s domestic monetary policy subcommittee.

61 See the Dodd-Frank Act, supra note 12, § 1102 (providing for audits of extensions of credit facilities by the Federal Reserve).
Better institutional roles for regulators

We do not take regulation very seriously in the United States, nor do we treat regulators very well. Where are the professors of regulation in the US? We don’t give knighthoods to regulators. They don’t get paid much in the UK but at least they are considered important. Instead, we pull them up in front of Congress and beat up on them, so they go and get highly paid jobs in the private sector.

Yet we need regulators who really understand the businesses they are regulating and have the moral authority to persuade and, where necessary, to coerce those they regulate. To attract such regulators from the private sector we assume we have to pay them very high salaries, and we do pay them more than most federal employees (at least in the financial agencies). Yet we know that public sector salaries can never compete with those in the private sector, at least for equivalent skills.

There might, however, be other ways to address the aspirations of publicly minded experts. Elite corps are not always the highest paid.62 Professors Akerlof and Kranton have demonstrated that people are incentivized by many values other than mere monetary compensation.63 Professor Carpenter has demonstrated how reputation and prestige has enhanced the quality of the FDA.64 And the same has been true at times of the SEC.65

Transference,Appearances and Disclosures

62 See, e.g., Lawrence Baxter, capture, THEPARETOCOMMONS (May 26, 2010), http://www.theparetocommons.com/2010/05/capture/ (discussing the JAG Corps and Naval SFTI program and providing references to other examples). (This post is also attached.)
63 GEORGE A. AKERLOFF & RACHEL E. KRANTON, IDENTITY ECONOMICS: HOW OUR IDENTITIES SHAPE OUR WORK, WAGES, AND WELL-BEING (2010) (the authors do not address the regulatory agencies directly but they do consider the importance of corporate identity to members of the military). Indeed, as the authors demonstrate, many factors other than salary influence performance in private firms as well, and companies often excel competitively, driven by superior employee culture, even when salaries are not competitive with other companies.
64 See CARPENTER, supra note 6.
65 See, e.g., Lawrence Baxter, capture iii: authority and prestige, THEPARETOCOMMONS (June 17, 2010), http://www.theparetocommons.com/2010/06/capture-iii-authority-and-prestige/. (This post is also attached.)
Louis Brandeis’ famous statement that “sunlight is said to be the best of disinfectants” remains as valid today as it ever was. We have made great strides, albeit not always in a straight line, toward rendering the regulatory process more transparent. Yet, even under the glare of modern publicity, the intense interaction between financial regulators and the industry, necessary as it might be for proper supervision, carries with it a constant danger of “transference”—regulators begin to think like the regulated and in the process lose their critical detachment. This is the reason the prison guards of highly intelligent political detainees in dictatorial regimes are rotated—lest they develop too great a sympathy for their prisoners. The French have a saying that captures the problem: “to understand all is to forgive all.”

Currently regulators spend years onsite at the same large institutions, often in offices on the very same floors of those they regulate. The Treasury Secretary seems to talk to the same CEOs all the time and did so, as President of the New York Federal Reserve Bank, long before ascending to his current post. We have to consider ways to insert rotation in the deployment of supervisors and to promote broader consulting by senior officials. Are certain prominent financial institutions, for example, a little over-represented at the highest levels of the Executive?

The Revolving Door

---


67 See supra note 37.

68 Practice might vary at the FDIC, where the chairman has emphasized the importance of rotating examiners. But failure to rotate examiners is a problem that has been noted, for example, under a recent audit of the Texas Department Savings and Mortgage Lending, for example. See the REPORT OF JOHN KEEL, TEXAS STATE AUDITOR, AN AUDIT REPORT ON THE DEPARTMENT OF SAVINGS AND MORTGAGE LENDING, (Rep. No. 09-049, Aug. 2009), http://www.sao.state.tx.us/Reports/report.cfm/report/09-049 (“The Department does not consistently rotate the examiners or the examiners in charge when it performs examinations of the institutions it regulates. Fifteen (75 percent) of 20 institutions were examined by the same examiners for at least three consecutive years”). See also Gillian G. H. Garcia, Failing prompt corrective action, 11 J. BANK. REG. 171, at 189 n. 40 (2010) (citing a report by a Treasury Department inspector general criticizing the failure to rotate regulators of a bank that failed).

69 As Eleanor Bloxham has put it, a “recurring trap” that regulators, boards and companies fall into is “making decisions based on ‘who’ rather than ‘what.’” The SEC still needs to escape regulatory capture. Here’s how, FORTUNE (Jul. 30, 2010), http://money.cnn.com/2010/07/30/markets/SEC_regulatory_capture.fortune/index.htm.
The more we need expert regulators, and the better regulators become, the faster will spin the doors between regulators and the industry.\textsuperscript{70} If we are to engage in technical regulation at all, this is not only unavoidable but also sometimes even desirable. But of course it is dangerous: many current examples vividly highlight the unseemly appearance, if not reality, of an incestuous relationship between regulators and industry that must surely foster an improper influence by the latter over the former. Formal ethical rules barring direct engagement on matters where regulators have already been on the other side help, but they are inevitably limited in their effect because the more absolute such rules become the less valuable are the career paths for incoming or outgoing regulators. Here too appearances are extremely important. A former regulator should simply have nothing to do with a matter his or her new employer is dealing with if that regulator was involved in developing or applying the policy or decision in question. How many employers, public or private, can honestly claim that they uphold this firewall rigorously?

Perhaps even more important than ethical rules is an ethical \textit{culture}, in which a former regulator, or regulator recently hired from the industry, would regard his or her involvement on such a matter simply wrong. Yet this culture is not one that we have actively promoted or celebrated for some time.

\textbf{Independent Reviews}

The venerable notion of checks and balances has not lost its value. Congressional hearings, when not abused, help to promote accountability for the implementation of regulations. Inspectors General perform a valuable (and lately much needed) role in unearthing mistakes and inappropriate conduct by agencies and their decision makers. Judicial review operates as a powerful check on errant rules and orders. But the focus is largely on the negative, on misdemeanor, rather than on whether regulatory actions are the best ones.

\textsuperscript{70} See \textit{supra} text accompanying note 27.
Here we might draw lessons from the MITRE Corporation, a federally funded research and development center spun off from the MIT Lincoln Laboratory and established in 1958 to perform research on national defense issues.\textsuperscript{71} The Corporation describes itself as a “not-for-profit corporation, chartered to work solely in the public interest.”\textsuperscript{72} MITRE operates federally funded research and development centers sponsored by the Department of Defense, Federal Aviation Administration, the Inland Revenue Service and Department of Veterans Affairs (jointly) and the Department of Homeland Security.\textsuperscript{73} The organization’s scope of activities has steadily been expanded over the years to provide objective research, testing and advice on wider scientifically-oriented issues including, even, organizational issues for the Department of Veterans Affairs, Financial Crimes Enforcement Network and the SEC.\textsuperscript{74}

Is there an opportunity for greater use of this or a similar organization in assessing the optimality of regulations governing the financial industry? Is there a reason this should not be funded out of the assessments levied on financial organizations via the Federal Reserve and federal deposit insurance systems, which provide the lynchpins of stability for the financial industry? No doubt we would hear an outcry against this idea, but if we really wanted the right decisions perhaps this institutional review structure would help to professionalize financial regulation.

These are the areas that seem most urgently in need of attention. There are of course many other interconnected issues that would have to be tended and explored in order to reset financial regulation so that it is directed toward the promotion of the common good. But even the reforms already discussed would require a major resolve of our collective will in order to transcend the deeply embedded political, cultural and institutional power of the financial industry itself.

\textsuperscript{71} MITRE \url{www.mitre.org}. Although stated to be an acronym that stands for “Missile Test and Readiness Equipment” and does not derive from the MIT origins of the organization (see \url{http://www.dictionary.net/mitre+corporation}), this is incorrect. “MITRE” is not an acronym at all (email from Ron Backus, The MITRE Corporation, dated Feb. 3, 2011, on file with the author).
\textsuperscript{72} See \url{http://www.mitre.org/about/ffrdcs.html}.
\textsuperscript{73} Id.
\textsuperscript{74} See MITRE’s Center for Enterprise Modernization (CEM), at \url{http://www.mitre.org/about/ffrdcs/cem.html}.
Until we make such resolution, however, pointing out and lamenting regulatory "capture" adds little to the overall debate and it only makes us angry, cynical or despondent.