Legal Political Moral Hazard: Does the Dodd-Frank Act End Too Big To Fail?

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Troy S. Brown*

Abstract

In the aftermath of the 2008 financial crisis, Senator Chris Dodd proposed the Restoring American Financial Stability Act of 2010 (the “Dodd-Frank Act”). The Dodd-Frank Act, the result of more than 18 months of negotiation and debate, aims to strengthen consumer protection, and regulate complex financial products. President Obama called the Dodd-Frank Act “the greatest overhaul of Wall Street since the Great Depression.” Among the many changes and hopes for the Dodd-Frank Act is that it will finally end the financial calamity, social unrest, and massive federal bailouts associated with the “too big to fail” concept. The “too big to fail” concept describes the belief that certain entities are so central to the macro-economy that their failure will precipitate widespread financial disaster, and, thus, should become recipients of beneficial financial and economic policies from governments and central banks. Favorable treatment, however, leads to moral hazard, when an entity does not take account of the full consequences and responsibilities of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to hold some responsibility for the consequences of those actions, a perversion of insurance theory.

Conceptually, moral hazard provides a rich perspective for analyzing the consequences of treating shadow banks as “too big to fail.” From this perspective, “shadow bank” institutions, such as Bear Stearns, Goldman Sachs, and Lehman Brothers, contributed to the 2008 financial crisis by adopting risk prone strategies, despite the possibility of collapse, because they relied on the federal government subsidizing their losses, specifically the Federal Reserve to provide bailouts. Thus, shadow banks are encouraged to act with moral hazard long before a federal bailout becomes necessary. First, shadow banks are encouraged to engage in “high-risk” strategies, defined as using extreme amounts of leverage to fund high risky investments during a credit bubble, while taking advantage of weak regulations, ineffective monitoring by public and private stakeholders, and pro-market laws, policies and entrenched relationships. Second, shadow banks use these high-risk strategies to net financial largesse, acquire additional political influence, and become highly interconnected with other companies and industries, characteristics often qualifying it as too big to fail. Third, when that shadow bank’s high-risk strategies bring the prospect of financial collapse it expects the federal government to provide bailouts, given these

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pro-market laws, policies, and relationships. Fourth, these bailouts provide the impetus for new, but weak regulations that allow for subsequent bailouts, and thus more moral hazard.

Given the decades of treating entities as being “too big to fail” and the corresponding policy inertia, it is fair to question whether the Dodd-Frank Act, in attempting to end the “too big to fail” concept, addresses the moral hazard implicit to it. To that end, passage of the Dodd-Frank Act raises three related questions, which this article will address. First, how does the Dodd-Frank Act purport to eliminate the moral hazard underlying too big to fail? Second, does Dodd-Frank Act, in fact, encourage or discourage moral hazard? Third, are there changes to the framework of the Dodd-Frank Act that would better enable it to end the moral hazard underlying too big to fail?

While many scholars have analyzed the “too big to fail” concept and the causes and consequences of the 2008 financial crisis, there is a dearth of scholarship assessing the collective impact of the laws, policies, and relationships that encourage the moral hazard underlying the “too big to fail” concept in the U.S. financial system. To better enable analysis of moral hazard, this article introduces the Legal Political Moral Hazard (LPMH) model, which utilizes a rating system that measures the extent of moral hazard based on the following five (5) factors: (1) over-speculation and over-leveraging (Minsky-evolution) to become “too big to fail”; (2) 3-dimensional information asymmetry; (3) entrenched relationships and policy; (4) principal-agent separation; and (5) institutionalized government intervention. The LPMH model’s rating system assesses, on a scale ranging from “nominal” to “dangerous,” whether moral hazard is being encouraged. The LPMH model can be used to assess whether moral hazard is encouraged within an industry, entity, or even whether specific pieces of legislation encourage or discourage moral hazard.

In applying the LPMH model to the Dodd-Frank Act, it is clear that, while it takes important steps in attempting to curb the moral hazard underlying too big to fail, it fails to address several of the factors that cause moral hazard and that led to the 2008 financial crisis; therefore too big to fail will continue. First, because the Dodd-Frank Act does not require liquidity requirements and does not break up or reduce the size of large bank-like institutions, it allows shadow banks to become “too big to fail,” thus, encouraging moral hazard. Second, because the Dodd-Frank Act codifies additional information asymmetries that contributed to the 2008 financial crisis it further encourages moral hazard. These codifications include the following provisions: regulatory exemptions for derivatives; allowing banks and investment firms to continue to mask their losses through over-valued assets and esoteric accounting methods; and an absence in the Dodd-Frank Act compelling shadow banks to reveal their financial statements indicating their actual liabilities. Third, because the Dodd-Frank Act does not strip the Federal Reserve, one of the prime culprits in perpetuating pro-cyclical and pro-shadow bank policies, of its bank-supervision roles, it helps perpetuate the same policies that led to the 2008 financial crisis also
encouraging moral hazard. Moreover, given the manner in which the pro-shadow bank relationships and pro-cyclical polices metastasized into federal bailouts, it is difficult to imagine that the passage of the Dodd-Frank Act will temper the Federal Reserve’s and Treasury Department’s pro-market policies, which have historically encouraged moral hazard. Fourth, because the Dodd-Frank Act does not restrict the size of shadow banks or the scope of their activities, it allows for more principal-agent separation, which encourages moral hazard. Fifth, because the Dodd-Frank Act authorizes, or fails to prohibit, resort to the same laws that permitted the 2008 bailouts, emergency mergers and sales of entire shadow banks, it further codifies moral hazard.

Given that all five factors in the LPMH model are present, the Dodd-Frank Act “dangerously” encourages moral hazard. As the LPMH analysis demonstrates, the Dodd-Frank Act shadow banks are still encouraged by pro-cyclical policies to act with high-risk strategies, additional information asymmetries are codified, and federal bailouts still exist under the Federal Reserve Act, despite the Dodd-Frank Act. Therefore, the Dodd-Frank Act therefore has not ended the “too big to fail” concept.

This article concludes by recommending that the Dodd-Frank Act be modified to include a counter-cyclical policy framework to better enable it to end the moral hazard underlying the “too big to fail” concept. Such a framework would include: (1) imposing wind-down procedures for highly interconnected shadow banks; (2) implementing random, counter-cyclical shocks to the financial markets by contracting credit to determine system stability; (3) re-implementing some version of the Glass-Steagall Act; (4) creating an independent regulatory body responsible solely for monitoring systemic risk; (5) avoiding governmentally orchestrated ad hoc “deals” in favor of principled actions based on balanced policies; and (6) imposing bank-like capital requirements to all lending entities. Ultimately, the Dodd-Frank Act is certainly groundbreaking for its attempt to regulate under-regulated areas of the economy and correcting polices that had become unquestioned. Arguably, the Dodd-Frank Act has enshrined moral hazard, while attempting to limit the chaos the “too big to fail” concept will cause in the future.

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Introduction

In light of the 2008 financial crisis and the subsequent financial reform designed to end the “too big to fail” concept, the Dodd-Frank Act, one can place arguments about the proper scope and content of financial reform and their effect on shadow banks\(^1\) as occurring on a spectrum between anti-market interventionism and pro-market fundamentalism. While nomenclature may vary, these terms describe the theoretical, political, and philosophical opposing poles of financial and economic innovation and government regulation, with politicians, economists, scholars, and businesspeople debating about how close to either extreme any financial regulation should lie when attempting to balance free market innovation and prudence.

Pro-market fundamentalism\(^2\) embodies nearly unfettered pro-cyclical monetary policies and lax regulations that not only encourage innovation, but often allow for risky behavior. Over time, pro-market fundamentalism can metastasize into cozy relationships with friendly regulators, and lax regulation that prohibit effective monitoring.\(^3\) For shadow banks that are too big to fail, risky behavior, poor monitoring,
and weak regulations can coalesce to create a perfect storm that leads to catastrophic financial collapses requiring government sponsored or brokered bailouts of businesses and industries considered “too big to fail.”

Conversely, anti-market interventionism holds that the government is the correcting agent to the market’s entropy. Anti-market interventionism regards the market as being indestructible. Those advocates of anti-market interventionism believe that large entrepreneurs, which would include financial institutions, like shadow banks, will produce an endless flow of wealth, services, products, taxes and jobs, regardless of how restrictive economic laws and policies Congress and regulators implement. Whether shadow banks are viewed as fearsome politically connected financial juggernauts to be subjugated by draconian measures, or viewed as vulnerable capitalists, essential to the functioning of the financial system, easily dissuaded by legal and regulatory disincentives, is conjecture, but such views are bound to influence individuals’ ideas on financial reform.

In discussing the proper balance between anti-market interventionism and pro-market fundamentalism, applying a consistent framework for analyzing moral hazard can limit the enacting of policies and laws that trend too strongly toward pure pro-market fundamentalism. This article will argue that laws that allow for policies that allow or create information asymmetries, foment pro-market policies and entrenched relationships between regulators and the regulated, and allow for government bailouts encourage moral hazard. This article premises this that argument on the basis that shadow banks are incentivized to take risk with a tacit belief that federal assistance will be forthcoming should the risks taken result in financial collapse.

Generally, moral hazard describes a situation where an institution does not take the full consequences and responsibilities of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to hold some responsibility for the consequences of those actions, absorb the $30 billion loss regardless of whether they rejected the merger deal. See David Russell, The Inappropriateness of Financial Regulation, REALCLEARMARKETS – ARTICLES, May 1, 2008. Bear Stearns leveraged the Federal Reserve’s and Treasury’s backstopping into a better negotiating position. In other words, Bear Stearns forced JPMorgan to re-negotiate for a contractually clear right to buy 39.5% of Bear Stearns for $10/share.

4 See generally, ANDREW ROSS SORKIN, TOO BIG TO FAIL (2009) [hereinafter A. SORKIN].

5 Leon Louw, “Market Fundamentalists” – Who are they?, THE AFRICAN EXECUTIVE, Jul. 16 – 23, 2008 at 1. (Louw describes in theoretical terms about the distinction between “market fundamentalists” and “interventionsists”)

6 See supra note 5 at 1.

7 Id.

8 This article will be the first of several where I apply the LPMH model to assess governmental responses to financial, environmental, and other crises.
a perversion of insurance theory.⁹ Applied to the context of financial regulation, moral hazard describes the tendency of some financial institutions lobbying for financial deregulation and pro-cyclical monetary policies, while manipulating financial innovations to lure investors, while regulators, like the Federal Reserve, declare these institutions “too big to fail” when bankruptcy appears imminent and allowing them to negotiate for federal bailouts.¹⁰ Over the decades, many institutions, including financial institutions, have been subsidized by federal government assistance.¹¹ Moral hazard can gain inertia when the U.S. government protects risk-prone entities from the consequences of their own behavior.¹²

The era of pro-market fundamentalism has created a cyclical pattern¹³: first, the fervent advocacy of market-based policy ideas, followed by their implementation, creates a bubble. Second, during the creation of these bubbles, some institutions not only acquire financial largesse, but also develop relationships with their regulators sufficient to influence the laws and policies designed to regulate them. Third, the bursting of this bubble threatens widespread financial damage sufficient to require extensive government intervention that often results in pro-market ad hoc bailouts, weak post-crisis remedial regulations, and subsequent moral hazard, particularly from institutions that have acted recklessly and benefitted from or ultimately lost little from federal bailouts.

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⁹ See infra note 49.

¹⁰ See generally GARY H. STERN AND RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS (2004). In this book, Bank of Minneapolis Fed President Gary Stern and Vice President Ron Feldman examine whether government policy influences bank failures. This book lucidly explains the moral hazard problem that plagues large financial institutions that policymakers deem “too big to fail.”


¹² See infra notes 52, 277.

¹³ Brown and Jacobs discern five phases in the cycle, but I have condensed phases two and three into phase one. First, conservatives deem the central problem in every arena to be an insufficient reliance on markets. Second, conservative policy experts propose a simple solution: a substitution of market forces for government. The third step in Brown and Jacobs’s framework is legislative action to implement the ideas proposed by the market worshippers. The fourth phase is when the seductive simplicity of free market theory meets complicated institutional reality. The final stage is when political backlash forces policymakers to respond to the unintended consequences and failures of the market-based approaches—causing government to grow and thereby subverting the original goals of the pro-market adherents. Even though Brown and Jacobs framework applies to banking deregulation, given that their publication predates the 2008 financial crisis, they could not have applied it to the financial crisis. See Greg Anrig, Paradox of Deregulation: Why market fundamentalism eventually leads to more government, not less, WASHINGTON MONTHLY, Nov/Dec 2008 at 2 (citing LAWRENCE D. BROWN and LAWRENCE R. JACOBS THE PRIVATE ABUSE OF THE PUBLIC INTEREST: MARKET MYTHS AND POLICY MUDDLE (2008)). Available at http://www.washingtonmonthly.com/features/2008/0811.anrig.html
The tide of pro-market fundamentalism that caused the 2008 financial crisis has been building with increasing momentum for three decades.\footnote{That wave of pro-market momentum produced the deregulation of the banking system that began in 1980 with the election of Ronald Reagan to the U.S. presidency. Even after the savings-and-loan fiasco of the 1980s and ’90s, the pro-market wave led to the repeal old Glass-Steagall Act in 1999, and a sustained, if not unreasonable, belief in free markets by Federal Reserve chairman Alan Greenspan, and the Bush economic team in the face of clear dangers posed by unregulated financial derivatives, predatory lending practices, and overly leveraged institutions and consumers. See infra note 16.} Over the past thirty years, economic policies reflected the prevailing view that any regulation that limited free market innovation was anathema to pro-market fundamentalism.\footnote{Id.} Ronald Reagan’s presidency ushered in an era of pro-market fundamentalism, and its underlying economic implemented ideology became the basis for the incremental deregulation of the U.S. banking system.\footnote{Krugman notes that Reagan broke with longstanding rules of fiscal prudence, and that indebtedness began rising under Reagan; it fell again in the Clinton years, but resumed its rise under the Bush administration, leaving us ill prepared for the recent financial crisis. Krugman continues by stating that the increase in public debt was dwarfed by the rise in private debt, which was made possible by Reagan’s financial deregulation. Krugman attributes the S&L crisis to Reagan’s deregulation, which gave the industry a license to gamble with taxpayers’ money. By the time the government closed the books on the affair, taxpayers had lost $130 billion, but Krugman argues that there was also a longer-term effect: Reagan-era legislative changes essentially ended New Deal restrictions on mortgage lending, restrictions that, in particular, limited the ability of families to buy homes without putting a significant amount of money down. \textit{See} Paul Krugman, \textit{Reagan Did It}, \textit{THE NEW YORK TIMES}, May 31, 2009 at 1 – 2.} Even after the savings & loan fiasco of the 1980s and ’90s, the wave of pro-market fundamentalism led to the Clinton administration’s 1999 repeal of the sixty-six-year-old Glass-Steagall Act,\footnote{See Tony Wilsdon, \textit{How the Democrats Are Also Responsible for the Financial Crisis}, \textit{SOCIALIST ALTERNATIVE}, Oct. 6, 2008 at 1. Available at \url{http://www.socialistalternative.org/news/article12.php?id=941}. Wilsdon notes that between the years of 1988 – 1996, Congress made four legislative attempts to weaken or repeal parts of the Glass-Steagall Act; however, Citigroup spent $100 million to vigorously advocate for passage of the Gramm-Leach-Bliley Act. However, in 1995, Robert Rubin, President Clinton’s Treasury Secretary, testified before the House Committee on Banking and Financial Services that the Clinton Administration was ready to repeal the Glass-Steagall Act: The banking industry is fundamentally different from what it was two decades ago, let alone in 1933…U.S. banks generally engage in a broader range of securities activities abroad than is permitted domestically… Even domestically, the separation of investment banking and commercial banking envisioned by Glass-Steagall has eroded significantly. Former-President Bill Clinton signed the Gramm-Leach-Bliley Act into law on November 12, 1999, thus repealing the Glass-Steagall Act.} which tore down barriers between investment and commercial banking activities. This pro-market fundamentalism also informed former Federal Reserve Chairman Alan Greenspan’s passive economic policies vis-à-vis the shadow banking system, as well as those of his successor, Benjamin Bernanke.\footnote{See \textit{infra} section entitled Entrenched Policies and Relationships.} The Bush administration also adhered to the pro-market trend, despite the fact that it passed few deregulatory laws, the Bush economic team ignored the obvious dangers posed by unregulated financial
derivatives, predatory lending practices in the housing market, and overly leveraged shadow banks.\textsuperscript{19} Deregulation, however, has lead to threatened widespread financial collapse, which has “forced” federal government bailouts or government orchestrated mergers or sales.\textsuperscript{20}

True to the cycle of pro-market fundamentalism, as the Wall Street shadow banks collapsed or contemplated becoming bank holding companies in 2008, credit markets froze and stocks crashed, the Bush administration partially nationalized the banking industry while still espousing the virtues of free market, deregulatory policies.\textsuperscript{21} Thus, from one perspective, the 2008 financial crisis was the result of thirty years worth of policies designed to encourage economic growth by implementing laws and policies that minimize the federal government’s role in the financial marketplace.\textsuperscript{22} Suffice to say, the severity of

\textsuperscript{19}Robert Berner and Brian Grow, \textit{Bush Administration Warned of Mortgage Crisis in 2003}, FREEDOM FROM THE PRESS, Oct. 1, 2008 at 1. Available at \url{http://www.freedomfromthepress.net/wordpress/2008/10/01/bush-admin-ignored-2003-mortgage-crisis-warnings-freedom-from-the-press/} (This article is from the original article \textit{They Warned US About the Mortgage Crisis} from Yahoo! NEWS, by Robert Berner and Brian Grow. For unknown reasons, Yahoo News has pulled this story.) Berner and Grow argue that the Bush Administration and many banks clung to what is known as “preemption,” a legal doctrine that can be invoked in court and at the rulemaking table to assert that, when federal and state authority over business conflict, the feds prevail even if it means little or no regulation. Berner and Grow interviewed Kathleen E. Keest, a former assistant attorney general in Iowa who now works for the Center for Responsible Lending, a nonprofit in Durham, N.C. “There is no question that preemption was a significant contributor to the subprime meltdown,” says Keest, “[i]t pushed aside state laws and state law enforcement that would have sent the message that there were still standards in place, and it was a big part of the message to the industry that it could regulate itself without rules.” (\textit{Id} at 2)

\textsuperscript{20}Krugman argues that the proximate causes of the 2008 financial crisis lie in events that took place long after Reagan left office, but Reagan-era legislative changes essentially ended New Deal restrictions on mortgage lending, that limited the ability of families to buy homes without putting a significant amount of money down. Overstretched borrowers were bound to start defaulting in large numbers once the housing bubble burst and unemployment began to rise. These defaults in turn wreaked havoc with a financial system that due to Reagan-era deregulation, took on too much risk with too little capital. \textit{See supra} note 16 at 2; \textit{see also infra} note 21.

\textsuperscript{21}In McCullagh’s article he notes that President Bush states the move to partially nationalize large U.S. banks, including Bank of America and Wells Fargo, was necessary to “preserve” the free market. McCullagh states that the Bush administration’s actions invite federal micromanaging and that politicians who are members of the committees overseeing the Treasury Department’s budget will enjoy outsize influence, so will Treasury and other regulators that banks must please to stay in business. Moreover, McCullagh notes that Washington bureaucrats charged administering bailout funds face temptation to favor their former banking colleagues, especially if they plan to return to their Wall Street jobs after departing the Bush administration. \textit{See Declan McCullagh, Will U.S. Taxpayers Need A Bailout?}, CBSNEWS.com, Oct. 15, 2008 at 1. Available at \url{http://www.cbsnews.com/stories/2008/10/14/politics/otherpeoplesmoney/main4522346.shtml}. Rodgin Cohen, a Sullivan & Cromwell attorney, advised Lehman Brothers to become a bank holding company for the purpose of giving it “access to the [federal reserve] discount window indefinitely, just like Citigroup or JP Morgan.” \textit{See A. SORKIN, supra} note 4 at 192. Tim Geithner was lukewarm to the idea, if for no other reason, than the signal of desperation it would send through the markets. \textit{Id} at 194. Moreover, Sorkin notes that during the financial crisis of 2008, each of the big five investment banks failed, was sold, or became a bank holding company: JP Morgan acquired Bear Stearns, Lehman Brothers collapsed, and both Goldman Sachs and Morgan Stanley became bank holding companies. \textit{Id} at 529. Sorkin notes that chaos further embroiled the markets: fear of loss, nationalization, and more turmoil resulted in the Dow Jones Industrial Average losing as much as 37% of its value even after President Bush signed TARP into law. \textit{Id} at 529.

\textsuperscript{22}\textit{See supra} note 16.
moral hazard in the U.S. financial system cannot be overstated. Federal bailouts are not new, but one must ask whether bailouts simply encourage moral hazard problem.

Frank Herbert’s *Dune* series analyzed many aspects of the human condition, including the moral hazard associated with government subsidies, and the best way to reduce this moral hazard. In *God Emperor of Dune*, a popular science fiction novel, a prescient and long-lived emperor determined that the only way to purge moral hazard from his military’s collective consciousness was to allow the notion of federal assistance to fade from memory, by simply doing nothing when calamity struck; with no federal safety net, this fictional emperor’s logic followed, institutions become resilient and self-reliant. Essentially, the God-Emperor recognized that, he had to destroy the belief that a bailout was inevitable. To the extent that the “financial catastrophe followed by federal bailout” cycle is socially undesirable, disruptive, tremendously costly, and an inefficient use of resources, governments must implement prudential regulation to reduce the moral hazard, without unreasonably curtailing financial innovation and economic growth. Thus, for the Dodd-Frank Act to end the “too big to fail” concept, the extent to which it encourages or discourages moral hazard associated with the “too big to fail” concept will be an essential performance measure of its success.

This article introduces the Legal Political Moral Hazard (LPMH) model, a 5-prong standard for assessing the presence of moral hazard within a given regulatory environment and acting upon an organization or industry. The LPMH model can help anticipate future crises, analyze past crises, and adjust current policies and laws by focusing discussion and analysis on the composite risk factors that contribute to moral hazard. This article will then apply this model to the Dodd-Frank Act, the regulatory progeny of the 2008 financial crisis, to determine whether and to what extent it encourages or discourages the moral hazard underlying the “too big to fail” concept. Thus, this article will explore three questions: (1) how does the Dodd-Frank Act purport to end “too big to fail”; (2) does the Dodd-Frank Act encourage or discourage legal political moral hazard; and (3) are there changes to the framework of the Dodd-Frank Act that would better enable it to end the moral hazard underlying too big to fail? This article

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23 See *supra* note 11.

24 The *Dune* series, set in the distant future of humanity, has a history that stretches tens of thousands of years (some 15,000 years in total) and covers considerable changes in political, social, and religious structure as well as technology. The *Dune* series’ portrays the downfall of empires as being caused, in part, to the corruption and division within the governing bodies.


26 *Id* at 247 – 254.

27 See *infra* note 43.
will argue that the finalized version of the Dodd-Frank Act offers various measures designed to address the “too big to fail” concept, but leaves open important opportunities for pursuing unstable growth, does not close information asymmetries, fails to align the interests of shadow bank executives and shareholders, does not adequately remove entrenched pro-market policies and relationships, and still allows for federal bailouts. Therefore, the Dodd-Frank Act dangerously encourages the moral hazard underlying the “too big to fail” concept.

Crisis and Opportunity: The 2008 Financial Crisis and the Dodd-Frank Act

In the wake of the 2008 financial crisis, many clamored for financial reform that would end the reviled “too big to fail” concept, particularly in light of the massive federal bailouts for the shadow banks who many believed caused or exacerbated the meltdown.28 Such an endeavor, however, beckons the question: what is “too big to fail” concept? In essence, the “too big to fail” concept represents the belief that bankruptcy proceedings by a large firm can cause a financial crisis, and that, if possible, bankruptcy should be prevented by loans, asset purchase, direct investment, and federal loan guarantees.29 Economist Anna Schwartz dubbed this logic as the “too big to fail” doctrine.30

28 Moscovitz and Housel argue that in 2009, Of the 8,195 banks in this nation, just four, JPMorgan Chase, Citigroup, Wells Fargo, and Bank of America control nearly 40% of the deposits. Those four, plus Goldman Sachs hold 97% of the industry's notional derivative exposure. They argue, however, that there is a downside: being “too big to fail.” In essence, taxpayers pay the price for their mistakes, yet many bankers still defend the practice. See Ilan Moscovitz and Morgan Housel, It's Time to End 'Too Big to Fail', THE MOTLY FOOL, Nov. 13, 2009 at 1. Available at http://www.fool.com/investing/general/2009/11/13/its-time-to-end-too-big-to-fail.aspx

29 See Anna J. Schwartz. The Misuse of the Fed's Discount Window, FEDERAL RESERVE BANK OF ST. LOUIS, ST. LOUIS REVIEW (September/October 1992) at 62. After two years of operations, the Penn Central Transportation company was put into bankruptcy on June 21, 1970. It was the largest corporate bankruptcy in American history up until that time. The Penn Central's bankruptcy was the final blow to long-haul private-sector passenger train service in the United States. The troubled line filed to abandon most of its remaining passenger rail service, causing a chain reaction among its fellow railroads. The federal government stepped in and, in 1971, created Amtrak, a virtual government agency, which began to operate a skeleton service on the tracks of Penn Central and other U.S. railroads. The Penn Central continued to operate freight service under bankruptcy court protection. After private-sector reorganization efforts failed, Congress nationalized the Penn Central under the terms of the Railroad Revitalization and Regulatory Reform Act of 1976. Facing continued loss of market share to the trucking industry, the railroad industry and its unions were forced to ask for deregulation. The 1980 Staggers Act, which deregulated the railroad industry, proved to be a key factor in bringing Conrail and the old Penn Central back to life. Schwartz notes that the Penn Central crisis episode fostered the view that bankruptcy proceedings by a large firm created a financial crisis, and that, if possible, bankruptcy should be prevented by loans and loan guarantees: the “too big to fail” doctrine in embryo.

30 Id at 62.
The “too big to fail” concept relies on five (5) justifications. First, potentially, major “systemic” problems can arise when a large shadow bank fails, leaving some investors and other creditors unprotected. Investors will rapidly withdraw funds from failing banks, and counter parties will insist on more collateral, thereby accelerating the problems facing these banks. The spillover effects of this exodus can further weaken other viable banks and cause their failure. Rapid investment reallocations in the shadow banking system also have negative effects on extension and maintenance of credit. Second, shadow bank regulators have a difficult time determining which shadow banks are viable and non-viable, once a run on a bank begins. Third, a considerable amount of time is required to unwind a large shadow bank. Fourth, the failure of large banking organizations adversely affects the market for mortgage-backed securities, government securities and municipal securities. Shadow banks provide liquidity to many of these markets because the banks play the role of a market maker. Consequently, the collapse of a large shadow bank could temporarily damage the operation of these markets. Fifth, because the “too big to fail” concept diminishes the incentive for investors to closely monitor and discipline risky banks, federal intervention is necessary to mitigate the consequences of total collapse. Such justifications can reinforce the moral hazard present within the financial system, if shadow banks rely on these justifications and believe that they will not bear the full consequences of their actions.

The Dodd-Frank Act: Opportunity for Financial Reform

On January 21, 2010, President Barack Obama announced his intention to end the “too big to fail” concept. Originally, President Obama’s proposal for financial reform following the 2008 financial crisis included the following components: (1) consolidation of regulatory agencies, elimination of the national thrift charter, and new oversight council to evaluate systemic risk; (2) comprehensive regulation of financial markets, including increased transparency of derivatives (i.e. – incorporation onto exchanges); and (3) tools for financial crises, including a “resolution regime” complementing the existing FDIC authority to allow for orderly winding down of bankrupt firms, including a proposal that the

31 Richard E. Randall, The Need to Protect Depositors of Large Banks, and the Implications for Bank Powers and Ownership, FEDERAL RESERVE BANK OF BOSTON, NEW ENGLAND ECONOMIC REVIEW, (September/October 1990) at 63-75.

32 For example, AIG’s senior vice president of strategic planning during the financial crisis, Brian Schreiber, insisted that the Federal Reserve would come to rescue from its credit default swap troubles given its vast counterparty exposure, stating with an air of cockiness “At this point, it’s a game of chicken.” See A. SORKIN, supra note 4 at 389. Moreover, according to Sorkin, the Federal Reserve had articulated a policy by 2008 that if the consequences of a financial crisis were serious enough to affect the entire financial system, the Federal Reserve might indeed have broader obligations that might require intervention. Id at 219.

Federal Reserve receive authorization from the Treasury Department for extensions of credit in “unusual or exigent circumstances.”

Representative Barney Frank and Senator Chris Dodd also proposed a financial reform bill in response to the 2008 financial crisis on December 2, 2009. After many months of negotiation and compromise, President Obama signed the Dodd-Frank Act into law on July 21, 2010. The Dodd-Frank Act, a product of the financial regulatory reform agenda of the democratically controlled 111th United States Congress and the Obama administration, is arguably the most sweeping change to financial regulation in the United States since the Great Depression, and represents the beginning of a paradigm shift in the American financial regulatory environment. By providing supervision and regulation where none existed previously and limiting or prohibiting the use of taxpayer dollars to salvage failing institutions, the Dodd-Frank Act explicitly seeks to end the too big to fail concept.

Structure of the Dodd-Frank Act

The Dodd-Frank Act changes the existing regulatory structure by creating several new agencies, and combining and removing others, in an effort to streamline the regulatory process, increasing oversight of specific institutions regarded as a systemic risk, amending the Federal Reserve Act, promoting


37 The purpose of the Dodd-Frank Act, in pertinent part, is as follows:

To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

See “Dodd–Frank Wall Street Reform and Consumer Protection Act (HR 4173).” Available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf
transparency, increasing coordination among regulatory agencies. The Dodd-Frank Act establishes relatively rigorous standards and supervision to protect the economy and American consumers, investors and businesses, supposedly ends taxpayer funded bailouts of financial institutions, provides for an advanced warning system on the stability of the economy, creates rules on executive compensation and corporate governance, and eliminates the loopholes that led to the economic recession.\(^{38}\) In many respects, the Dodd-Frank Act alters the way America’s financial markets will operate in the future. It eliminates the Office of Thrift Supervision, creates the Financial Stability Oversight Council and the Office of Financial Research, in addition to creating several consumer protection agencies, including the Bureau of Consumer Financial Protection.\(^{39}\) The Act is divided is into sixteen titles\(^{40}\) and by one law firm's count, it requires that regulators create 243 rules, conduct 67 studies, and issue 22 periodic reports.\(^{41}\) The Sarbanes-Oxley Act required, by comparison, a few dozen.\(^{42}\)

While the Dodd-Frank Act specifically addresses the objectives of President Obama's proposal, it nevertheless includes factors that encourage moral hazard. Those factors include over-speculation, the oversight of the Federal Reserve and Treasury, vague and overbroad directives to implement counter-cyclical financial policies, multiple information asymmetries, misalignment of shadow bank executive and shareholder interests, and institutionalized government intervention in the form of federal bailouts. Given that the Dodd-Frank Act fails to address these risk factors, all of which directly contributed to the 2008 financial crisis, it is important to specifically assess how the Dodd-Frank Act encourages the moral hazard implicit to the “too big to fail” concept.


\(^{39}\) See HR 4173,§111 (Financial Stability Oversight Council), §152 (Office of Financial Research), and §1011(Office of Financial Research).


\(^{41}\) Davis Polk & Wardell LLP created a summary addressing the major aspects of the Dodd-Frank Act. See generally, Summary of the Dodd–Frank Wall Street Reform and Consumer Protection Act, available at http://www.davispolk.com/files/Publication/70849fe-6580-413b-b870b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.

\(^{42}\) The Sarbanes-Oxley Act (Pub.L. 107-204, 117 Stat. 745) required more than fifteen separate rulemaking projects to implement many of the Act’s provisions. The Act also called for several mandated studies on particular aspects of the capital markets. The Act requires six studies, pursuant to Section 401(c) of the Sarbanes-Oxley Act. The Act also mandated studies, such as those to be conducted by the General Accounting Office on consolidation of public accounting firms (Section 701), mandatory rotation of accounting firms (Section 207) and investment banks (Section 705). The Act also called for reviews of Federal Sentencing Guidelines by the United States Sentencing Commission (Sections 805, 905 and 1104).
The Legal Political Moral Hazard Model

Moral hazard describes the risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles. The common example is for the car owner to drive more recklessly once he obtains car insurance. Thus, moral hazard is the prospect that a party, once insulated from risk, may behave differently from the way it would behave if fully exposed to that risk. Moral hazard arises because an individual or institution does not take full account of the consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear responsibility for the consequences of those actions. Conventional theory on moral hazard posits that information asymmetries and principal-agent separation alone produce moral hazard. This article will argue; however, that the traditional conception of moral hazard (i.e. – a one-dimensional information asymmetry and principal-agent problem) is inadequate to explain the dynamics among the shadow banks, credit ratings agencies, regulators, and investors that, not only contributed to the 2008 financial crisis, but also continue to plague the financial system.

Economist Hyman Minsky’s Financial Instability Hypothesis provides the theoretical basis for the LPMH model. Economist Paul McCulley further states that the longer an actor can derive profits from excessive risk taking, the more imprudent the risk-taking becomes. If every actor in a sector is

43 Investopedia defines moral hazard as the risk that a party to a transaction has not entered into the contract in good faith, has provided misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles. Moral hazard can be present any time two parties come into agreement with one another. Each party in a contract may have the opportunity to gain from acting contrary to the principles laid out by the agreement. For example, when a salesperson is paid a flat salary with no commissions for his or her sales, there is a danger that the salesperson may not try very hard to sell the business owner's goods because the wage stays the same regardless of how much or how little the owner benefits from the salesperson's work. Moral hazard can be somewhat reduced by the placing of responsibilities on both parties of a contract. In the example of the salesperson, the manager may decide to pay a wage comprised of both salary and commissions. With such a wage, the salesperson would have more incentive not only to produce more profits but also to prevent losses for the company. See http://www.investopedia.com/terms/m/moralhazard.asp

44 Id.


46 See, Hyman Minsky, The Financial Instability Hypothesis (May 1992) at 1. The Jerome Levy Economics Institute Working Paper No. 74. Available at SSRN: http://ssrn.com/abstract=161024 or doi:10.2139/ssrn.161024. Minsky wrote this article in 1992, long before the 2008 financial crisis. The FIH is descriptive and is being heavily adapted to apply to the LPMH model for this article. Specifically, the LPMH model, as it applies to the shadow banking industry, examines the how shadow banks respond to business cycles.

47 See McCulley supra note 1 at 3. McCulley notes that the longer people make money by taking risk, the more imprudent they become in risk-taking. “If everybody is simultaneously becoming more risk-seeking, that brings in risk premiums, drives up the value of collateral, increases the ability to lever and the game keeps going.
simultaneously becoming more risk-prone, as many shadow banks had become, this dynamic, in turn, drives up the value of collateral, increases the ability to use leverage, and causes a general sense of stability. When one extrapolates stability into infinity, one is likely to ignore the consequences of a credit freeze or massive default. Likewise, the federal government can encourage this sense of stability by implementing laws and financial policies that encourage shadow banks to engage in risky behavior and protect them should collapse become possible. Specifically, the federal government has encouraged moral hazard through pro-cyclical interest rates, deregulation of shadow banks and the investments they make, and legislative enactments that provide for federal bailouts. The combined effect of this hodge-

48 Id.

49 See McCulley supra note 1 at 3. (“This pro-cyclical tendency applies to central banks and policymakers as well… too much success in stabilizing goods and services inflation, while conducting an asymmetric reaction function to asset price inflation and deflation, is a dangerous strategy. Yes, it can work for a time. But precisely because it can work for a time, it sows the seeds of its own demise. Or, as Minsky declared, stability is ultimately destabilizing, because of the asset price and credit excesses that stability begets. Put differently, stability can never be a destination, only a journey to instability.”)

50 Greenspan eerily acknowledged in a sober cost-benefit analysis during a Congressional hearing in 1998, that the cost of American prosperity and a “free market” was moral hazard and the occasional recession borne of excessive leverage and weak financial regulations. See http://www.bog.frb.fed.us/boarddocs/testimony/1998/19981001.htm for Greenspan’s entire testimony. Specifically Greenspan’s policies of adjusting interest rates to historic lows certainly contributed to a housing bubble in the US. See generally BARRY RITHOLTZ, BAILOUT NATION (2009). After the Enron accounting scandal, the Federal Reserve dropped the federal funds rate from 1.25% to 1%. See Economic Outlook Hearing before the Joint Economic Committee, Congress of the United States, U.S. GOVERNMENT PRINTING OFFICE, Nov. 13, 2002. A few months after luring homeowners with this 1% interest rate and his recommendation, however, Greenspan began raising interest rates in a series of rate hikes that would bring the funds rate to 5.25% about two years later. See Chris Martenson, Connect the Dots, ATLANTIC FREE PRESS, Jan. 23, 2007, available at http://www.atlanticfreepress.com/content/view/7688/81/. For borrowers who were not prepared for an increasing interest rate, massive defaults were inevitable. As a result of these schizophrenic policies Greenspan has been criticized for his role in the rise of the housing bubble and the subsequent problems in the mortgage industry. See Nouriel Roubini, Who is to Blame for the Mortgage Carnage and Coming Financial Disaster? Unregulated Free Market Fundamentalism Zealotry, RGE MONITOR, Mar. 19, 2007 at 8, available at http://www.rgemonitor.com/blog/roubini/184125. Moreover, Greenspan admitted that his free-market ideology shunning certain regulations was flawed during a congressional hearing on October 23, 2008. See Scott Lanman, and Steve Matthews, Greenspan Concedes to ‘Flaw’ in His Market Ideology, BLOOMBERG.COM. Oct. 23, 2008, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=ah5qh9Up4rg.

51 The Financial Services Modernization Act of 1999 (“Gramm-Leach-Bliley Act”) repealed sections 20 and 32 of the Glass-Steagall Act. Section 20 prohibited any member bank from affiliating in specific ways with an investment bank. Section 32 prohibited investment bank directors, officers, employees, or principals from serving in those capacities at a commercial member bank of the Federal Reserve System. The repeal of Section 32 allowed interlocking directorships that made untangling Lehman Brothers’ affiliations extremely complicated. The most significant aspect of the Gramm-Leach-Bliley Act is that it purposely weakened several important enforcement provisions. For example, section 108 for a study of the “Use of Subordinated Debt to Protect Financial System and Deposit Funds From ‘Too Big To Fail’ Institutions.” This section is significant because it refers to an institution as “too big to fail,” and represents an explicit recognition that financial institutions have been acquiring such power and influence that they cannot be allowed to fail.
podge of laws ultimately fosters the perception that the federal government will act as a lender of last resort when shadow banks face the prospect of bankruptcy. Descriptively, ignoring known risks while believing that the federal government will subsidize the costs is moral hazard.53 Indeed, the federal government has “forced” private mergers or acquisitions to rescue “too big to fail” institutions when they faced failure.54 Consequently, each federal bailout can encourage moral hazard in the future, if the institutions that take excessive risks come to believe the federal government, as the proxy for taxpayers, will subsidize the costs of their risky behavior.55 The lack of attention paid to the moral hazard presented by decades of federal bailouts simply serves to reaffirm this perception.

In order for the Dodd-Frank Act to end the “too big to fail” concept, it must attack the various factors that have built the expectation that unreasonably risky behavior will be subsidized because of the supposed importance of a shadow bank to the financial system. In other words, the Dodd-Frank Act must reverse decades of moral hazard to end the “too big to fail” concept. Otherwise, the federal government and the American people will forever be hostages to the moral hazard of those considered “too big to fail.” We will probably never fully eliminate moral hazard in any industry or system, but sufficient attention must be focused on reasonably reducing the moral hazard present in the financial system lest another financial crisis occurs that requires another round of massive federal bailouts.56 With the objective

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52 In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which amended Section 13(3) to allow the Federal Reserve to lend directly to shadow banks in unusual and exigent circumstances. Prior to that amendment, only a narrowly restricted set of loans and securities that most shadow banks tended not to hold could be collateral under section 13(3). The amendment eliminated the requirement that the notes, drafts, or bills tendered by non-banks be eligible for discount by member banks. It is not surprising that law firms seized on this language and construed it as a de facto insurance policy for shadow banks. For example, as construed by Sullivan & Cromwell LLP for its clients in a memorandum of December 2, 1991, shadow banks security firm could seek loans from the Federal Reserve in emergencies. See Anna J. Schwartz, *The Misuse of the Fed’s Discount Window*, FEDERAL RESERVE BANK OF ST. LOUIS, ST. LOUIS REVIEW (September/October 1992) at 62. The Dodd-Frank Act Title XI, §1101 does limit this authority to prohibit assisting an individual company, but it does not eliminate it.

53 See supra note 43. Moral hazard also includes a situation where one has an incentive to take unusual risks.


55 See supra note 32.

of reasonably reducing moral hazard in mind, the LPMH model is designed for use by risk managers and companies in all industries and sectors, financial or otherwise, regulatory agencies, and investors to assist in focusing discussion and analysis on the risk factors that contribute to moral hazard.

The LPMH model incorporates the traditional elements of information asymmetry and principal-agent separation, but also analyzes the manner in which an institution becomes “too big to fail,” the policies that have encouraged risk taking and use of extreme leverage, and the laws that authorize taxpayer money to be allocated for federal bailouts. Thus, the LPMH model examines these five (5) factors:

(1) **Minsky-evolution to become “too big to fail” (5pts.)** – The LPMH model examines how shadow banks achieve the “too big to fail” status, and focuses on whether “Minsky Cycle” growth is permitted to “force” the government to render assistance to them during a crisis, regardless of the cause, given the shadow bank’s importance to a vital sector in the economy.57 Three (3) stages characterize this progression: (1) hedged; (2) speculative; and (3) ponzi.58 Allowing shadow banks to use “Minsky Cycle” growth strongly encourages moral hazard, because shadow banks are free to over-speculate and, but expect the federal government to cushion any shocks attributable to their actions.59 This pattern of unsustainable shadow bank growth also helped precipitate the 2008 financial crisis.60

(2) **3-dimensional information asymmetry (2pts. per information asymmetry)** – There are three dimensions of information asymmetry that prevent effective monitoring of the investment activities within the shadow banks, thereby encouraging a lack of accountability. First, the Investor – Shadow Bank information asymmetry examines the manner and extent to which shadow banks share material

\[57 \text{ See McCulley, supra, note 1 at 1. McCulley notes that the private sector wants to reduce the extent of its risk on its balance sheet, so the federal government through the Federal Reserve is “persuaded” to do so. McCulley states that when the Federal Reserve extends balance sheet support to buffer a “reverse Minsky journey,” there’s no difference between the federal government’s balance sheet and the Federal Reserve’s balance sheet.}
\[58 \text{ See Minsky supra note 46 at 7.}
\[59 \text{ See supra note 32.}
\[60 \text{ See McCulley, supra, note 1 at 3 - 4. McCulley states that the 2008 financial crisis involved a Minsky cycle: “The progression of risk-taking in the financial markets represented by the excess of subprime loans, structured investment vehicles (SIVs) and other shady characters inhabiting the shadow banking system. Their apparent stability begat ever-riskier debt arrangements, which begat asset price bubbles. And then the bubbles burst … we have since been … moving backward through the three-part progression, with asset prices falling, risk premiums moving higher, leverage getting scaled back and economic growth getting squeezed. Minsky’s Ponzi debt units are only viable as long as the levered assets appreciate in price. But when the price of the assets decline, as we’ve seen in the U.S. housing market, Minsky tells us we must go through the process of increasing risk-taking in reverse – with all its consequences.”}
information with shareholders and investors. Second, the Government – Shadow Bank information asymmetry prevents government regulators from appreciating or understanding the risk being taken by the shadow bank, or the regulator simply does not the risk being taken by the shadow bank. Third, the Credit Rating Agency – Shadow Bank information asymmetry examines the causes and effects of ratings agencies lacking the historical data or understanding of the financial products and instruments that shadow banks are using. This sub-factor also examines how shadow banks obscure the ability of ratings agencies to assign accurate ratings for these financial products and instruments. An information asymmetry (factor two) can be exogenous or endogenous.

(3) **Principal-agent separation (5pts.)** – Investing in complex and interwoven financial instruments separates ownership from control encouraging shadow banks to mismanage and undermanage the investments of their principals. The principal–agent problem arises when a principal compensates an agent for performing certain acts that are useful to the principal and costly to the agent, where the interests of the principal and agent may not align, and where aspects of agent’s performance are cost prohibitive to monitor. Conceptually, the solution to this problem is simple: ensure the provision of appropriate incentives so agents act in the way principals wish. In reality, this problem is much more complicated to solve. Shadow bank executives and managers are naturally interested in maximizing their own profits. In order to maximize their profits, shadow bank executives and managers took huge risks that lead to huge short-term profits in the run-up to the 2008 financial crisis. These short-term profits often corresponded to the profit a shadow bank earns in the short run, or bonuses, and there was often no downside for the executives and managers. This arrangement is inevitable; nevertheless, the potential for misalignment of interest does encourage moral hazard. The more significant problem, however, is when information asymmetries develop from the principal-agent separation. By definition, the presences of information asymmetry and principal-agent separation are sufficient to encourage moral hazard. Thus, the presence of factor two and factor three indicate both endogenous and exogenous influences on moral hazard.

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61 Corporate managers are trained to profit maximize. See Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, Columbia Business Law Review 773-848 (2004) at 1. Moreover, one of the core doctrines of corporate law is that the managers have no obligation to maximize shareholder returns in any particular time frame. *See Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985) (holding that directors may not delegate determination of whether to sell company to shareholders); *see also Paramount v. Time*, 571 A.2d 1140 (Del. 1989) (court may not “substitut[e] its judgment as to what is a ‘better’ deal for that of a corporation’s board”).

62 See McCulley, *supra*, note 1 at 2 (“The longer people make money by taking risk, the more imprudent they become in risk-taking.”).
(4) Entrenched Policies and Relationships (5pts.) – Close affiliations and relationships between government regulatory personnel and shadow banks often lead to pro-market policies. These policies become entrenched over time and the relationships that develop between shadow banks and their regulators nullify the regulatory function, because they often either result in pro-shadow bank arrangements, strained interpretations of existing legislation, or requests for extraordinary authority through new legislation.

(5) Institutionalized Government Intervention (6pts.) – The presence of institutionalized government intervention (factor five) indicates the presence of laws that allow for federal bailouts, such as the Section 13(3) of the Federal Reserve Act. Section 13(3), despite the Dodd-Frank Act limitations, can still be authorized to provide massive loans to shadow banks during “exigent and unusual circumstances.” Thus, even when these laws are not used, there very presence can produce strongly encourage moral hazard.

63 For example, a relatively minor provision in the Gramm-Leach-Bliley Act illustrates the effects of relationships on policy. While Congress was drafting the Gramm-Leach-Bliley Act, lobbyists for Goldman Sachs persuaded the committee writing the bill to include a minor amendment they had sought in the event that Goldman Sachs ever wanted to become a bank holding company. That provision allowed any bank that owned a physical power plant to continue to own it as a bank holding company. Goldman Sachs was the only bank that owned a power plant. See A. SORKIN, supra, note 4 at 173. As a bailout example, AIG leveraged its securities lending business, financial products unit, and its high degree of interconnectivity with many other Wall Street firms to extract a bailout from the Federal Reserve in 2008, despite the fact that the Federal Reserve did not regulate AIG. Id at 209. Even when AIG though considered filing for bankruptcy protection, an AIG executive still insisted that the Federal Reserve would come to the rescue, stating with an air of cockiness “[a]t this point, it’s a game of chicken.” Id at 388 - 389.

64 Prior to the Dodd-Frank Act, section 13(3) of the Federal Reserve Act read, in pertinent part, as follows:
In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

Title XI, §1101 amends the section 13(3) of the Federal Reserve Act as follows:
(3)(A)In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for participant in any program or facility with broad-based eligibility, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange the Federal reserve bank shall obtain evidence that such participant in any program or facility with broad-based eligibility is unable to secure adequate credit accommodations from other banking institutions. All such discounts for any participant in any program or facility with broad-based
After performing a qualitative analysis of the above five (5) factors, the quantitative aspect of the LPMH model requires the user to total the penalty points corresponding to each factor present in the qualitative analysis. The penalty point total identifies the extent to which moral hazard is being encouraged on the rating chart below:

- **“Nominally encourages moral hazard”** (0 pts.): If no factor is present than, moral hazard is being nominally encouraged.
- **“Encourages moral hazard”** (2 – 8pts.): The only way to score a “0” or “2” on the LPMH model is to have no more than one level of information asymmetry. This score indicates that moral hazard is being weakly encouraged based on the presence of one level of information asymmetry. While problematic, one information asymmetry should not encourage moral hazard, unless the presence of other factor present as well. The implications of there being an endogenous information asymmetry include delayed responses to changing circumstances within a shadow bank. Examples of the potential consequences of endogenous information asymmetry include AIG’s Financial Products Unit in relation to the larger corporate structure. In each instance, the endogenous information asymmetry prevented the larger corporate structure from responding proactively to limit, or perhaps eligibility shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe. See, H.R. 4173, §1101.

65 It was not until January 2008, that the Chairman of AIG’s Board, Robert Willumstad, realized just how precarious AIG’s financial situation was. While reading a monthly report issued to AIG board members, Willumstad read that the FP group had insured more than $500 billion in subprime mortgages, mostly for European banks. See generally A. SORKIN, supra, note 4 at 160. Only after reading this report did Willumstad understand the gravity of the situation: with mortgage defaults dramatically increasing, AIG may have to pay absurd amounts of money. In addition to Willumstad not knowing the depth of FP’s involvement in subprime mortgages, he also hired AIG’s outside auditor, Pricewaterhouse Coopers (PwC), and ordered a secret meeting to help him gain an understanding of what FP was doing, because neither he, nor many others had an understanding of FP’s business model. See generally A. SORKIN, supra, note 4 at 160.
prevent, losses from the then declining housing market. With exogenous information asymmetries, such as those between shadow banks and ratings agencies, and between shadow banks and regulators, the shadow bank prevents broader public from predicting mid- to long-term trends, because the information upon which they rely is inaccurate. On the other end of this range, in order to score an “8,” an endogenous or exogenous information asymmetry must be present along with a strongly weighted exogenous factor, such as entrenched policies and relationships or institutionalized government intervention. The combination of two exogenous factors or exogenous and endogenous factors working together certainly encourages shadow banks to act pro-cyclically or in expectation of a government bailout.

• **“Strongly encourages moral hazard”** (9 – 18pts.): To score “9” or higher on the LPMH model requires the presence of either multiple endogenous or the presence of strongly weighted exogenous and endogenous factors. Taken together, the presence of enough factors to score “9” or more demonstrates that there are possibly multiple information asymmetries, and either serious over speculation and over-leveraging or the misalignment of principal and agent’s interests, all of which seriously encourage moral hazard. Clearly, on the other end of the range, even a single dimension of information symmetry along with the misalignment of principal and agent’s interests, over speculation and over-leveraging, entrenched policies and relationships or institutionalized government intervention strongly encourages moral hazard.

• **“Dangerously encourages moral hazard”** (19 – 28pts.): To score “19” or higher on the LPMH model requires either the presence of four or five factors to be present, which indicates that moral hazard is being dangerously encouraged, both exogenously and endogenously. Whether there are single or multiple information asymmetries, the shadow bank is operating pro-cyclically and over-leveraging and over-speculating, entrenched policies and relationships, and it may be expecting a bailout in case its business strategies result in financial collapse. The confluence of these factors dangerously encourages moral hazard.

**Analysis of the Dodd-Frank Act**

While the Dodd-Frank Act makes many important changes to the regulatory environment and makes a significant stride toward ending the “too big to fail” concept and its implicit moral hazard, it still cannot be argued to have ended it. In summary, the LPMH model demonstrates that the Dodd-Frank Act encourages moral hazard rather than discourages it. Specifically, it fails to empower a single regulator that would have stripped the Federal Reserve, one of the prime culprits in perpetuating pro-cyclic and pro-shadow bank policies, of its bank-supervision roles; rather, it grants the Federal Reserve with
additional supervisory powers,\textsuperscript{66} such as placing the supposedly “independent” consumer protection agency within the Federal Reserve.\textsuperscript{67} In addition, the Dodd-Frank Act implements a version of the “Volcker Rule” to prohibit risky trading by banks, but only after a period of study.\textsuperscript{68} Moreover, the Dodd-Frank Act is deficient in that it fails to address other factors that encourage moral hazard in the financial system, namely the influence of entrenched policies and relationships, principal-agent misalignment, and institutionalized government intervention codified in the form of federal bailouts.

\textbf{(1) Minsky-Evolutionary Growth}

In light of the boom-bust cycle that characterizes the American economy,\textsuperscript{69} institutions have an incentive to engage in risky speculative activity, because during “good times,” speculative activities allow for greater demand for underlying assets and, in turn, higher asset prices.\textsuperscript{70} Hyman Minsky’s Financial Instability Hypothesis demonstrates the importance of limiting a use of speculation.\textsuperscript{71} Minsky’s Financial Instability Hypothesis offers the theoretical framework for understanding how over-speculation helped create the bubbles in property prices, mortgage finance, and shadow banking that characterize the 2008 financial crisis.\textsuperscript{72} Minsky’s Financial Instability Hypothesis argues that economic cycles can be described as a progression through kinds of debt units: (1) hedge financing units, in which the borrower’s cash flows cover interest and principal payments; (2) speculative finance units, in which cash flows cover only interest payments; and (3) Ponzi units, in which cash flows cover neither and are reliant on rising asset

\textsuperscript{66} See \textit{H.R. 4173} Titles VIII and Title XI.

\textsuperscript{67} See \textit{H.R. 4173}, Title X, §1011.

\textsuperscript{68} \textit{H.R. 4173}, Title VII, §§701 and 754 both state that the provisions of this subtitle shall take effect on the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision of this subtitle.

\textsuperscript{69} See McCulley, supra note 1 at 3. McCulley adapts Minsky’s Hypothesis to explain the endemic boom-bust cycles of capitalism, including the bubbles in property prices, mortgage finance, and shadow banking that characterize the 2008 financial crisis.

\textsuperscript{70} McCulley cites Minsky’s teaching that when credit is evolving from hedge units to speculative units, there is no fear, as the journey increases demand for the underlying assets that are being levered, and drives up their prices. See McCulley, supra note 1 at 4.

\textsuperscript{71} See Minsky, \textit{supra} note 46 at 7. (“It can be shown that if hedge financing dominates, then the economy may well be an equilibrium seeking and containing system. In contrast, the greater the weight of speculative and Ponzi finance, the greater the likelihood that the economy is a deviation amplifying system.”)

\textsuperscript{72} See McCulley, supra note 1 at 2. (“The shadow banking system, from its explosive growth to its calamitous collapse, followed a path that may have looked quite familiar to the economist Hyman P. Minsky.”)
prices to keep the Ponzi unit afloat. The mortgage debt market followed Minsky’s three-step path almost precisely. Therefore, in order for the Dodd-Frank Act to end the “too big to fail” concept it must discourage the over-speculation Minsky warned against.

The Dodd-Frank Act attempts to directly address speculation by addressing its two related aspects, securitization and leverage, through mechanisms: (1) Title VI entitled “Improvements to Regulation” (the “Volcker Rule”); (2) the “Collins Amendment”; and (3) the new rules on securitization. These mechanisms, while providing important changes would do little prevent the same over speculate that led to the 2008 financial crisis, and thus does not end the “too big to fail concept.”

**The Volcker Rule**

Title VI, §619 of the Dodd-Frank Act contains the “Volcker Rule.” Named after former Chairman of the Federal Reserve Paul Volcker, it specifically prohibits a bank, or institution that owns a bank, from engaging in proprietary trading not requested by a client, from owning or investing in a hedge

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73 *See Minsky, supra* note 46 at 7.

74 *See McCulley supra* note 1 at 4. McCulley states that the bubble in the U.S. housing market provides a plain illustration of the forward Minsky journey in action, as people bet that prices would stably rise forever and financed that bet with excessive debt. The first phase of the progression in Minsky’s hypothesis in the financial markets involved the shadow banking system’s excessive use of subprime loans, structured investment vehicles (SIVs) and other dubious financial instruments to create new types of financial instruments. *See McCulley supra* note 1 at 2. By 2008, many shadow banks had become Minsky’s Ponzi units and they imploded as a run on their assets forced them to decrease their leverage, which, in turn, drove down asset prices, and eroded equity. *Id* at 8 - 9. Because, the shadow bank system is particularly vulnerable to bank runs during credit crunches, shadow banks drained their back-up lines of credit with conventional banks or liquidated assets at distressed prices. *Id* at 10. Indeed, conventional banks sought to reduce their connectedness to shadow banks. *Id*. Such a credit contraction can cause a liquidity crisis, if a shadow bank relies on this short-term financing, like may Bear Stearns.

75 *See H.R. 4173*, Title VI.

76 The “Collins Amendment” refers to SA 3879 to bill S. 3217.

77 *See H.R. 4173*, Title IX.

78 *See The ‘Volcker Rule’ could clarify roles and risks in the financial system*, THE WASHINGTON POST, Jan. 23, 2010 at 1. The article notes that the Volcker Rule would not have prevented the current financial crisis, which began with the collapse of a pure investment bank, Lehman Brothers; moreover, two non-commercial banks, Bear Stearns and AIG, received bailouts, but their interconnection with other institutions, not size alone, frightened the government into saving them. *Id* at 1.

79 *See H.R. 4173*, Title VI, §619. The Volcker rule separates investment banking, private equity and proprietary trading (hedge fund) sections of financial institutions from their consumer lending arms. Banks are not allowed to simultaneously enter into an advisory and creditor role with clients, such as with private equity firms. The Volcker rule aims to minimize conflicts of interest between banks and their clients through separating the various types of business practices financial institutions engage in.
fund or private equity fund, as well as limiting the liabilities that the largest banks could hold; however, this proprietary trading ban was dropped at the request of Senator Scott Brown, whose vote was needed in the Senate to pass the bill. The rule attempts to distinguish between the activities and transactions that banking entities may conduct and those that nonbank financial companies supervised by the Federal Reserve Board may conduct. The Volcker Rule also requires that regulators impose capital requirements upon financial institutions that are “countercyclical, so that the amount of capital maintained by a financial institution increases in times of economic expansion and decreases in times of economic contraction,” to ensure the safety and solvency of the financial institution and society; however, this crucial aspect of the Volcker rule has yet to go into effect.

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82 H.R. 4173, §102(a)(4)(B) defines the term “U.S. nonbank financial company” to mean a company (other than a bank holding company, a Farm Credit System institution chartered and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.), or a national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), security-based swap execution facility, or security-based swap data repository registered with the Commission, or a board of trade designated as a contract market (or parent thereof), or a derivatives clearing organization (or parent thereof, unless the parent is a bank holding company), swap execution facility or a swap data repository registered with the Commodity Futures Trading Commission), that is (i) incorporated or organized under the laws of the United States or any State; and (ii) predominantly engaged in financial activities, as defined in paragraph (6).

83 Collins, Parry, and Bullitt note that the final version of the Volcker Rule adopted by the conference committee applies to proprietary trading activity conducted by a banking entity or nonbank financial company supervised by the Federal Reserve as a systemically important nonbank. See Kathleen W. Collins, Monica Lea Parry, P. Georgia Bullitt (Morgan, Lewis & Bockius LLP), Financial Regulatory Reform Heads Down the Homestretch, MORGAN LEWIS PUBLICATIONS, Jun. 29, 2010. Available at http://www.morganlewis.com/index.cfm/fuseaction/publication.print/publicationID/dd2cd589-9b01-4d3a-93ff-4a12198fdefa/. See also H.R. 4173 (a)(1)(B)(2) which states, in pertinent part, any nonbank financial company supervised by the Board that engages in proprietary trading or takes or retains any equity, partnership, or other ownership interest in or sponsors a hedge fund or a private equity fund shall be subject, by rule, as provided in subsection (b)(2), to additional capital requirements for and additional quantitative limits with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund, except that permitted activities as described in subsection (d) shall not be subject to the additional capital and additional quantitative limits except as provided in subsection (d)(3), as if the nonbank financial company supervised by the Board were a banking entity.

84 See H.R. 4173, § 616.

85 See Will Henley, CFTC says rule deadlines “might slip,” GLOBAL FINANCIAL STRATEGY NEWS, Mar. 17, 2011, available at http://www.gfsnews.com/article/1374/1/CFTC_says_rule_deadlines_might_slip This article notes that Gary Gensler, the chairman of the futures regulator, said that the Volcker rule deadline “might slip” and not be completed by April 2011.
Additionally, the Volcker Rule prohibits a bank, having a direct or indirect relationship with a hedge fund or private equity fund, from entering “into a transaction with the fund, or with any other hedge fund or private equity fund that is controlled by such fund”86 without disclosing the full extent of the relationship to the regulating entity, the rule seeks to prevent conflicts of interest. Thus, the Dodd-Frank Act’s approach to ending the “too big to fail” concept relies on this approach of distinguishing “good” from “bad” trades, and classifying financial institutions as either “banking entities” or “non-bank financial companies.”87 In essence, the Volcker Rule restricts banking entities from making speculative investments that do not benefit their customers, and requires non-bank financial companies (shadow banks) that engage in proprietary trading to hold additional capital and subjects them to quantitative limits.88 Volcker argued that this speculative activity contributed to the 2008 financial crisis.89 Simply stated, while the Volcker Rule make important steps to toward curbing the abuses that contributed to the 2008 financial crisis, it fails to prohibit shadow banks from becoming too big to fail for three reasons.

First, the Volcker Rule’s reliance on categorization and characterization for determining prohibited activities only invites the kind of regulatory discretion that will lead to inefficient and ineffective action. Regulators are still placed in the unwinnable position of having to determine what trades should be permissible because they are done on behalf of a client, and which should be prohibited.90 In fact, the U.S. Congress is clearly aware that the Volcker Rule would not have prevented the 2008 financial crisis, and, more importantly, was not designed to do so.91 Senator Chris Dodd, one of

86Id. § 619 amends 12 U.S.C § 1841, § 13(f).

87 Id.

88 Id.

89 See David Cho and Benjamin Appelbaum, Obama’s “Volcker Rule”: Shifts Power Away From Geithner, THE WASHINGTON POST, Jan. 22, 2010, at 1 - 2. This article notes that Volcker has argued that such speculative activity played a key role in the financial crisis. Volcker had been arguing that banks, which are sheltered by the government because lending is important to the economy, should be prevented from taking advantage of that safety net to make speculative investments.

90 See John Cassidy, The Volcker Rule, THE NEW YORKER Jul. 26, 2010 at 11. Available at http://www.newyorker.com/reporting/2010/07/26/100726fa_fact_cassidy Cassidy notes that the practical challenge in implementing the Volcker Rule lies ahead when it is implemented in 2012. Cassidy states that institutions may try avoid it, by, for example, placing big proprietary bets and trying to define them as something else. Without the legislative purity that Volcker was hoping for, enforcing his rule will be difficult, and will rely on many of the same regulators who did such a poor job the last time around, particularly those at the Federal Reserve.

91 See Nicole Gelinas, The Volcker Rule and Congress’ Unlearned Lesson, THE MOTLEY FOOL, Feb. 11, 2010 at 2. Gelinas argues that the Volcker Rule’s “separate and regulate” strategy will fail unless Congress bans debt securitization and trading. She notes that during a hearing, Sen. Mike Johanns got Volcker to admit that the Volcker Rule “certainly would not have solved the problem at AIG nor at Lehman Brothers… it was not designed to solve those particular problems.” Moreover, Gelinas asserts that Congress knows that the Volcker Rule will not work,
the principal drafters of the Dodd-Frank Act, and Paul Volcker acknowledged that regulators would likely have great difficulty distinguishing between appropriate bank hedging activities and dangerous for-profit trading.92 Within a week of its passage, Goldman Sachs had devised a way around several of the most important aspects of the new regulations regarding proprietary trading imposed by the Volcker Rule.93

Second, because the Volcker Rule still permits shadow banks to engage in proprietary trading, (with capital requirements and quantitative limits to be determined later), it fails to meaningfully address the dangers posed by rampant securitization.94 The Volcker Rule permits nonbank financial companies to engage in proprietary trading, and, if a nonbank financial company engages in activities permitted of a banking entity, then the capital requirements or quantitative limits applied to banking entities will apply to the nonbank financial company.95 The Volcker Rule, while giving the appearance of being “tough” on Wall Street, does little to prevent another similar financial crisis from occurring,96 because the problem 2008 financial crisis resulted not from proprietary trading; rather, it resulted from over-leveraging and speculation.97

because of the inability to distinguish between allowable “bank hedging behavior” and prohibited “profit making trades.”

92 See Alison Vekshin, Dodd ‘Strongly’ Supports Volcker Rule Limiting Banks (Update1), Feb. 2, 2010 at 2. Available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4Yx7pCGUvaI&pos=7. (“Dodd asked Volcker how Congress should interpret the proposed ban on proprietary trading and whether it’s possible to separate bank hedging behavior from profit-making activities. ‘It does put a burden I think, inevitably, on the supervisor,’ Volcker said.”)

93 See Charlie Gasparino, Goldman Already a Step Ahead of FinReg, FOX BUSINESS, Jul. 27, 2010 at 1. Available at http://www.foxbusiness.com/markets/2010/07/27/goldman-step-ahead-finreg. While the Volcker Rule is supposed to scale back proprietary trading, Gasparino notes that Goldman Sachs moved about half of its “proprietary” stock-trading operations, which had made market bets using the firm’s own capital, into its asset management division, where these traders can talk to clients and then place their market bets. But by having the traders work in asset management, where they will take market positions while dealing with clients, Goldman believes it can meet the rule’s mandates, avoid large-scale layoffs and preserve some of the same risk taking that has earned it enormous profits, people close to the firm say. Thus, the move is designed to exploit a loophole in the Volcker Rule. Goldman’s move also underscores the weakness in the Volcker Rule, which was designed to reduce the same type of risk-taking activities that led to the 2008 financial meltdown. Bank of America seems to be following suit, the rest of Wall Street may soon follow Goldman Sachs’ lead.

94 Id.

95 See HR 4173 §619.

96 See Cassidy, supra note 90 at 6. Cassidy notes a conversation he had with Benn Steil, an economist at the Council on Foreign Relations where Steil states that even if the Volcker Rule had been in effect before 2008 “the crisis would have unfolded exactly as it did.” This is so because their proprietary-trading desks had not been the problem. Many independent analysts agreed, arguing that Bear and Lehman had been destroyed by excessive borrowing and by their sunny view of the subprime-mortgage market.

97 Id.
Third, if a banking entity is prepared to abandon the insurance and protections afforded depository institutions under the Federal Reserve, it can become a nonbank financial company and still openly engage in proprietary trading while performing the permitted activities of a banking entity. It is doubtful whether the Volcker Rule would discourage the moral hazard associated with becoming too big to fail, because Goldman Sachs, a bank holding company, has indicated that its own deposit-taking bank is an insignificant part of its $900 billion balance sheet. The implication being that it could abandon the deposit-taking bank and resume its proprietary trading as a U.S. nonbank financial company. Despite the supposed toughness of the Volcker Rule, Goldman Sachs executives do not believe they would have to relinquish their bank holding company status acquired during the 2008 financial crisis to escape the Volcker Rule’s ban on proprietary trading, because of the vagueness within the proprietary trade ban definition. Therefore, bank holding companies, like Goldman Sachs, can operate both a private equity unit and a proprietary trading desk, allowing it to borrow from the Federal Reserve’s discount window while taking massive risks. Any financial institutions entities wishing to avoid the Volcker Rule and escape regulation have an incentive to follow Goldman Sachs’ rationale for evading the proprietary trading ban. If correct, Goldman Sachs and others that adopt the same strategy could conceivably force

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98 Vekshin notes that Treasury Deputy Secretary Neal Wolin stated the Volcker Rule forces firms to choose between owning an insured bank, protected by government programs, and engaging in proprietary trading, hedge fund or private equity activities. See Vekshin supra notes 92 at 2. See also supra note 81 and H.R. 4173, §102(a)(4)(B) defines the term “U.S. nonbank financial company” to mean a company (other than a bank holding company, a Farm Credit System institution chartered and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.), or a national securities exchange (or parent thereof), clearing agency (or parent thereof, unless the parent is a bank holding company), security-based swap execution facility, or security-based swap data repository registered with the Commission, or a board of trade designated as a contract market (or parent thereof), or a derivatives clearing organization (or parent thereof, unless the parent is a bank holding company), swap execution facility or a swap data repository registered with the Commodity Futures Trading Commission), that is (i) incorporated or organized under the laws of the United States or any State; and (ii) predominantly engaged in financial activities, as defined in paragraph (6). See also


100 See supra note 93.


102 Id.
the federal government to bailout an entire industry, regardless of whether the industry acted recklessly.\(^3\) The Dodd-Frank Act has not eliminated the moral hazard implicit to the “too big to fail” concept, on this basis, it has encouraged it.

The Collins Amendment

The Collins Amendment,\(^4\) named after Senator Susan Collins, imposes, over time, leverage and risk-based standards currently applicable to U.S. insured depository institutions on shadow banks. The Collins Amendment also directs the appropriate federal banking supervisors, subject to Council recommendations, to develop capital requirements for all insured depository institutions, depository institution holding companies, and systemically important nonbank financial companies to address systemically risky activities.\(^5\)

Under the Collins Amendment, the appropriate Federal banking agencies are required to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies and systemically important nonbank financial companies.\(^6\) The minimum leverage capital and risk-based capital requirements applicable to these institutions are subject to two floors: they must neither be less than the generally applicable risk-based capital requirements and the generally applicable leverage capital requirements, nor quantitatively lower than the above requirements that were in effect for insured depository institutions as of the date of enactment of the bill.\(^7\)

The Collins Amendment defines “generally applicable risk-based capital requirements”\(^8\) and “generally applicable leverage capital requirements”\(^9\) to mean the risk-based capital requirements and

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\(^3\) The Dodd-Frank Act (H.R. 4173, §1101) amends Section 13(3) of the Federal Reserve Act to prevent loans to individual companies, but it still allows the Federal Reserve Act to bail out an industry or multiple entities. Under the scenario posed, there seems to be little preventing a number of shadow banks adopting Goldman Sachs’ strategy and “forcing” the Federal Reserve to use its emergency powers to extend loans to systemically important institutions. In fact, since the Federal Reserve’s emergency powers under Section 13(3) can now only be used to bailout multiple entities, it may be more willing to provide bailouts if several systemically important are endangered.

\(^4\) See SA 3879 (“Collins Amendment”).

\(^5\) Id.

\(^6\) See Collins Amendment SA 3879; see also Davis Polk & Wardwell LLP, Client Memorandum: Collins Amendment – Minimum Capital and Risk-Based Capital Requirements, Jun. 28, 2010, at 1. Available at http://www.davispolk.com/files/Publication/b051fc39-7118-4b4e-9fda-9b6934f4c2d9/Presentation/PublicationAttachment/07ba18e6-3c02-424a-afeb-9e3636532e10/062810_collins_summary.pdf

\(^7\) Id.

\(^8\) See Collins Amendment SA 3879. The formula for “generally applicable risk-based capital requirements” must include the required ratio of regulatory capital components (numerator) over risk-weighted assets (denominator).
minimum ratios of Tier 1 capital to average total assets, respectively, established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action provisions of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure.\textsuperscript{110} Davis Polk & Wardwell LLP noted that the leverage and risk-based capital requirements on minimum risk-based capital ratios for Tier 1 are 6% to be considered “well capitalized” and 4% to be considered “adequately capitalized.”\textsuperscript{111} Bank holding companies and systemically important nonbank financial companies are required to have a 10% total capital ratio in order to be considered “well capitalized” and 8% to be considered “adequately capitalized.”\textsuperscript{112}

The Collins Amendment also makes important steps to toward curbing the abuses that contributed to the 2008 financial crisis, but it similarly fails to prohibit shadow banks from becoming too big to fail for three reasons. First, the Collins Amendment does not expressly permit the U.S. banking supervisors to amend capital adequacy guidelines in accordance with the Basel III\textsuperscript{113} standards, which becomes effective by the end of 2012.\textsuperscript{114} As a result, the Collins Amendment will create a statutory floor and U.S. banking regulators would be able to implement Basel III only to the extent it is consistent with the Collins Amendment floor.\textsuperscript{115} Davis Polk & Wardwell LLP (“Davis Polk”) believes this generally means that the more stringent Basel III capital rules could be imposed on some shadow banks, with the possible exception of giving effect to any countercyclical requirements contemplated by Basel III and the bill.\textsuperscript{116} Davis Polk also summarized the difficult work of implementing the Collins Amendment as follows:

\textsuperscript{109} See Collins Amendment SA 3879. The formula for “generally applicable leverage capital requirements” must include the required ratio of regulatory capital components (numerator) over average total assets (denominator).


\textsuperscript{111} Id at 2.

\textsuperscript{112} Id.

\textsuperscript{113} See \textit{http://www.bis.org/publ/bcbs188.htm}. The Basel Committee on Banking Supervision released the final Basel III rule in December 2010. It would require 7% Tier 1 common equity (after accounting for a 2.5% buffer) and an additional systemic risk capital surcharge for the largest institutions thought to be about 1%. See also Davis Polk & Wardwell LLP, \textit{Client Memorandum: Collins Amendment – Minimum Capital and Risk-Based Capital Requirements}, Jun. 28, 2010, at 2

\textsuperscript{114} See supra note 110 at 2.

\textsuperscript{115} Id.

\textsuperscript{116} Id. The summary provided by Davis Polk & Wardwell LLP provides a very thorough breakdown of the Collins Amendment. See \textit{http://www.davispolk.com/files/Publication/b051fc39-71f8-4b4c-9fdb9b6934fe4c2d9/PublicationAttachment/07ba8e6-3c02-424a-afeb9e3636532e10/062810_collins_summary.pdf}.
U.S. banking supervisors will have the unenviable task of implementing the intersection of Collins Amendment, Basel III, capital standards under the systemic risk regime, the requirement elsewhere in the bill to adopt countercyclical regulatory capital requirements and the capital requirements that will apply to the separately capitalized subsidiaries required for certain derivatives activities... at a minimum, the Collins Amendment will set a floor for the U.S. banking supervisors in the ongoing Basel III discussions.\footnote{Davis Polk & Wardwell LLP, \textit{Client Memorandum: Collins Amendment – Minimum Capital and Risk-Based Capital Requirements,} Jun. 28, 2010, at 1.}

This assessment makes clear the logistical difficulty associated with implementing overlapping mandates, particularly ones that do not explicitly coincide with one another, implying that some desirable Basel III regulations could conflict with the Collins amendment. As a result, the regulatory gap could allow undesirable capital levels untouched.

Second, it is not clear that systemically important shadow banks will necessarily be subject to the Collins Amendment. Some shadow banks will certainly be categorized as “systemically important nonbank financial companies.” If the Federal Reserve exempts any shadow banks that qualifies as “systemically important nonbank financial companies,” then these shadow banks could arguably evade the Collins Amendment.\footnote{See Margaret E. Tahyar, Davis Polk & Wardwell LLP, \textit{Collins Amendment Sets Minimum Capital Requirements,} THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, Jul. 8, 2010. Available at \url{http://blogs.law.harvard.edu/corpgov/2010/07/08/collins-amendment-sets-minimum-capital-requirements/}. This section notes that while systemically important nonbank financial companies are subject to the Collins Amendment, in another part of the bill, the Federal Reserve has the authority to exempt systemically important nonbank financial companies from application of the risk-based capital requirements and leverage requirements. In order to do so, the Federal Reserve must determine, after consulting with the Council, that the requirements are not appropriate for a company because of the company’s activities or structure, and must apply other standards that result in similarly stringent controls.} In order to do so, the Federal Reserve must determine, after consulting with the Council, that the requirements are not appropriate for a company because of the company’s activities or structure, and must apply other standards that are supposed to result in similarly stringent controls.\footnote{\textit{Id. See} \textsc{H.R. 4173}\textsection113(f)(1); \textit{see also supra} note 98 at 4.} A healthy financial institution should be resilient enough to absorb large losses, but many shadow banks could remain fragile if the Federal Reserve exempts them from compliance with the Collins Amendment.\footnote{See \textit{supra} note 118. Tahyar notes that if the Federal Reserve makes this determination, Davis Polk does not believe that the Collins Amendment would apply to a systemically important nonbank financial company, but the interaction of the two portions of the bill is not as clear as one would hope. Tahyar further states that, “[a]ssuming the better reading applies, then hedge funds, asset managers and systemically important insurance companies would have tailored, rather than bank-centric, capital standards apply to them as the new regime is implemented.” This assumption places a lot of faith in the Federal Reserve.} For example, by March 2008, Bear Stearns had $11.1 billion in tangible equity capital
supporting $395 billion in assets, a leverage ratio of more than 35-to-1, even a small loss of only 3.2% of the assets would obliterate stockholder equity. The importance of liquidity is has certainly been known since at least 1984, when Continental Illinois National Bank & Trust Co. failed, because its overnight lending grew costlier as lenders worried about its viability. An exemption, even the possibility of one, is anathema to the Dodd-Frank Act’s stated purpose of ending the “too big to fail” concept. Moreover, the lack of a capital cushion and over-leveraging contributed to the need for a federal bailout of Bear Stearns and AIG, and the failure of Lehman Brothers. Until the day before JPMorgan bought Bear Stearns in March 2008; however, regulators said its capital buffer was sufficient. The 2008 bailouts illustrates that, in order for the Dodd-Frank Act to discourage the moral hazard implicit to the “too big to fail” concept, there should be no exceptions or discretion to the Collins Amendment’s leverage requirements, lest another massive collapse occurs.

Last, nothing in the Dodd-Frank Act protects shadow bank creditors, beyond a shadow bank’s equity capital, should it collapse. To the extent that one of the rationales for the necessity of federal bailouts of “too big to fail” shadow banks is that investors have a diminished incentive to closely monitor and discipline shadow banks, because federal intervention exists to mitigate the consequences of total collapse, the Dodd-Frank Act offers little solace. When a large shadow bank’s stability becomes precarious and it suffers losses, market participants, especially creditors, become suspicious that the shadow bank’s assets are insufficient to cover its liabilities. Despite the breadth of the Dodd-Frank Act,


122 See Eric Dash, Andrew Ross Sorkin, Government Seizes WaMu and Sells Some Assets, THE NEW YORK TIMES, Sept. 26, 2008 at A1. Available at http://www.nytimes.com/2008/09/26/business/26wamu.html. The case of Continental Illinois National Bank and Trust Company represents another step in the institutionalization of the “too big to fail” concept. Continental experienced a fall in its overall asset quality during the early 1980s. Difficulty acquiring loans, Mexico’s default, and plunging oil prices followed a period when the bank had aggressively pursued commercial lending. Continental also held highly-speculative oil and gas loans of Oklahoma’s Penn Square Bank. Complicating matters further, the Continental’s funding mix was heavily dependent on large CDs and foreign money markets, which meant its depositors were more risk-averse than average retail depositors in the U.S.

123 See Yalman Onaran, Lehman’s Fuld Snubbed Risk Managers, Nerds Got Revenge: Books, BLOOMBERG, Apr. 20, 2010 at 2. Onaran interviewed Mark T. Williams, a former risk manager in the 1990s after a stint as a Federal Reserve bank examiner. Williams stated, “liquidity is a big risk especially if you’re relying very heavily on overnight borrowing. Lehman was borrowing $180 billion a day on the repo market. Bear Stearns Cos. was knocking on the repo door for about $50 billion every day, assuming it was going to be open for them.”

124 See A. SORKIN supra note 4 at 17. Sorkin notes that during an interview with the Wall Street Journal regarding rumors that Lehman Brothers would soon be joining Bear Stearns as a failed bank, Dick Fuld, of Lehman Brothers, assured Wall Street Journal reporter Susanne Craig that between Lehman’s liquidity and the Federal Reserve’s discount window that Lehman would not fail.

125 See generally Paul Krugman, The Return of Depression Economics and the Crisis of 2008 (2009). Economist Paul Krugman described the run on the shadow banking system as the core of what happened to cause the crisis. As
it does not heighten creditors’ capacity to absorb large losses. To address this concern, the Dodd-Frank Act requires a “study” on the effects of having contingent convertible capital. Unless this study results in an explicit requirement that a portion of large shadow banks’ senior debt automatically converts to common equity capital, many creditors will be relatively unprotected, thus exacerbating one of the major compulsions for federal bailouts. A mandatory conversion ensures that another financial crisis triggers automatic changes in a shadow bank’s capital structure to resolve uncertainty about negative equity through established rules of ownership priority, a kind of “bail-in” instead of a federal bailout. The Dodd-Frank Act already reduces leverage, but shifting some quantum of risk from equity to debt holders is not only cost-neutral, but also reduces pressure to bailout failing shadow banks. This change is also especially important now because of the uncertainty created by the new “orderly resolution authority” and the manner in which the rules governing this authority are being implemented.

The alternative to this mandatory conversion is an ad hoc TARP-like program whereby the federal government provides additional equity capital to increase net assets, a politically and socially unpalatable resort in light of the massive 2008 bailouts.

Shadow banks will predictably cite traditional pro-market fundamentalist arguments that mandatory equity conversions will increase the cost of capital, yet this increased cost may be a necessary measure anti-market intervention to reduce moral hazard in the shadow banking system.

the shadow banking system expanded to rival or even surpass conventional banking in importance, politicians and government officials should have realized that they were re-creating the kind of financial vulnerability that made the Great Depression possible—and they should have responded by extending regulations and the financial safety net to cover these new institutions. He referred to this lack of controls as “malign neglect.”

126 See Christopher Papagianis, Fixing Dodd-Frank: 3 Targets, SEEKING ALPHA, Feb. 09, 2011 at 2. Papagianis argues that the Congress should replace the Dodd-Frank Act’s “study” on contingent convertible capital with an explicit requirement that a portion of large financial firms’ senior debt automatically converts to equity, because there is “no plan to reform bankruptcy law, address the payment priority for derivatives payables, increase the capacity of creditors to withstand losses, or otherwise introduce market discipline for creditors to the largest banks, the only thing standing between taxpayers and another bailout is bank’s equity capital.”

127 Id at 2 -3.

128 Id.

129 Id.

130 Id. Mandatory equity conversion is theoretically cost neutral because it will cause lower the cost of equity while raising the cost of convertible senior debt, leaving the total cost of capital unchanged.


132 Under this scheme, bank equity will be safer while reducing its cost, and encourage shadow banks to hold less risky portfolios.
Securitization

The proponents of the Dodd-Frank Act believed an essential cause of the 2008 financial crisis was that shadow banks lacked risk in securitization deals.133 Securitization is a process of turning non-marketable credit instruments into marketable ones through pooling and creates credit worthiness out of the theory of large numbers and the theory of averaging to manage the risk of default by spreading it to a large pool.134 The major aspect of the Dodd Frank Act’s securitization reform requires the securitizer to retain 5% of risk; however, if originator retains some amount of risk, the securitizer only retains the remaining risk (up to 5% total).135 Risk retention also to apply to CDOs, securities collateralized by CDOs and similar instruments.136 The risk retention types, forms and amounts for commercial mortgages will be determined by the appropriate regulators, including permitting a third party that purchases a first-loss position at issuance and who holds adequate financial resources to back losses which will substitute for the risk retention requirement of the securitizer.137 Regulations relating to credit risk retention requirements will become effective one year from enactment for residential mortgage assets, and will become effective two years from enactment for all other asset classes.138 The Dodd-Frank Act also requires asset-level disclosures, including data with unique identifiers relating to loan brokers or originators, the nature and extent of the compensation of the broker or originator of the assets backing the security, and the amount of risk retention of the originator or securitizer of such assets.139 In addition, the originator must aggregate fulfilled and unfulfilled repurchase requests across all trusts so investors can identify originators with clear underwriting deficiencies.140 The Dodd-Frank

133 See supra note 126 at 2.


136 Id.


138 See supra note 137.

139 Id.

140 Id.
Act permits no hedging or transfer of risk and requires securitizers to perform due diligence analyses for investors.\textsuperscript{141}

The new securitization rules not only fail to address the root of the 2008 financial crisis, but also potentially exacerbate the risks associated with risk retention. The proponents reasoned that shadow banks sold inferior quality collateralized mortgage-backed securities based on low quality loans to unsuspecting investors of the loans because the shadow banks did not retain the risk of the securities.\textsuperscript{142} In fact, shadow banks use of complex securitization forms like asset-backed commercial paper (ABCP) conduits, structured investment vehicles (SIVs), and other variable interest entities (VIEs) failed to transfer the associated risks as intended.\textsuperscript{143} The Dodd-Frank Act proponents’ view is also at odds with the research of other several scholars.\textsuperscript{144} That research suggests that late-stage securitization markets concentrated financial risks in the banking sector, rather than dispersing them, and failed to transfer risk to third parties.\textsuperscript{145} Such research also indicates that these late-stage securitization markets reduced shadow banks’ capital as well.\textsuperscript{146} Thus, the problem was inadequate capital regulation, rather than insufficient exposure to the credit risk of the underlying loans. If anything, shadow banks had too much exposure.\textsuperscript{147} By stipulating that securitizers hold 5\% of the risk, rather than increasing their further increasing capital

\textsuperscript{141} Id at 8. In addition to the changes effected by the Dodd-Frank Act, the SEC released a 667-page rule amending Regulation AB’s registration, disclosure, and reporting requirements for asset-backed securities and other structured finance products. The FDIC also proposed a rule amending its “securitization rule” safe harbor to require financial institutions to retain more of the credit risk from securitizations. Moreover, the Federal Accounting Standards Board revised its accounting rules relating to sales of financial assets and consolidation of certain off-balance sheet entities.

\textsuperscript{142} See Papagianis, supra note 126 at 2.

\textsuperscript{143} Id.

\textsuperscript{144} These scholars include NYU Professors Viral Acharya and Philipp Schnabl, and Gustavo Suarez in Securitization Without Risk Transfer, NBER Working Paper No. 15730, June 2010 at 3 – 4, 16 - 31. Their main conclusion is that, somewhat surprisingly, this crisis in the asset backed commercial paper market did not result (for the most part) in losses being transferred to outside investors in asset-backed commercial paper. Instead, the crisis had a profoundly negative effect on commercial banks because banks had, in large part, insured outside investors in asset backed commercial paper by providing guarantees to conduits, which required banks to pay off maturing asset-backed commercial paper at par. Effectively, banks had used conduits to securitize assets without transferring the risks to outside investors, contrary to the common understanding of securitization as a method for risk transfer. We establish this finding of securitization without risk transfer using a hand-collected panel dataset on the universe of conduits from January 2001 to December 2009.

\textsuperscript{145} Id.

\textsuperscript{146} Id.

\textsuperscript{147} See Papagianis, supra note 126 at 2- 3. Papagianis states that given banks’ cumulative losses on structured securities, it seems more accurate to say banks had too much skin in the game and should have dramatically reduced exposures, and that the problem was inadequate capital regulation and disclosure rules, not insufficient exposure to the credit risk of the underlying loans.
requirements, not only reduces liquidity, but also syndication, the process by which multiple banks
distribute large loans to a number of companies or investors.\textsuperscript{148} While, this would reduce liquidity risk, it
would have the effect of raising the cost of capital and conceivably make them less profitable. Assuming
that a proper balance between stability and economic growth requires diminished profits for the sake of
stability, this concession may be unpleasant, but necessary.

Given that the Dodd-Frank Act does not fully address the effect that over-speculation has on debt
securitization, the Dodd-Frank Act perpetuates one of the major contributors of the 2008 financial crisis.
Ultimately, the Dodd-Frank Act encourages moral hazard, because it allows shadow banks to escape
important regulations, does not sufficiently constrain regulatory discretion, and does not sufficiently
address and restrict the use of over-speculation to become “too big to fail.” Allowing shadow banks to
engage in Minsky-evolution strongly encourages moral hazard, because shadow banks are still free to
over-speculate and over-leverage. This pattern of unsustainable growth will likely cause another financial
crisis. Therefore, 5-points will be assessed.

\textbf{(2) 3-Dimensional Information Asymmetry}

The LPMH model analyzes three dimensions of information asymmetry. Generally, information
asymmetry describes a situation where one party to a transaction has more information than another party
does.\textsuperscript{149} Moral hazard is encouraged when the party with superior information can use that information to
take advantage of the party with inferior information.\textsuperscript{150}

In the context of the 2008 financial crisis, the information asymmetries within shadow banks,
between shadow banks and investors, between shadow banks and the major ratings agencies, and between
shadow banks and government regulators contributed to several large shadow banks’ overall risk prone
investing.\textsuperscript{151} Because the ratings agencies profited from assigning overly high ratings to investments, they

\textsuperscript{148} \textit{Id.} Papagianis argues that by employing debt syndication, several banks, investment firms or other companies
share both the profits and the risk of making a large loan. It is common to use debt syndication when the loan
required to fund a company is at least several million US dollars (USD). A decline in the number of available
lenders complicated debt syndication.

\textsuperscript{149} Investopedia defines asymmetric information as a situation in which one party in a transaction has more or
superior information compared to another. This often happens in transactions where the seller knows more than the
buyer, although the reverse can happen as well. Potentially, this could be a harmful situation because one party can
take advantage of the other party’s lack of knowledge. Available at \url{http://www.investopedia.com/terms/a/asymmetricinformation.asp}.
When one takes advantage of asymmetric information, it can lead to immoral behavior, or moral hazard. For example, if someone has fire insurance they may
be more likely to commit arson to reap the benefits of the insurance.

\textsuperscript{150} \textit{Id.}

\textsuperscript{151} See McCulley, \textit{supra} note 1 at 2.
had an incentive to mislead investors to ensure continued patronage. This is particularly true given the lag time between when an investment rating assigned and when investors realized the ratings were not reflective of the risk involved. The shadow banks, in turn were able to attract investors by leveraging their lofty credit ratings. Ultimately, given legislative changes such as the Commodity Futures Modernization Act of 2000, this information asymmetry forced government regulators to rely on the credit ratings agencies, not only for information, but also for de facto supervision of an otherwise under-regulated derivatives market. Shadow banks must endeavor to prevent endogenous information asymmetries, but the Dodd-Frank Act must eliminate any exogenous ones. Thus, in order for the Dodd-Frank Act to end the “too big to fail” concept it must close these three remaining exogenous information asymmetries.

1st Dimension of Information Asymmetry: Government – Shadow Bank Information Asymmetry

As stated above, the disjointed structure of U.S. regulatory agencies was outdated for dealing with the complex and interwoven financial instruments currently used. Regulators generally lacked the adequate legal authority and expertise to keep pace with the development of innovative financial products and processes that they were suppose to regulate. This information asymmetry provided the opportunity

152 Morris notes that the public may think of the ratings agencies as detached arbiters of security quality, buy they were, in fact, building booming, diversified, high-margin businesses. Moreover, the ratings agencies gave high investment-grade ratings, in short, not because their models were hostage to recent history, but because they strenuously ignored it. See CHARLES R. MORRIS, TRILLION DOLLAR MELTDOWN (2008) at 77 - 78.

153 See McCulley, supra note 1 at 2.

154 Id.

155 Despite, undeniable mounting evidence of the risks of the derivatives and the obvious fact that shadow banks were gorging on them, the Federal Reserve had failed to gauge the severity of the situation. See A. SORKIN, supra note 4 at 89. Timothy Geithner, in fact, had repeatedly warned of the catastrophe he helped “resolve” in many speeches. Id at 65. Specifically, Geithner had warned that the reliance on derivatives was making the financial industry more insecure, rather than less because of the potential of default inertia: defaults causing more defaults. Alan Greenspan, on the other hand, did not share Geithner’s skepticism on the use of derivatives. Id Greenspan would later admit that even he did not understand the mechanics behind the CDO:

I’ve got some fairly heavy background in mathematics,” he stated two years after he stepped down from the Federal Reserve, “but some of the complexities of some of the instruments that were going into CDOs bewilders me. I didn’t understand what they were doing or how they actually got the types of returns out of the mezzanines and the various tranches of the CDO that they did. And figured if I didn’t understand it and I had access to a couple of hundred PhDs, how the rest of the world is going to understand it sort of bewildered me. Id; see also DAVID FABER, AND THEN THE ROOF CAVED IN: HOW WALL STREET’S GREED AND STUPIDITY BROUGHT CAPITALISM TO ITS KNEES (2009) at 95.

Even as late as June 5, 2008, Bernanke had declared in a speech “at this point, the troubles in the subprime sector seem unlikely to seriously spill over to the broader economy or the financial system.” See A. SORKIN, supra note 4 at 89. Bernanke’s analysis, however, failed to take into account certain critical factors, primarily the link between the housing market and the financial system through the ubiquitous use of derivatives. Id.
to engage in risky investing strategies, because regulators typically lacked the necessary information to effectively guard against these new risks. While innovation tends to outpace regulation, regulators put unjustified faith in credit-rating agencies whose judgment was impaired by information asymmetry. Usage of two financial instruments that exemplified the information asymmetry in the shadow banking system were the collateralized debt obligation (CDO) and credit default swap (CDS).

The commercial paper market first burgeoned in the 1960s and for four decades, collateralized debt obligations dominated the global credit market until the 2008 credit crisis. The CDO relied on securitization. When a lender lends to a risky company, he bears the full risk of default. If the lender invests in a CDO; however, he is lending to a pool of companies whose theoretical default rate is coverable by the interest rate spread. Securitization ceases to work during a liquidity crisis, because all exits from purportedly open markets are suddenly closed, when all participants move to the sell side, and no buyers remain. Moreover, in the US, where loan securitization is widespread, banks are naturally tempted to push risky loans by passing on the long-term risk to non-bank investors through debt ignorance and failure to appraise the risk to the overall financial system, it is clear that information asymmetries existed between the regulators and shadow banks regarding the risks of CDOs and other derivatives. Id.

156 Id.

157 See McCulley, supra note 1 at 1. McCulley notes that the rating agencies face an in-built problem of putting ratings on new innovations, because they have not had a chance to observe a historical track record and monitor their performance over a full cycle.

158 See Henry C.K. Liu, Too Big to Fail Versus Moral Hazard, ASIA TIMES, Sept. 23, 2008, at 4. Available at http://www.stwr.org/global-financial-crisis/too-big-to-fail-versus-moral-hazard.html. Liu notes that the credit default swap related aspects of the 2008 financial crisis was rooted AIG's trouble in its decision in the late 1980s to take over a group of derivatives specialists from Drexel Burnham Lambert, which went bankrupt due to speculative losses in junk bonds. AIG Financial Products (AIGFP) wrote hundreds of billions of dollars of derivatives, spilling over from AIG's insurance business. The business model rested on leveraging AIG's low-cost of short-term funds to profit from high-yield long-term investments. With its AAA credit rating, AIG was an attractive counterparty for swap transactions. The Financial Products division, unregulated because it is not an insurance entity nor a banking operation, fell between the regulatory crack. It expanded geometrically over the decades into areas such as credit-default swaps (CDS), which insure against risks of default, as well as originating mortgages and consumer debt. AIG, faced with $441 billion of exposure to credit-default swaps and other derivatives, faced losses on these contracts and it drove AIG into a vicious downwards spiral needing ever more cash to remain a top-rated counterparty. Its interconnectedness “forced” the Federal Reserve to structure a bailout for AIG.

159 Id at 9.

160 Id.

161 Id.

162 Id.

163 See supra note 158 at 9.
Because this game of financial “hot potato” focuses on reselling rather than monitoring, no one party has access to all the information needed to make reasonable decisions, including regulators.

The second financial instrument was the credit-default swaps. Credit-default swaps allow investors to hedge against securitized mortgage pools. This type of contract, had been limited to the corporate bond market, conventional home mortgages, and auto and credit card loans. In June 2005, hedge funds began using a new standard contract to trade bets on home-equity securities backed by adjustable-rate loans to sub-prime borrowers, not as a hedge strategy but as a profit center. Credit default swaps and CDOs were incredibly lucrative for some time, but the system engendered a massive lack of accountability. Titles I, VII, IX, and XI of the Dodd-Frank Act are designed to close the information asymmetries between regulators and shadow banks, yet they do not completely eliminate the information asymmetry. Title I attempts to close the information asymmetry between regulators and shadow banks by creating two new agencies tasked with monitoring systemic risk and researching the state of the economy. Title VII abrogates some of the exemptions granted under sections 206B and 206C of the Gramm-Leach-Bliley Act to regulate the credit default swaps and credit derivatives that contributed to the 2008 financial crisis. Title IX focuses on “credit risk retention” that would require originators and securitizers of financial assets to retain a portion of the credit risk of securitized financial assets. In addition, the securitization provisions in the Dodd-Frank Act set forth disclosure requirements

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164 Id at 6. Liu states that loan securitization is widespread in the US and banks are tempted to push risky loans by passing on the long-term risk to non-bank investors through debt securitization.

165 Cecchetti states that when lending standards decline, the securitization process becomes a hot potato because all of the actors want to pass along the risky loans. See STEPHEN G. CECCHETTI, MONEY, BANKING AND FINANCIAL MARKETS (2nd Edition) (2010), Chap 11; see also Module on Chapter 11, entitled, Screening, Monitoring and Free Riding at 4. Available at http://highered.mcgraw-hill.com/sites/0070983992/student_view0/update_modules.html.

166 See supra note 158 at 6.

167 Id.

168 See supra note 158 at 6. Liu states that the disjointed structure of US regulatory agencies was outdated for dealing with today’s complex and interwoven financial instruments. He also notes that regulators generally lacked adequate mandate and expertise to keep pace with the supersonic speed of innovative financial products and processes that they are suppose to regulate.


170 See H.R. 4173, §§761, 762, 763, 766, and 768. Financial instruments have the meanings given the terms in section 1a of the Commodity Exchange Act (7 U.S.C. § 1a).
for the issuer and credit rating agencies who rate the issuer’s securities.\textsuperscript{171} Title XI of the Dodd-Frank Act explicitly states that Federal Reserve’s responsibility is to “[…] identify, measure, monitor, and mitigate risks to the financial stability of the United States.”\textsuperscript{172}

**Title I – Financial Stability**

Title I creates the Financial Stability Oversight Council (the “Council”) and the Office of Financial Research,\textsuperscript{173} but, as argued below, it closes neither the information asymmetry between shadow banks and ratings agencies, nor the information asymmetry between shadow banks and investors.

Title I creates the Financial Stability Oversight Council (the “Council”) and the Office of Financial Research.\textsuperscript{174} Both the Council and the Office of Financial Research are under the aegis of the Treasury Department, with the Treasury Secretary being Chair of the Council, and the Head of the Financial Research Office being a Presidential appointment with Senate confirmation. The Council has three objectives: (1) identifying risks to the financial stability of the United States; (2) promoting market discipline; and (3) responding to emerging threats to the stability of the financial markets.\textsuperscript{175} At a minimum, the Council must meet quarterly.\textsuperscript{176}

The Council has very broad powers to monitor, investigate, and assess any risks to the US financial system. The Council is responsible for collecting data from regulators and financial institutions to assess systemic risks to the financial system, monitor the financial services marketplace, and make general regulatory recommendations to affiliated agencies reflecting a broader consensus.\textsuperscript{177} The Council has the authority to collect information from any State or Federal financial regulatory agency, and may direct the Office of Financial Research, which supports the work of the Council, “to collect information from bank holding companies and nonbank financial companies.”\textsuperscript{178} Moreover, the Council may also require the Federal Reserve to assume an oversight position of certain financial institutions considered to pose a systemic risk to the financial system.\textsuperscript{179} The Council and the associated Office of Financial

\textsuperscript{171} See H.R. 4173, § 941.

\textsuperscript{172} H.R. 4173, § 712(d)(1).

\textsuperscript{173} See H.R. 4173, §§ 112, 152.

\textsuperscript{174} Id.

\textsuperscript{175} See H.R. 4173, § 112(a)(1).

\textsuperscript{176} Id.

\textsuperscript{177} See H.R. 4173, § 112(a)(2).

\textsuperscript{178} Id.

\textsuperscript{179} See H.R. 4173,112(a)(2)(H).
Research are to facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy development, rule-making, examinations, reporting requirements, and enforcement actions.\textsuperscript{180} On a regular basis, the Council is required to make a report to Congress describing the state of the financial system.\textsuperscript{181} Each voting member of the Council is required to either affirm that the Federal Government is taking all reasonable steps to assure financial stability and mitigate systemic risk, or describe needed additional measures.\textsuperscript{182}

Under specific circumstances, the Chairman of the Council, with the concurrence of 2/3 voting members, may place non-bank financial companies or domestic subsidiaries of international banks under the supervision of the Federal Reserve if it appears that these companies could pose a threat to the financial stability of the US.\textsuperscript{183} The Federal Reserve may promulgate safe harbor regulations to exempt certain types of foreign banks from regulation, with approval of the Council.\textsuperscript{184} The Council may also recommend that the primary regulatory agency provide stronger regulation of a specific financial activity.\textsuperscript{185} The Council then reports to Congress on the implementation or failure to implement such recommendations.\textsuperscript{186} A potentially powerful tool in the Council’s regulatory arsenal to close the government–shadow bank information asymmetry is the Council’s ability to require any bank or non-bank financial institution with assets over $50 billion to submit certified reports as to the following information: (1) financial condition; (2) systems in place to monitor and control any risks; (3) transactions with subsidiaries that are regulated banks; and (4) the extent to which any of the institution's activities could have a potential disruptive impact on financial markets or the overall financial stability of the country.\textsuperscript{187}

Title I certainly attempts to close any conceivable information asymmetry between the regulatory government agencies, yet it does not close any of the three dimensions of information asymmetry that existed before the 2008 financial meltdown. First, the Council, being under the Treasury Department, is

\textsuperscript{180} See H.R. 4173 § 112(a)(2).
\textsuperscript{181} See H.R. 4173 §112(a)(2)(N).
\textsuperscript{182} See H.R. 4173 § 112(b).
\textsuperscript{183} See H.R. 4173 § 113.
\textsuperscript{184} See H.R. 4173 § 170.
\textsuperscript{185} See H.R. 4173 § 120.
\textsuperscript{186} See H.R. 4173 § 120(d).
\textsuperscript{187} H.R. 4173, § 116.
susceptible to a possible policy dissonance that could obscure the scope and manner in which it collects data.\footnote{See infra section entitled, “Entrenched Relationships and Policies.”}

Second, the bureaucratic difficulties associated with the Council deciding on how to evaluate whether to label a nonbank “systematically important” according to the Dodd-Frank Act’s factors create the possibility that primary regulators may provincially horde information to protect certain shadow banks or the entire shadow banking industry.\footnote{See Dave Clarke and Rachelle Younglai, Volcker Rule Tests New Systemic Risk Council, HUFFINGTON POST, Jan. 14, 2011 at 1. The council is expected to release a study by the time this article will be published recommending how to implement the Volcker rule. Under Dodd-Frank, the council must consider a series of factors including the institution's leverage and risk exposures in determining whether to label a nonbank “systemically important.” The article quotes Heather Slavkin, a policy adviser for the country's largest labor federation the AFL-CIO, who stated that regulators “can't just focus on the institution, they have to look at the relationships the institution has with other institutions.” This article also notes that supporters of the rule want regulators to send banks a signal that their lobbying for weak implementation has been ineffective. The council is also expected to propose criteria that will be used to determine which nonbanks should be subject to additional scrutiny by the Fed and how a section of law concerning concentration limits should be implemented.} In particular, the given Federal Reserve and Treasury Department’s decades long pro-market policies and relationships,\footnote{See G. COOPER, THE ORIGIN OF FINANCIAL CRISES (2008) [hereinafter G. COOPER] at 2. see also infra section entitled, “Entrenched Relationships and Policies.” Cooper states that The US Federal Reserve does not appear to believe there can be an excessive level of money growth, credit creation or asset inflation. It does, however, believe, according to Cooper, that there can be an unacceptably low level of all three. As a result, Cooper argues that the Federal Reserve’s monetary policy can be characterized as one in which policy is used aggressively to prevent or reverse credit contraction or asset price deflation, but is not used to prevent credit expansion or asset inflation. This philosophy has been encapsulated by the idea that asset bubbles cannot be identified until after they burst, and it is only then that the central banks can and should take action} each may be prone to protect activities or entities important to the financial system, despite Title I’s requirements. Given that each voting member of the Council is required to either affirm that the federal government is taking all reasonable steps to assure financial stability and mitigate systemic risk,\footnote{See H.R. 4173 § 112(b).} the question remains, what will Congress do with this information. This question is only made more complicated by the logistical difficulties associated with inter-agency coordination, the time delay between concluding that the federal government should take additional reasonable steps, implementation of those steps, and measurement of any expected outcome.\footnote{See Jeffrey Owen Herzog, Senate Passes Dodd-Frank Act Financial Reform Headed to President for Signature, U.S. Banking Watch, Jul. 15, 2010. Available at http://www.bbwaresearch.com/KETD/fbin/mul/100715_BankingWatchEEUU_15_tcm348-229326.pdf?ts=1672010. Herzog notes that although the Dodd-Frank Act entails a number of notable changes for the banking system, a} Unless there is an efficient and objective way to collect data, interpret the information, and report, this provision could prove difficult to actualize.
Third, Title I assigns the onus for financial reporting to the shadow banks without stipulating the manner in which such information is reported, which offers the opportunity for “creative” or even distortive reporting, specifically, given the questions raised by the Lehman Brothers use of “Repo 105” transactions, which were recorded as sales rather than secured borrowings. Given that, the Council is required to review and submit comments to the SEC and any standard-setting body with respect to an existing or proposed accounting principle, standard or procedure, it is odd that the Dodd-Frank Act imposes no clear rules on the entities it regulates with regard to reporting standards so that “creative” accounting cannot mask losses. In fact, when traditionally requested to provide information as their financial health, shadow banks have routinely provided misleading or untrue information reflecting stability where none existed. A report by Frank Partnoy and former SEC Chief Accountant Lynn Turner concluded that abusive off-balance sheet accounting was a major cause of the financial crisis. 

considerable amount of the legislation defers to regulators for study, definition, and implementation of the legislative language, suggesting it will take many months before the final regulatory picture is in place.

193 See Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner’s Report, available at http://lehmanreport.jenner.com/. According to the Lehman Brothers examiner's report prepared during Lehman Brothers’ bankruptcy, Lehman Brothers took advantage of accounting rules to record temporarily a loan as a sale. By carefully timing this transaction just before the release of its quarterly financial report, it was able to deceive the public and regulators into believing it was adequately capitalized. The federal bankruptcy court examiner found colorable claims against Lehman’s senior officers who oversaw and certified the firm's misleading financial statements. Although the repurchase transactions engaged in by the firm may not have been inherently improper, the federal bankruptcy court examiner found a colorable claim that their sole function as employed by Lehman was balance sheet manipulation.

194 The authors note that the Dodd-Frank Act has no provisions on financial reporting or accounting—neither for financial firms nor nonfinancial firms, despite the questions raised in March by the Lehman Brothers Examiner's Report about Lehman Brothers' use of “Repo 105” transactions, which were accounted for as sales rather than secured borrowings. See Stephen Barlas, Dallon Christensen, and Dennis Whitney, The Dodd-Frank financial reform bill, STRATEGIC__FINANCE INSTITUTE OF MANAGEMENT at 1. Available at http://www.highbeam.com/doc/1G1-237233890.html (“The Lehman bankruptcy was the most expensive bust of all time, so one might have assumed that the Dodd-Frank Act might have tightened up requirements in that corner of off-balance-sheet accounting.”)

195 See H.R. 4173, §112(a)(2)(L). This provision requires the Council to review and, as appropriate, may submit comments to the SEC and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.

196 See supra note 193. The Lehman Brothers debacle is a prime example of such data manipulation.

197 Off-balance sheet problems have recurred throughout history, with a similar progression, and abusive off-balance sheet accounting was a major cause of the financial crisis. These abuses triggered a daisy chain of dysfunctional decision-making by removing transparency from investors, markets, and regulators. Off-balance sheet accounting facilitated the spread of the bad loans, securitizations, and derivative transactions that brought the financial system to the brink of collapse. Banks in particular have become predisposed to narrow the size of their balance sheets, because investors and regulators use the balance sheet as an anchor in their assessment of risk. Banks use financial engineering to make it appear they are better capitalized and less risky than they really are. Complex institutions increase their use of off-shore subsidiaries and swap transactions to avoid disclosing liabilities, as they did during both the 1920s and the 2000s. Over time, the exceptions eat away at the foundations of financial statements, and the
Their report found that accounting abuses caused regulatory opacity by removing transparency from investors, markets, and regulators.\(^{198}\) Moreover, Title I allows, but does not require the Council to compel any bank or non-bank financial institution with assets over $50 billion to submit certified reports on its overall health, risk management; and the extent to which any of the institution’s activities could have a potential disruptive impact on financial markets or the overall financial stability of the country.\(^{199}\) Moreover, as regulators implement the Dodd-Frank Act, senators argued that complete disclosure of all off-balance sheet activities is necessary for the largest and most interconnected shadow banks.\(^{200}\) Without such disclosure, they argue that effective implementation of the Dodd-Frank Act will be almost impossible, because regulators will have no reliable basis upon which to set appropriate capital and leverage requirements.\(^{201}\) It is difficult to imagine that any shadow bank will present an objective perception of the riskiness of large institutions becomes disconnected from reality. Without transparency, investors and regulators can no longer accurately assess risk. Finally, the entire edifice collapses. Because off-balance sheet assets and liabilities were not included in financial statements, banks took leveraged positions that were hidden from regulators and investors. Because bank liabilities used to finance assets were not transparent, the financial markets could not effectively discipline banks that used derivatives and complex financial engineering to take excessive risks. Even if there are legitimate exceptions for items that might not belong on the balance sheet, those exceptions should not swallow the rule. Yet that is what has happened. See Jeff Partnoy and Lynn Turner, *Bring Transparency To Off-Balance Sheet Accounting*, MAKE MARKETS BE MARKETS, 2009 at 85. Available at http://www.makemarketsbemarkets.org/report/MakeMarketsBeMarkets.pdf.

\(^{198}\) Id.

\(^{199}\) H.R. 4173, § 116, in pertinent part, states, “subject to subsection (b), the Council, acting through the Office of Financial Research, may require a bank holding company with total consolidated assets of $50,000,000,000 or greater or a nonbank financial company supervised by the Board of Governors, and any subsidiary thereof, to submit certified reports to keep the Council informed.” See H.R. 4173, § 116 (emphasis added).

\(^{200}\) Senators Robert Menendez, Ted Kaufman, Barbara Boxer, Diane Feinstein, Carl Levin, and Sherrod Brown have urged the SEC to use its existing authority under Sarbanes-Oxley to require that companies write detailed descriptions of all their off-balance sheet activities in their annual Form 10-K reports and not just descriptions of those activities that are reasonably likely to affect the firm’s financial condition, as the regulations currently state. In a letter to SEC Chair Mary Schapiro, the senators also urged the Commission to require companies to explicitly justify why they have not brought those liabilities onto the balance sheet. As regulators implement the Dodd-Frank Wall Street Reform and Consumer Protection Act, noted the senators, the complete disclosure of all off-balance sheet activities is particularly crucial for the largest and most interconnected companies, including both banks and non-banks. Without such disclosure, they emphasized, it will be almost impossible for regulators to set appropriate capital and leverage requirements under Dodd-Frank and for investors and counterparties to make wise decisions about where to put their money. See James Hamilton, *Key Senators Urge the SEC to Adopt Regulations Enhancing Off-Balance Sheet Disclosures*, JIM HAMILTON’S WORLD OF SECURITIES REGULATION, Aug. 18, 2010 at 1-2. Available at http://jimhamiltonblog.blogspot.com/2010/08/key-senators-urge-sec-to-adopt.html. See also August 6, 2010 letter to Sen. Mary L. Schapiro from Senators Robert Menendez, Ted Kaufman, Barbara Boxer, Diane Feinstein, Carl Levin, and Sherrod Brown. Available at http://menendez.senate.gov/newsroom/press/release/?id=5d15ad41-3196-432c-919a-3a8d2e0df3eb.

\(^{201}\) Id.
assessment of its health or any of its activities that cause concern unless specific reporting requirements are implemented.

Fourth, the Dodd-Frank Act places the Council in the noble, but difficult position of having to anticipate the negative consequences of new financial instruments and other financial innovations. No matter the context: doping scandals or financial crises, innovation always outpaces regulation, if only temporarily.

Fifth, the Council’s power is limited to making recommendations, and therefore has little if any emergency power. The use and ultimate of effect of its studies and recommendations is yet to be determined. Moreover, while the agency refusing to implement the Council’s recommendation is required to provide its rationale; it is still free to refuse on plausible, albeit unwise grounds.

As of January 18, 2011, the Financial Stability Oversight Council met for the third time, but it was the first time the Council discussed how to implement the Dodd-Frank Act. The Dodd-Frank Act

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202 See Edward J. Kane, The Importance Of Monitoring And Mitigating The Safety-Net Consequences Of Regulation-Induced Innovation, Nov. 1, 2009 at 7. Available at SSRN: http://ssrn.com/abstract=1507802. Kane argues that as national markets became highly connected and products developed more potential substitutes, compartmentalization strategies quickly became riddled with loopholes. Regulators and legislatures in different jurisdictions competed eagerly with one another for regulatory domain and seemed all too willing to accept as tribute a mere fraction of the incremental value that the loopholes they create generate for the firms that use them. Much of this variation is driven by an irreconcilable tension between adjustments in regulation or supervision and loophole-seeking avoidance activity undertaken to make regulatory interference less burdensome. Regulation begets avoidance activity, and avoidance eventually begets some form of re-regulation. Regulatory adjustments, problems, and market events unfold and mutate as part of alternating sequences in which either regulation spawns new forms of avoidance (RA sequences) or the growing effectiveness of particular avoidance activities calls for innovative re-regulation (AR sequences). Adapting regulatory protocols to innovative avoidance activity is an endless task. Each and every piece of regulatory re-engineering kicks off a series of RA sequences. Inevitably, the range, size, and speed of regulation-induced innovation outpaces the vision and disciplinary powers that regulatory authorities can bring to bear.

203 Id.

204 H.R. 4173 §112(a)(2)(K) requires the Council make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets. See H.R. 4173, §112(a)(2)(K). (Emphasis added).

205 H.R. 4173, §115(a)(1), in pertinent part, states the following:

in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions, the Council may make recommendations to the Board of Governors concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies supervised by the Board of Governors and large, interconnected bank holding companies...See H.R. 4173, §115(a)(1).

The emphasis places the power to recommend with the Council, but the §115 gives no emergency powers to the Council.

206 See Clarke and Younglai, supra note 189 at 1 - 2. The Financial Stability Oversight Council will hold its third meeting on January 18, 2011 to discuss how they believe major aspects of the Dodd-Frank Act should be
already requires the Council to consider a series of factors, including the institution’s leverage and risk exposures in determining whether to label a nonbank “systematically important.” The criteria proposed did not require much more detail than what is required in Title I of the Dodd-Frank Act.

**Title VII – Wall Street Transparency and Accountability**

Title VII addresses the credit default swaps and credit derivatives that contributed to the 2008 financial crisis. On a broader level, the Dodd-Frank Act encourages swaps, which were traditionally traded over the counter, to be traded through exchanges or clearinghouses. The Commodity Futures Trading Commission (CFTC) and the SEC both regulate swaps under the Dodd-Frank Act, but the SEC has authority over “security-based swaps.” The regulators are required to consult with each other before implemented, including how to put into a practice a ban on banks trading with their own capital for profit in securities, derivatives and certain other financial instruments (the “Volcker Rule”), and discussing additional criteria that will be used to determine which nonbanks should be subject to additional scrutiny by the Federal Reserve (See supra note 189). Clarke and Younglai note that the Volcker Rule and other items on the agenda will challenge the regulators to prove they can avoid the type of turf fights that have divided them in the past and produce the single regulatory vision imagined by the law. Clarke and Younglai state that the criteria, if proposed, is not expected to provide much more detail than what is already outlined in Dodd-Frank, one source familiar with the regulators’ plan said.

207 H.R. 4173, §113(a)(2) requires the Council to consider the following factors in making a determination under that an institution should be subject to prudential standards: (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. See H.R. 4173, §113(a)(2)

208 See supra note 206.

209 See infra note 210.

210 See Byungkwon Lim and Emilie T. Hsu, Derivatives Regulations: Central Clearing and Transparency, Vol. 4 Number 7, DEBEVOISE & PLIMPTON FINANCIAL INSTITUTIONS REPORT, Jul. 2010, at 16. Title VII of the Dodd-Frank Act, the “Wall Street Transparency and Accountability Act” (“Title VII”), lays the foundation of a new regulatory system for the U.S. market for swaps and other over-the-counter derivatives. Lim and Hsu note that prior to the enactment of the Dodd-Frank Act, the focus of derivatives regulation had been mostly on the prevention of fraudulent and manipulative practices in futures and securities markets and on the preservation of the financial soundness of regulated financial institutions such as banks and broker-dealers. Under the new regime, all derivatives transactions and all entities that enter into them could be subject to potential regulations, and the goal of the regulatory framework is to promote the stability of the entire financial system and further transparency and competition in the derivatives market.

211 H.R. 4173, § 712(a) states, in pertinent part, the following:
implementing any rule-making or issuing orders regarding several different types of security swaps.\textsuperscript{212} The Act also repeals the exemptions for security-based swaps under Gramm-Leach-Bliley Act.\textsuperscript{213} The CFTC and SEC, in consultation with the Federal Reserve are responsible for further defining swap related terms.\textsuperscript{214} The prohibition on federal assistance to any “swaps entity” only goes into effect at the end of a transition period that could be as long as five years, which allows for time to sow the seeds for financial disaster in the interim.\textsuperscript{215} Given the role that misuse and under-regulation played in the 2008 financial crisis, these financial and economic regulations attempt to strike the proper balance between pro-market fundamentalism and anti-market interventionism; however, this section could be interpreted to create an information asymmetry between regulators and shadow banks if a swap does not require clearing.\textsuperscript{216}

Before commencing any rulemaking or issuing an order regarding swaps, swap dealers, major swap participants, swap data repositories, derivative clearing organizations with regard to swaps, persons associated with a swap dealer or major swap participant, eligible contract participants, or swap execution facilities pursuant to this subtitle, the Commodity Futures Trading Commission shall consult and coordinate to the extent possible with the Securities and Exchange Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible. \textit{See H.R. 4173, § 712(a)}.

\textsuperscript{212} \textit{See supra} note 211.


\textsuperscript{215} \textit{See} Robert M. Kurucza, \textit{United States: The Wall Street Transparency and Accountability Act of 2010: Regulation of Derivatives Markets - Part 1 (Financial Services Alert - Special Edition)}, MONDAQ, Aug. 3, 2010. Available at \url{http://www.mondaq.com/unitedstates/article.asp?article_id=106944}. Kurucza notes that the prohibition against federal assistance will become effective two years after the effective date of the Derivatives Act, which will take effect on the later of (i) 360 days after the Enactment Date. \textit{See H.R. 4173 §§754 and 774}. Banking entities may have up to 24 months to spin off a “swaps entity” as determined by the applicable Prudential Regulator (after consultation with the SEC or the CFTC, as applicable). Such 24-month transition periods may be further extended an additional year for potentially up to five to six years elapsing before a banking entity must comply with the push-out rule.

\textsuperscript{216} \textit{Id} at 64. According to §723(a)(3), the CFTC occupies a gate-keeping role in determining which swaps must be cleared. The CFTC may review swaps by two alternative means. First, it may review a swap or group, category, type or class of swaps to determine whether it should be required to be cleared on its own initiative. The CFTC must consider several broad factors in making its decision: (1) the existence of significant outstanding notional exposures,
capital and margin requirements imposed by subsequent rulemaking could be of limited utility given the nature of financial innovation.

Ultimately, Titles I and VII make important strides in closing the information asymmetry between government regulators, but in attempting to close the asymmetries between regulators it leaves open important information asymmetries between the government regulators and shadow banks. Therefore, 2-points will be assessed.

2nd Dimension Information Asymmetry: Investor – Shadow Bank Information Asymmetry

Buried deep within the free market theory is the unstated assumption that investors always have the necessary information with which to calculate the correct price of an asset. If this assumption turns out to be false, and investors lack the necessary information to make informed judgments about asset prices and, ultimately their investments, or worse still if they receive misleading information, then it becomes possible for asset price bubbles to form.\(^{217}\) Thus, this information asymmetry, in conjunction with the other LPMH model factors, contributes to the shadow banking system’s belief that the true extent of the risky behavior never reaches their investors. Hiding the true extent of the risks associated with their investments perversely strengthens the argument that some shadow banks are “too big to fail” because, investors remain unaware that they face tremendous losses until the specter of that shadow bank’s collapse seems imminent.\(^{218}\) Moreover, because there is a perception that the Federal Reserve is underwriting all bank-like institutions equally,\(^{219}\) there is no incentive for investors to investigate the practices of the shadow banks with whom they invest.

Title IX, Subtitle D of the Dodd-Frank Act, entitled “Investor Protections and Improvements to the Regulation of Securities Improvements to the Asset-Backed Securitization Process” attempts to rectify trading liquidity and adequate pricing data; (2) the availability of rule framework, capacity, operational expertise and resources and credit infrastructure to clear the contract; (3) the effect on mitigation of systematic risk; and (4) the effect on competition; and the existence of reasonable legal certainty in the event of the insolvency of the derivatives clearing organization or its members. See H.R. 4173 Act §723(a)(3). Regardless of these factors, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates notes that it remains difficult to predict what swaps will be subject to the requirement.

\(^{217}\) See G. COOPER, supra note 190 at 112. Cooper argues that within the Efficient Market Hypothesis is the unstated assumption that investors always have the necessary information with which to calculate the correct price of an asset. If this assumption turns out to be false and investors are sometimes denied the necessary information to make informed judgments about asset prices, or worse still if they are given misleading information, then it becomes possible for asset price bubbles to form

\(^{218}\) See supra note 194.

\(^{219}\) Cooper argues that there is a perception that the Federal Reserve is underwriting all banks equally, and thus, there is no incentive for investors to investigate the practices of the banks with whom they invest. The only interest and investor has is seeking the highest rate of return. Typically, the banks offering the highest rates of return were the ones taking the most risk with investors’ money. See G. COOPER, supra note 190 at 70 – 87.
the information asymmetry between investors and shadow banks by revamping the SEC, credit rating agencies, and the relationships between investors.\textsuperscript{220} Title IX is deficient in several ways. First, the SEC is empowered to promulgate a fiduciary standard for broker-dealers that provide personalized investment services, but it is not required to do so.\textsuperscript{221} Second, nothing in the Dodd-Frank Act prevents shadow banks from short-circuiting capital markets by using illusory accounting tricks to mislead investors and creditors.\textsuperscript{222} As the financial markets attempt to recover from the latest meltdown, the SEC has faced Congressional pressure to implement new rules that will inhibit shadow banks’ ability to mislead investors and creditors in the future.\textsuperscript{223} The SEC exists to filter full and accurate information about companies’ finances so investors and creditors have can effectively allocate capital.\textsuperscript{224} Despite its mandate, six Democratic senators have urged the SEC to use its existing authority under the Sarbanes-Oxley Act to require that companies write detailed descriptions of all of their off-balance sheet activities in their annual Form 10-K reports.\textsuperscript{225} These off-balance sheet accounting arrangements allowed shadow banks to hide trillions of dollars in obligations from regulators.\textsuperscript{226} For example, the senators noted that Citigroup reportedly kept $1.1 trillion worth of assets off its books in various financing vehicles and trusts that used to handle mortgage-backed securities and issue short-term debt. It never reasonably disclosed the risks posed by their off-balance sheet activities to investors.\textsuperscript{227} Had the shadow banks disclosed the

\textsuperscript{220} H.R. 4173, § 911 states, in pertinent part, that the Committee shall advise and consult with the Commission on (i) regulatory priorities of the Commission; (ii) issues relating to the regulation of securities products, trading strategies, and fee structures, and the effectiveness of disclosure; (iii) initiatives to protect investor interest; and (iv) initiatives to promote investor confidence and the integrity of the securities marketplace. See H.R. 4173, § 911.

\textsuperscript{221} H.R. 4173, § 913(f). states, in pertinent part, that the Commission \textit{may} commence a rulemaking, as necessary or appropriate in the public interest and for the protection of retail customers (and such other customers as the Commission may by rule provide), to address the legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment advisers for providing personalized investment advice about securities to such retail customers. See H.R. 4173, § 913(f) (emphasis added).

\textsuperscript{222} See supra note 194.

\textsuperscript{223} See supra note 200. These six senators also want to aggressively investigate and prosecuting past misconduct.

\textsuperscript{224} See, SEC website, INTRODUCTION. (“The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”) Available at http://sec.gov/about/whatwedo.shtml.

\textsuperscript{225} See August 6, 2010 letter referred to supra note 200.

\textsuperscript{226} Id; see also supra note 197.

\textsuperscript{227} At an investor presentation in May 2008, Keoun noted that Citigroup Inc. Chief Executive Officer Vikram Pandit said that shrinking the bank’s $2.2 trillion balance sheet, the biggest in the U.S., was a cornerstone of his turnaround plan. Nowhere mentioned in the accompanying 66-page handout were the additional $1.1 trillion of assets that New York-based Citigroup keeps off its books: trusts to sell mortgage-backed securities, financing vehicles to issue short-
associated risks, these senators argued that investors and creditors might have made better decisions. In order to prevent this from happening in the future, the senators urged the SEC to require the disclosure of period-end and daily average leverage ratios in quarterly and annual reports. Rather than relying on artfully framed quarterly and annual reports, the senators argued that investors and creditors should have access to a complete a company's financial situation. This would provide better information to investors and creditors to assist their decision-making processes and help significantly reduce the information asymmetry between investors and shadow banks.

Moreover, Lehman Brothers use of the “repo 105” is paradigmatic of the information asymmetry shadow banks opportunistically used to maintain superior information over investors, as well as regulators, given the strong indications that Lehman Brothers actively concealed information necessary for the credit ratings agencies to make informed decision as to what ratings to assign. Investors ultimately relied on these ratings in deciding whether to invest in Lehman Brothers: a March 2010 report by the court-appointed examiner indicated that Lehman executives regularly used cosmetic accounting tricks at the end of each quarter to bolster its financial outlook. This practice was a type of repurchase agreement that temporarily removed securities from the company's balance sheet. However, unlike typical repurchase agreements, Lehman Brothers described these deals as the sale of securities and created “a materially misleading picture of the firm’s financial condition in late 2007 and 2008.” This report revealed that Lehman Brothers used an accounting procedure termed “repo 105” to exchange temporarily $50 billion of assets into cash just before publishing its financial statements. Distorting its financial

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228 See supra note 226.

229 Id.

230 When senior management gave balance sheet targets to business divisions within Lehman, the orders were given so that the firm could manage its business towards a target net leverage ratio with an eye toward rating agencies and the firm’s public disclosures. (citing Examiner’s Interview of Joseph Gentile, Oct. 21, 2009, at p. 5, stating that Lehman as a firm managed its entire business towards a target net leverage ratio, and Examiner’s Interview of Ian T. Lowitt, Oct. 28, 2009, at p. 10 stating that businesses within Lehman managed their respective businesses toward balance sheet targets.) See Examiner’s Report at section III.A.4 at 853. Available at http://lehmanreport.jenner.com/.

231 Id at 853 - 854.

232 Trumbull notes that the court-appointed examiner found that Lehman Brothers used the “Repo 105” repurchase agreement, an unusual accounting gimmick, to make its finances appear more robust. See Mark Trumbull, Lehman Bros. used accounting trick amid financial crisis – and earlier, THE CHRISTIAN SCIENCE MONITOR, Mar. 12, 2010 at 1.

233 The report notes that the total amount of Repo 105 transactions at the end of first quarter (February) 2008 was approximately $49 billion, the intra-quarter dip as of April 30, 2008 was approximately $24.7 billion and the quarter-end amount for second quarter (May) 2008 was approximately $50.38 billion. See Examiner’s Report at section III.A.4 at 857.
state could reasonably lead investors into believing that Lehman Brothers’ capital reserves were greater than they were, that their losses were not as great, and that its overall financial health was better than it actually was. Because of the effects of this information asymmetry and the remaining factors, Lehman Brothers was nearly able to extract a bailout from the Federal Reserve and Treasury Department.  

Therefore, Title IX still leaves open critical information asymmetries between investors and shadow banks, and 2-points will be assessed. 

**3rd Dimension Information Asymmetry: Credit Rating Agency – Shadow Bank Information Asymmetry**

Credit ratings agencies purport to safeguard investors by providing investment information to determine the risk of securities. In the lead up to the 2008 financial crisis, shadow banks required some seal of approval, so that providers of short-dated funding could convince themselves that their investments were de facto “just as good” as deposits at banks with access to the government’s liquidity safety nets. Conveniently, the credit rating agencies acted cooperatively and provided such seals of approval. Moreover, these credit ratings agencies lacked any incentive to provide accurate information, because they were paid handsomely by the shadow banks. Moody’s and Standard & Poor (“S&P”) would

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234 The primary reasons for the ultimate denial of a bailout for Lehman Brothers was not that it was not considered to be “too big to fail;” rather, a lack of legal authority to affect any of Lehman’s non-U.S. units, concerns of political backlash given the recent Bear Stearns bailout, and fear of accusation of nepotism prevented the government interventionism witnessed in previous bailouts. Id at 218. There were also other reasons that made a bailout of Lehman politically unpalatable: the intersection between government and private relations. Then-President Bush’s brother, Jeb, the former governor of Florida, worked as an adviser to Lehman’s private equity business; President Bush’s cousin, George H. Walker, was on Lehman’s executive committee; and Paulson’s brother, Richard, worked for Lehman. Fearful of even the appearance of nepotism made bailing Lehman Brothers out unlikely. Thus, Lehman found itself without government assistance, no buyer, and no LTCM-like solution. The only resort was an orderly Bankruptcy. Id at 284. See A. SORKIN supra note 4 at 218, 284.


236 McCulley states that shadow banking needed some seal of approval, so that providers of short-dated funding could convince themselves that their claims were “just as good” as deposits at banks with access to the government’s liquidity safety nets. Conveniently, the friendly faces at the rating agencies, paid by the shadow bankers, stood at the ready to provide such seals of approval. Moody’s and S&P would put an A-1/P-1 rating on the commercial paper, which in turn would be bought by money market funds. McCulley further argues that the rating agencies face an in-built problem of putting ratings on new innovations, because they have not had a chance to observe a historical track record. See McCulley, supra note 1 at 1- 2.

237 Id.
put an A-1/P-1 rating on the commercial paper, which in turn would be bought by money market funds.\textsuperscript{238} The credit rating agencies were tasked with rating new financial innovations for which there was no historical track record.\textsuperscript{239} In other words, these credit ratings agencies could not observe their performance over a full cycle.\textsuperscript{240} During the late 1980s and early 1990s, shadow bankers and issuers created a range of highly rated asset-backed transactions and collateralized bond obligations, credit rating agencies, specifically S&P and Moody’s, became more profitable and also began providing ratings of transactions designed to achieve particular ratings.\textsuperscript{241} By the early 2000s, rating agency models, and assumptions about historical default, recovery, and correlation, suggested that extant mortgage-backed securities could be repackaged and resold in ways that would outperform, not only the mortgage-backed securities themselves, but also other comparably rated securities.\textsuperscript{242} Since these credit rating agencies faced either no risk, or, at least, a deferred of loss from inaccurate ratings, while the potential gains from inaccurate ratings were immediate and increased over time, they had every incentive to exacerbate any information asymmetry between themselves and the investors.\textsuperscript{243} If the credit rating agencies had used accurate models and assumptions, then it is reasonable to believe that investors would have responded by refusing to invest in these securities that carried risk beyond some degree.\textsuperscript{244} Thus, these credit ratings agencies had incentive to distort the data used for their models.

By using models and data that distorted the actual risk of the underlying mortgages, including risks that already were included in the price of those securities in the market for mortgage-backed

\textsuperscript{238} Id.

\textsuperscript{239} Id.

\textsuperscript{240} Id.

\textsuperscript{241} As the regulatory reliance on credit ratings agencies increased, Partnoy notes the ratings agencies profited from assigning overly high ratings to investments since they had an incentive to mislead investors to ensure continued patronage. This is particularly true given the lag time between assigning a rating and when investors realized that the ratings that credit agencies assigned were not reflective of the risk involved. \textit{See} Jeff Partnoy, \textit{Overdependence on Credit Ratings Was a Primary Cause of the Crisis}, FEEM Working Paper No. 27, Jun. 22, 2009 at 3 - 8. \textit{Available at SSRN: http://ssrn.com/abstract=1427167}

\textsuperscript{242} \textit{Id} at 5. In particular, CDOs and SIVs were designed to create large tranches of AAA-rated assets backed by lower-rated mortgage-backed securities. Even after a mortgage-backed security had been re-securitized through cash-flow based CDOs, market participants suggested that there was no reason why investors could not take on exposure to a particular mortgage-backed security more than once. Arrangers created synthetic exposure based on side bets derived from the value of the underlying mortgage-backed securities so that investors could obtain exposure to the performance of a pool of mortgages without having an investment vehicle or special purpose entity actually buy the mortgage-backed securities. Synthetic CDOs obtained exposure through derivatives transactions, most commonly credit default swaps.

\textsuperscript{243} \textit{Id} at 7 - 8.

\textsuperscript{244} Id.
securities, credit ratings agencies could ensure their fees by issuing attractive ratings and still generate attractive yields for purchasers. Credit rating agency assumptions and models did not accurately capture the risk associated with “second-level” securitizations. Default rate assumptions were derived from historical information, including default data about other asset categories as well as asset price correlations, rather than default correlations. Thus, the rating agencies created models that generated tranche credit ratings for repackaged securities deals based on the inputs of mortgage-backed securities, and those models, in turn, relied on assumptions relating to the expected distribution on the returns of the underlying collateral.

Given how freely credit ratings agencies assigned AAA ratings (the highest and safest rating), many investors believed that the securities were indeed very safe and thus they made investments in mortgage-backed securities. Investors trusted these ratings, because the credit rating agencies are supposed to assist in making informed decisions. The interests of the rating agencies and the investors were misaligned and thus they were less reliable as a source for information for the investors. Thus, the

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245 Id at 10.

246 Id. Partnoy states that the simplest way to generate inappropriately high ratings was to use outdated and inapplicable historical assumptions with respect to the underlying mortgage-backed securities. The inputs to the relevant models were straightforward: expected default rate, recovery rate upon default, and, for portfolios of assets, the correlation of expected defaults.

247 The SEC investigation of the credit rating agencies found that the struggled to adapt to the complexity of mortgage-backed structured finance deals. See Securities and Exchange Commission, “Summary Report of Issues Identified in the Commission Staff’s Examinations of Select Credit Rating Agencies,” July 2008, at 12 (“One analyst expressed concern that her firm’s model did not capture ‘half’ of the deal’s risk, but that ‘it could be structured by cows and we would rate it.’”). The SEC also found that “Rating agencies made ‘out of model’ adjustments and did not document the rationale for the adjustment.” Id. at 14. See also Partnoy, supra note 243 at 9.

248 See supra note 243 at 11.

249 Id.

250 Partnoy argues that if the rating agencies had used accurate models and assumptions, then it is reasonable to believe that investors would have responded by refusing to invest in these securities that carried risk beyond some degree. Id at 13.


252 See generally Partnoy, supra note 243.
credit ratings agencies willfully became subject to a dangerous information asymmetry that inhibited their ability to determine the true risk associated with these innovations.

The Credit Rating Agency Reform Act that passed in 2006 requires credit ratings agencies to register with the SEC and submit reports. The Dodd-Frank Act’s amendments to the SEC rules attempts to address the information asymmetry between the credit ratings agencies and investors, but it can only do so to the extent that it first corrects the information asymmetry between investors and shadow banks. Rather than focus on the credit ratings agency – shadow bank information asymmetry, the Dodd-Frank Act directs the SEC’s attention on credit agencies’ procedures and methodologies for assigning ratings. While these procedures and methodologies are the basis for how ratings are assigned, these new measures do not address the information flow from shadow banks to their credit ratings agencies, and creates little incentive for the credit ratings agencies to perfect their information. Section 939G of the Dodd-Frank Act repeals SEC Rule 436(g) promulgated under the Securities Exchange Act of 1933. In general, rule 436(g) stated that credit ratings were not expert portions of registration statements. Under rule 436(g), credit rating agencies were not subject to strict liability under §11 of the Securities Act for the opinion reflected in their ratings. Section 939G now exposes credit rating agencies to liability by classifying their rating as an expert-certified part of the registration statement for a security. This flawed approach is not likely to remedy the information asymmetry between the shadow bank and credit ratings agencies. Arguably, civil liability, the only incentive for credit ratings agencies to demand more transparency so far has not incentivized credit ratings agencies to demand better information from shadow banks. In fact, it has resulted in Fitch Ratings, S&P’s and Moody’s, the three major credit ratings agencies, to initially refuse to have their ratings included in registration documents for fear of civil liability while leaving the capital markets in limbo. This temporarily froze the capital markets, until the

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254 The Dodd-Frank Act also requires the SEC to conduct a study of the independence of ratings agencies, issue rules regarding ratings procedures and methodologies, and establish, maintain and enforce policies and procedures that define and disclose the meanings of any ratings. Moreover, federal agencies will review reliance on references to ratings. See H.R. 4173, §932; see also Morrison & Foerster LLP, supra note 139 at 16.

255 Standard & Poor’s, Moody’s Investors Service, and Fitch Ratings fear being exposed to new legal liability created by the landmark Dodd-Frank financial reform law. The companies say that, until they get a better understanding of their legal exposure under the Dodd Frank Act, they are refusing to let bond issuers use their ratings. See Anusha Shrivastava, Bond Sale? Don’t Quote Us, Request Credit Firms, WALL STREET JOURNAL, Jul. 21, 2010 at 1, available at http://online.wsj.com/article/SB10001424052748704723604575379650414337676.html?mod=loomia&loomia_si=t0:a16:g2;r2;c0.0661899:b35877358 256 Id at 2 -3.
SEC stepped in to allow deals to go forward if ratings were not included in the prospectus.\textsuperscript{257} The uncertainty over Rule 436(g) is impeding, rather than enabling, the recovery of legitimate parts of the securitization markets that are critical to supplying credit to households and businesses.\textsuperscript{258}

Moreover, this “remedy” for investors is replete with problems that will not only fail to incentivize the credit ratings agencies, but also offer little solace to investors. Litigation as a remedy is, by definition, retrospective and uncertain. Under §939G of the Dodd-Frank Act, credit ratings agencies will almost certainly react to create a litigation buffer, or otherwise include the expected costs and probability of litigation into the costs of doing business. Because the Dodd-Frank Act does not correct the credit ratings agency – shadow bank information asymmetry, it encourages moral hazard. Therefore, 2-points will be assessed.

(3) Entrenched Relationships and Policies

While shadow banks often calculate during times of crisis that the Federal Reserve and Treasury Department will consider them indispensible to the financial system, or “too big to fail,” it is not necessarily the Federal Reserve’s or Treasury Department’s role to bailout failing entities. Two policy concepts encouraged the moral hazard associated with the “too big to fail” concept observed during the 2008 financial crisis and resulting bailouts: (1) central bank policy imbalance, and (2) interest distortion.

A policy imbalance describes a central bank’s difficulty in balancing its competing and often contradictory roles given the dynamism of a financial system. In many economies, including the U.S., central banks are required to balance the following contradictory objectives: (1) restrain credit creation for financial stability; (2) promote credit creation for demand management; (3) restrain monetization to control inflation; and (4) promote monetization to avoid economic contractions, after policies of promoting credit expansion have been too successful.\textsuperscript{259} The original purpose of the U.S. Federal Reserve System, according to the Federal Reserve Act was, in part, “to afford means of rediscounting commercial paper” by providing a currency that could respond to the ebbs and flows of the economic cycle,\textsuperscript{260} which

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\textsuperscript{257} By repealing Rule 436(g) under the Securities Act of 1933, Papagianis notes the Dodd-Frank Act would expose rating agencies to new lawsuits by treating their rating as an expert-certified part of the registration statement for a new security. Papagianis also notes that Fitch Ratings, Standard & Poor’s and Moody’s Investor Service responded by refusing to be named as experts in registration documents. This temporarily froze the market, until the SEC stepped in to allow deals to go forward if ratings were not included in the prospectus. \textit{See supra} note 128.

\textsuperscript{258} \textit{Id.}

\textsuperscript{259} Cooper states that central Banks are required to balance the following contradictory objectives: (1) restrain credit creation for financial stability; (2) promote credit creation for demand management; (3) restrain monetization to control inflation; and (4) promote monetization to avoid economic contractions, after policies of promoting credit expansion have been too successful. \textit{See} G. COOPER, \textit{supra} note 190 at 87 - 112.

\textsuperscript{260} This quote can be found on the original paperwork written by congress when the act was debated and passed. It used to be at the top of the official Federal Reserve Act page on the official Federal Reserve Board of Governors
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allowed Congress to expand the Federal Reserve’s role to foster a sound banking system and a healthy economy.\textsuperscript{261} The Federal Reserve also acts to manage consumer demand, in its role as guardian of financial stability, by raising or lowering interest rates.\textsuperscript{262} When it lowers interest rates, it encourages borrowing. Borrowing, however, increases leverage, which causes financial fragility.\textsuperscript{263} Along these lines, when credit creation becomes excessive, the Federal Reserve’s role is to raise interest rates and push the economy into contraction;\textsuperscript{264} economists refer to this concept as counter-cyclical policy.\textsuperscript{265} Once the contraction has had the desired effect, the Federal Reserve’s role is then to lower interest rates triggering credit expansion again.\textsuperscript{266} Given the dynamism of such a system, perfect stability is desirable, but not possible. Policies that inhibit growth through credit and monetary restraint to create stability, but Policies that encourage growth tends to dismiss any possibility an economy can generate too much credit, while viewing any economic expansion as a sign that an economy is moving toward a stable equilibrium.\textsuperscript{267} The difficulty for the Federal Reserve, however, has been determining which theory and policy framework the financial system needs.\textsuperscript{268} This requires accepting a fact that pure pro-market fundamentalism rejects – credit creation can be excessive. Ultimately, financial stability requires limiting credit expansion while demand management requires maintaining credit expansion – two policies that are difficult to balance.


\textsuperscript{262} The Federal Reserve acts to manage consumer demand, in its role as guardian of financial stability, by raising or lowering interest rates. When it lowers interest rates it encourages borrowing. Borrowing, however, increases bank leverage, which causes financial fragility. See G. COOPER, supra note 190, at 87.

\textsuperscript{263} Id.

\textsuperscript{264} Id.

\textsuperscript{265} A “counter-cyclical policy” is a government economic policy designed to dampen the effects of the Business Cycle. During the inflation of the early 1980s, the action by the Federal Reserve Board (FRB) to raise interest rates was a countercyclical policy designed to reduce demand and thus end inflationary expansion. Definition available at: http://www.answers.com/topic/countercyclical-policy#ixzz1JNsVvWvM.

\textsuperscript{266} See G. COOPER, supra note 190, at 87.

\textsuperscript{267} Cooper states that financial stability requires limiting credit expansion while demand management requires maintaining credit expansion – two policies that are difficult to balance. Id at 87.

\textsuperscript{268} Id.
Many central banks, like the Federal Reserve, tend to ignore their financial stability role and focus instead on the demand management role. 269

Interest distortion occurs when a subset (the “interest group”) forms from a larger group, subject to a body of laws or regulation, identifies a common interest relative to the subset, but narrowly held relative to the larger group, form relationships with their regulators that result in policies beneficial to the subset, but not to the larger group. Thus, regulators inflate or distort the importance of the interest group’s narrow interest relative to its importance to the larger group. 270 In The Rise and Decline of Nation, Mancur Olson analyzed the nature of interest distortion, by studying some of the policies resulting from close relationships between regulators and the regulated. 271 Olson argued that successful countries give rise to interest groups that accumulate increasing levels of influence over time. 272 Eventually, the groups become powerful enough to win government favors, in the form of new laws, policies, or co-opted regulators. 273 Favorable policies and friendly regulators breed practices that encourage moral hazard, because the beneficiaries welcome government intervention when it protects their profits, but resist regulation on the basis that it stifles innovation and competitiveness. 274 Favorable policies, and friendly

269 Id.

270 Olson described the special interest groups in his 1982 Rise and Decline of Nations, drawing on a variety of historical examples, he summarized his argument with a set of general implications that he then listed at the end of the chapter after discussing them individually. They are as follows: (1) there will be no countries that attain symmetrical organization of all groups with a common interest and thereby attain optimal outcomes through comprehensive bargaining; (2) stable societies with unchanged boundaries tend to accumulate more collusions and organizations for collective action over time; (3) members of “small” groups have disproportionate organizational power for collective action, and this disproportion diminishes but does not disappear over time in stable societies; (4) on balance, special-interest organizations and collusions reduce efficiency and aggregate income in the societies in which they operate and make political life more divisive; (5) encompassing organizations have some incentive to make the society in which they operate more prosperous, and an incentive to redistribute income to their members with as little excess burden as possible, and to cease such redistribution unless the amount redistributed is substantial in relation to the social cost of the redistribution; (6) distributional coalitions make decisions more slowly than the individuals and firms of which they are comprised, tend to have crowded agendas and bargaining tables, and more often fix prices than quantities; (7) distributional coalitions slow down a society’s capacity to adopt new technologies and to reallocate resources in response to changing conditions, and thereby reduce the rate of economic growth; (8) distributional coalitions, once big enough to succeed, are exclusive, and seek to limit the diversity of incomes and values of their membership; and (9) the accumulation of distributional coalitions increases the complexity of regulation, the role of government, and the complexity of understandings, and changes the direction of social evolution. See MANCUR OLSON, IN THE RISE AND DECLINE OF NATIONS (1982) at 74.

271 See OLSON, supra note 270.

272 Id.

273 Id.

274 Id.
regulators, however, inevitably allow the beneficiaries to benefit or profit at the public’s expense, because the loose regulatory environment encourages, rather than prevents, crises.\textsuperscript{275}

The combined effect of these two phenomena also encourage moral hazard, because the policies interest groups advocate for tend to favor little to no regulation, and the cozy relationships tend to cause weak enforcement of the existing laws.\textsuperscript{276} Sorkin demonstrates how these two phenomena were certainly observable during the 2008 financial crisis and subsequent bailouts: when many of the shadow banks faced the probability of collapse, they abandoned their sacred pro-market or free market mantra of deregulation in favor of raw government interventionism in the form of taxpayer funded or federally orchestrated bailouts.\textsuperscript{277}

Empirically, the Federal Reserve’s practices demonstrate its belief that there can be no excessive level of money growth, credit creation, or asset inflation.\textsuperscript{278} It does believe, however, that there can be an unacceptably low level of all three; in fact, the past three Federal Reserve Chairmen all shared a similar ideology: credit expansion is the primary driver of economic growth, and policy should promote credit expansion.\textsuperscript{279} For over thirty years, that ideology formed the basis for the Federal Reserve’s pro-cyclical monetary policies.\textsuperscript{280} Those policies, in turn, ignited the proliferation of dubious financial innovations, increasingly risky investments, and an overall willingness within Americans to borrow.\textsuperscript{281} Economic

\textsuperscript{275} Id.

\textsuperscript{276} See OLSON, supra note 270.

\textsuperscript{277} Lehman Brothers, Bear Stearns, AIG, and Goldman Sachs all sought the assistance of the Federal Reserve and each attempted to persuade the Federal Reserve of its importance to the financial system, either citing section 13(3) of the Federal Reserve Act as authority for financial assistance, or for assistance finding a potential buyer for their respective businesses. See generally SORKIN, supra note 4.

\textsuperscript{278} Cooper argues that the Federal Reserve does not appear to believe there can be an excessive level of money growth, credit creation or asset inflation. It does, however, believe that there can be an unacceptably low level of all three. As a result, Cooper argues that the Federal Reserve’s monetary policy can be characterized as one in which policy is used aggressively to prevent or reverse credit contraction or asset price deflation, but is not used to prevent credit expansion or asset inflation. This philosophy has been encapsulated by the idea that asset bubbles cannot be identified until after they burst, and it is only then that the central banks can and should take action. See G. COOPER supra note 190, at 23 - 24.

\textsuperscript{279} Id.

\textsuperscript{280} Morris states that Ronald Reagan’s election in 1980 signaled that Keynesian liberalism was dead and, under Reagan, free market theorists would get “to run the race.” See MORRIS, supra note 164 at 18, see also supra note 16.

\textsuperscript{281} McCulley states that regulators and rating agencies believed that low default rates during the period of soaring home prices were the normalized default rates for low quality borrowers, particularly ones with no down payment. McCulley further states that the rating agencies’ actions was particularly egregious, because the lofty ratings they put on securities backed by dud loans were the fuel for explosive growth in the shadow banking system, which issued tons of similarly highly-rated commercial paper to fund purchases of the securities. See McCulley, supra note 1 at 5.
growth may be a short-term benefit of these policies, but one consequence of this lopsided pro-market focus is that the Federal Reserve reallocates attention away from credit and monetary restraint. As a result, the Federal Reserve’s monetary policy has been to aggressively prevent or reverse credit contraction or asset price deflation, but rarely has it worked to prevent credit expansion or asset inflation.282

Failure to implement or enforce diligently these two counter-cyclical policies during the short-term may be a regulatory failure; however, over several decades, this failure can become the regulatory equivalent of a blind spot, where regulators, like the Federal Reserve, become unable to appreciate the risk presented by an activity, because they believe that crises cannot be anticipated.283 In essence, the Federal Reserve’s philosophy is as follows: bubbles cannot be identified until after they burst, and it is only then that the central bank can and should take action.284 Unfortunately, deviating from a chosen course can be difficult and can produce unintended effects. For example, a central bank may make the decision to accept more types of collateral for access to its discount window in hopes of increasing overall stability during financial emergencies,285 thus unintentionally encouraging excessively risky business strategies and subsequent reliance on the central bank during emergencies.286 Many of the shadow banks’ dealings with the Federal Reserve during the 2008 financial crisis fit this pattern.287 These unintended effects can become entrenched when those policies become institutional norms over a long period, and when relationships form between the regulators and the regulated. From the above analysis, it follows that the Federal Reserve either helps cause or solve financial instability.288

282 See supra note 190.

283 Id.

284 Id. It is a logical belief that the best method for preventing moral hazard may be to prevent bubbles before they develop, but that requires constant vigilance and prudential regulation.

285 See Schwartz supra note 29 at 63. This example is drawn from Schwartz’s article where she notes that the 1991 amendments to FDIC Improvement Act following the S&L crisis, which amended Section 13(3) to allow the Federal Reserve to loan to non-banks without requiring that their notes, drafts, or bills be eligible for discount by member banks, was quickly seized upon by Sullivan & Cromwell, a New York law firm, that interpreted the amendments to lend directly to nonbank firms during times of emergency.

286 Schwartz presciently asks whether the Federal Reserve will be firm in the future in resisting pressures to fund insolvent firms that are politically connected. Id.

287 See generally, A. SORKIN, supra note 4. Lehman Brothers, Bear Stearns, AIG, and Goldman Sachs all sought the assistance of the Federal Reserve and each attempted to persuade the Federal Reserve of its importance to the financial system, either citing section 13(3) of the Federal Reserve Act as authority for financial assistance, or for assistance finding a potential buyer for their respective businesses.

288 Cooper argues that either Federal Reserve causes or solves financial instability. If the Friedman school of Efficient Market Hypothesis is correct that financial markets are destabilized by the moral hazard partially created
Similarly, the Treasury Department is responsible for maintaining a strong economy and creating economic and job opportunities by promoting the conditions that enable economic growth and stability at home and abroad, strengthen national security by combating threats and protecting the integrity of the financial system, and manage the U.S. Government’s finances and resources effectively. The relevant functions of the Department of the Treasury include: (1) managing federal finances; (2) collecting taxes, duties and money paid to and due to the U.S. and paying all bills of the United States; (3) managing government accounts and the United States public debt; (3) supervising national banks and thrift institutions; (4) advising on fiscal policy, including domestic and international financial, monetary, economic, trade and tax policy; and (5) enforcing Federal finance and tax laws.

In light of the history of the Federal Reserve’s and Treasury Department’s pro-market policies and close relationships with shadow banks, it would be logical for any post-crisis financial reform to strip away supervisory powers from each agency, given their contribution to the 2008 financial crisis. The Dodd-Frank Act, however, took the counter-intuitive course of giving greater supervisory authority to the Federal Reserve and Treasury Department over shadow banks. Moreover, the Dodd-Frank Act seeks to challenge the pro-market policy inertia by requiring these agencies to produce a unified counter-cyclical regulatory vision, despite shunning counter-cyclical policies over the decades. The difficulty associated with implementing a new counter-cyclical financial policy is made more complicated by the fact that the individuals tasked with implementing it, Geithner and Bernanke, were responsible for continuing many of

289 The “Mission” Statement of the Department of Treasury is available at http://www.treasury.gov/about/role-of-treasury/Pages/default.aspx

290 A list of Department of Treasury functions is available at http://www.treasury.gov/about/role-of-treasury/Pages/default.aspx. This simple list of Treasury Department functions does not nearly capture the de facto power the Treasury wields.

291 Title I outlines two new agencies tasked with monitoring systemic risk and researching the state of the economy and clarifies the comprehensive supervision of bank holding companies by the Federal Reserve. Title I creates the Financial Stability Oversight Council and the Office of Financial Research. The two new offices are attached to the Treasury Department, with the Treasury Secretary being Chair of the Council, and the Head of the Financial Research Office being a Presidential appointment with Senate confirmation. See generally H.R. 4173.

292 See H.R. 4173, 616(a)(2) (“In establishing capital regulations pursuant to this subsection, the Board shall seek to make such requirements countercyclical, so that the amount of capital required to be maintained by a company increases in times of economic expansion and decreases in times of economic contraction, consistent with the safety and soundness of the company.”)
the same pro-market policies that caused the 2008 financial crisis. Unless these individuals and agencies can balance anti-market interventionism with pro-market fundamentalism in creating counter-cyclical policies, they will consciously and sub-consciously circumvent and ignore the Dodd-Frank Act, potentially deepening the same entrenched policies and relationships that contributed to the 2008 financial crisis. Thus, in order to end the “too big to fail” concept, the Dodd-Frank Act must prevent the pro-market ideologies of the regulators and shadow banks from co-opting its regulations, and provide barriers against the formation of the cozy relationships that have historically inhibited effective supervision and enforcement. Without questioning the sincerity or authenticity of those tasked with implementing the policies embodied in the Dodd-Frank Act, it would be oversight to ignore the ideologies and recent actions of the individuals leading the major institutions tasked with its implementation – Federal Reserve Chairman Ben Bernanke and Treasury Secretary Tim Geithner. Ideology and genuine difference of opinion could lead to incomplete or partial implementation of the Dodd-Frank Act such that the contradictory policies of the Federal Reserve remain unbalanced. This section examines the difficulty associated with policy inertia. For three reasons, there is legitimate concern that the pro-market policy and relationship inertia may encourage moral hazard.

First, because the Federal Reserve Chairman and Treasury Secretary are presidential appointees, it is possible that innate policy biases will be implemented despite the fact that the Dodd-Frank Act calls for the implementation of counter-cyclical policies. Having leaders helm the very agencies whose complicity contributed to the policies that caused the 2008 financial crisis undermines thorough implementation and enforcement of the Dodd-Frank Act. If policies are an unbroken line of concepts designed to bring about a desired behavior or result, then it should come as no surprise that the 2008 financial crisis occurred given the policymakers who have helmed the Federal Reserve. While many

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293 See infra notes 298, 315, 316, 318, and 320.


295 The Federal Reserve is headed by a government agency in Washington known as the Board of Governors of the Federal Reserve. The Board of Governors consists of seven presidential appointees, each of whom serves 14 year terms. All members must be confirmed by the Senate and can be reappointed. The board is led by a chairman and a vice chairman, each appointed by the President and approved by the Senate for four-year terms. See The Federal Reserve in Plain English, Board of Governors of the Federal Reserve System (2006) at 10 Available at http://www.stlouisfed.org/inplainenglish/default.html; see also 12 U.S.C. §241. The Secretary of Treasury is appointed by the US President pursuant to 31 U.S.C. § 301(b).

296 See H.R. 4173, § 619.

297 See infra notes 298, 315, 316, 318, and 320.
competing policies, interests and contradictory visions of the American financial system contributed to the 2008 financial crisis, the policies of former Federal Reserve Chairman Alan Greenspan and current Chairman Ben Bernanke, have contributed more than most.\textsuperscript{298}

Several notable economists\textsuperscript{299} have also argued that Greenspan’s entrenched policies about global capitalism and free competitive markets contributed the 2008 financial crisis.\textsuperscript{300} Greenspan’s policies were as responsible for the need for financial reform as any shadow bank’s recklessness\textsuperscript{301}, and those

\textsuperscript{298} While many competing policies, interests and contradictory visions of the American financial system contributed to the 2008 financial crisis, the policies of former Federal Reserve Chairman Alan Greenspan and current Chairman Ben Bernanke, have contributed more than most. Greenspan kept interest rates too low for too long and ignored warnings from his own colleagues about the brewing storm in the mortgage market. See John Cassidy, The Minsky Moment, THE NEW YORKER, Feb. 4, 2008 at 1 – 2. As early as 1998, Greenspan eerily acknowledged in a sober cost-benefit analysis during a Congressional hearing that the cost of American prosperity and a “free market” was moral hazard and the occasional recession borne of excessive leverage and weak financial regulations. See Greenspan’s concession on the consequences of a free market economy. Greenspan’s entire testimony is available at: http://www.bog.frb.fed.us/boarddocs/testimony/1998/19981001.htm. Unchecked credit expansion was only part of Greenspan’s legacy. He had also championed financial deregulation, resisting calls for tighter government oversight of the newer financial products, such as over-the-counter derivatives, and championed the growth of subprime mortgages. See Nouriel Roubini, Who is to Blame for the Mortgage Carnage and Coming Financial Disaster? Unregulated Free Market Fundamentalism Zealotry, RGE MONITOR, Mar. 19, 2007 at 7 - 8. Available at http://www.roubini.com/roubini-monitor/184125/who_is_to_blame_for_the_mortgage_carnage_and_coming_financial_disaster_. Greenspan’s policies of adjusting interest rates to historic lows certainly contributed to a housing bubble in the United States, because the housing market is a key channel of monetary policy transmission, asset prices are influenced by the Federal Reserve’s interest rates. Id.


\textsuperscript{300} Id.

\textsuperscript{301} From 2001 to 2005, Greenspan’s policies helped guide the economy towards excess. Beginning in 2001, Greenspan’s lowering of the Federal Reserve’s funds rate contributed to the surging home sales that marked the beginning of the housing bubble. See "Monetary Policy Report to the Congress", Feb. 27, 2002. (To avoid an economic slump following the September 11, 2001 attacks, the Federal Open Market Committee voted to reduce the federal funds rate from 3.5% to 3.0%. Then, after the accounting scandals of 2002, the Federal Reserve dropped the federal funds rate from 1.25% to 1%. Greenspan acknowledged that these interest rate drops would lead to a surge in home sales and refinancing. This surge in the home sales and refinancing created a need for more lending to prospective homeowners. ) Available at http://www.federalreserve.gov/boarddocs/hh/2002/February/FullReport.txt. Greenspan’s explicit and implicit encouragement of prospective homeowner’s use of Adjustable Rate Mortgages (ARMs) and subsequent federal fund rate hikes also helped start the massive chain reaction of home loan defaults that triggered the 2008 financial crisis. See also Sue Kirchhoff, Barbara Hagenbaugh, Greenspan says ARMs might be better deal, USA TODAY, Feb. 23, 2004. Available at http://www.usatoday.com/money/economy/fed/2004-02-23-greenspan-debt_x.htm. Economist Joseph Stiglitz stated that Greenspan never truly supported regulation, because his adherence to free market theory required self-regulation “when the excesses of the financial system were noted...an oxymoron.” Joseph Stiglitz, How to prevent the next Wall Street crisis, CNN Sept. 17, 2008. Available at http://www.cnn.com/2008/POLITICS/09/17/stiglitz.crisis/
policies heavily influenced on his protégé, Benjamin Bernanke.302 Until 2007, Ben Bernanke’s policies rarely, deviated from his predecessor, Alan Greenspan’s policies: in fact, Greenspan had a direct impact on Bernanke’s economic philosophy.303 One of the defining moments in Bernanke’s career, and on his economic policies as Federal Reserve Chairman, occurred in the summer of 1999, at the height of the internet stock bubble, when he presented a paper at an annual policy conference organized by the Federal Reserve Bank of Kansas City at a resort in Jackson Hole, Wyoming.304 Bernanke believed that the Federal Reserve should ignore bubbles and stick to its traditional policy of controlling inflation.305 Henry Kaufman, a notable Wall Street economist, argued in response to Bernanke’s theory that it would be irresponsible for the Federal Reserve to ignore rampant speculation.306 Further, in a prescient tone, Rudi Dornbusch, the late M.I.T. professor, pointed out that Bernanke had ignored the possibility that credit could dry up after a bubble burst, and that such a development could have serious effects on the economy.307 Despite the criticism, Alan Greenspan was more receptive to Bernanke’s theories.308

Once Bernanke became Federal Reserve Chairman, he generally adhered to Greenspan’s laisser-faire approach.309 In May 2006, he rejected calls for direct regulation of hedge funds, arguing that such a move would “stifle innovation.”310 In 2007, Bernanke and a core group of advisers, including Tim Cassidy argues that for more than a year after he was appointed by President George W. Bush to chair the Federal Reserve, in February, 2006, he faithfully upheld the policies of his immediate predecessor, Alan Greenspan, and he adhered to the central bank’s formal mandates: controlling inflation and maintaining employment. But since the market for subprime mortgages collapsed, in the summer of 2007, the financial crisis forced Bernanke to intervene on Wall Street: He has slashed interest rates, established new lending programs, extended hundreds of billions of dollars to troubled financial firms, bought debt issued by industrial corporations such as General Electric, and even taken distressed mortgage assets onto the Fed’s books. See John Cassidy, Anatomy of a Meltdown: Ben Bernanke and the financial crisis. NEW YORKER, Dec. 1, 2008 at 2. Available at http://www.newyorker.com/reporting/2008/12/01/081201fa_fact_cassidy?currentPage=all.

302 Cassidy argues that for more than a year after he was appointed by President George W. Bush to chair the Federal Reserve, in February, 2006, he faithfully upheld the policies of his immediate predecessor, Alan Greenspan, and he adhered to the central bank’s formal mandates: controlling inflation and maintaining employment. But since the market for subprime mortgages collapsed, in the summer of 2007, the financial crisis forced Bernanke to intervene on Wall Street: He has slashed interest rates, established new lending programs, extended hundreds of billions of dollars to troubled financial firms, bought debt issued by industrial corporations such as General Electric, and even taken distressed mortgage assets onto the Fed’s books. See John Cassidy, Anatomy of a Meltdown: Ben Bernanke and the financial crisis. NEW YORKER, Dec. 1, 2008 at 2. Available at http://www.newyorker.com/reporting/2008/12/01/081201fa_fact_cassidy?currentPage=all.

303 Id.

304 Id at 6.

305 Id at 7. Bernanke argued that if a bubble inflated and burst on its own, according to Bernanke, the Federal Reserve could always bring down rates to mitigate broader economic damage.

306 Id.


308 Id.

309 See supra note 305.

310 The following month, in a speech on bank supervision, he expressed support for allowing banks, rather than government officials, to determine how much risk they could take on, using complicated mathematical models of their own devising—a policy that had been in place for a number of years. “The ongoing work on this framework has already led large, complex banking organizations to improve their systems for identifying, measuring, and
Professor Troy S. Brown
Legal Political Moral Hazard:
Does the Dodd-Frank Act End Too Big To Fail? Spring 2011

Geithner, Donald Kohn, the Federal Reserve vice chairman, Bill Dudley, the New York Fed’s markets desk chief, and Brian Madigan, director of the division of monetary affairs, presented what became known as the “Bernanke Doctrine” at Jackson Hole.\(^{311}\) In this address, Bernanke stated, “[i]t is not the responsibility of the Federal Reserve, nor would it be appropriate, to protect lenders and investors from the consequences of their financial decisions.”\(^{312}\) Nevertheless, Bernanke’s next sentence bolstered what had been perceived as the Federal Reserve’s policy since the Federal Reserve organized and Wall Street financed bailout of LTCM in 1998: “But developments in financial markets can have broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy.”\(^{313}\) Simply stated, the Federal Reserve, through Bernanke, articulated a policy of taxpayer-funded federal bailouts of shadow banks during a financial crisis, if that financial crisis were arguably serious enough to affect the entire financial system. Thus, the Federal Reserve was forced to endorse a policy of pro-shadow bank economic interventionism.\(^{314}\)

The “Bernanke Doctrine” faced harsh criticism as being ad hoc, ineffective and promoting moral hazard, despite having made a plea to erect a statutory resolution process designed to wind down shadow managing their risks,” Bernanke said.

\(^{311}\) Bernanke and his colleagues settled on a two-part approach to the crisis, the “Bernanke doctrine.” First, to prevent the economy from stalling, the Federal Reserve would lower the federal funds rate to 4.5%, but this did not directly address the crisis of confidence afflicting the financial system. However, borrowing from the Fed’s discount window, its main tool for supplying banks with cash, not only meant paying a hefty interest rate, but also signaled to competitors that the lender was having difficulty raising money. Versions of the Y2K proposals became the second part of the Bernanke doctrine. The programs, which have received little public attention, were supposed to be temporary, but they have been greatly expanded and remain in effect. “It’s a completely new set of liquidity tools that fit the new needs, given the turmoil in the financial markets,” Kevin Warsh, the Federal Reserve governor, said. “We have basically substituted our balance sheet for the balance sheet of financial institutions, large and small, troubled and healthy, for a time.” See John Cassidy, Anatomy of a Meltdown: Ben Bernanke and the financial crisis. THE NEW YORKER, Dec. 1, 2008 at 14 - 15.

\(^{312}\) Id.

\(^{313}\) In his address at the 2007 conference, Bernanke said “It is not the responsibility of the Federal Reserve, nor would it be appropriate, to protect lenders and investors from the consequences of their financial decisions.” Yet his next sentence bolstered what had been perceived as the federal Reserve’s policy since the hasty, Federal Reserve organized, Wall Street financed bailout of Long-Term Capital Management in 1998: “But developments in financial markets can have a broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy.” Simply stated, the Federal Reserve had articulated a policy that if the consequences of a financial crisis were serious enough to affect the entire financial system, the Federal Reserve might indeed have broader obligations that might require intervention. See A. SORKIN, supra note 4, at 219.

\(^{314}\) Id.
banks. It is clear now that the policy of self-regulation was a resounding failure. Questions remain as to whether the 2008 financial crisis has truly altered his pro-market fundamentalism and whether the Dodd-Frank Act can constrain his discretion if it has not. Given the amount of oversight responsibility with which the Dodd-Frank Act empowers the Federal Reserve, particularly over shadow banks’ liquidity, leverage, and capital requirements, adherence to core counter-cyclical policies will be essential to successful implementation. Yet, given Bernanke’s pro-market philosophy this is an open question despite public protestations to the contrary.

Treasury Secretary Timothy Geithner, while not as outspoken on his own market philosophy, has clearly demonstrated a propensity to rescue failing institutions when he believed it was necessary. Moreover, Geithner has expressed his own frustration with aspects of the Dodd-Frank Act, specifically the Volcker Rule. One of the clearest indications of Geithner’s market ideology is his response to the 2008 financial crisis: when AIG was in the midst of preparing for bankruptcy, Geithner, clearly aware of the vast counterparty exposure that AIG’s failure would cause, asked representatives from JP Morgan and Goldman Sachs during a Federal Open Markets Committee meeting, on September 16, 2008, how to

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315 The 2008 conference found the “Bernanke Doctrine” facing harsh criticism as being ad hoc, ineffective and promoting moral hazard, despite having made a plea to erect a statutory resolution designed to wind down shadow banks. *Id* at 220.

316 Timothy Geithner role in the bailouts of 2008 demonstrate his belief that federal intervention is occasionally necessary. For example, when Paulson and Geithner considered bailing out Lehman Brothers, they envisioned a public-private pooling of money to loan Bank of America so it could buy Lehman Brothers, much like the LTCM solution. *See supra* note 4 at 280. Moreover, on Thursday, March 13, 2008, Gary Parr, a banker at Lazard, who represented Bear Stearns, called Jamie Dimon and asked if he could speak with Alan Schwartz, the CEO of Bear Stearns. The call meant that Bears Stearns’ financial condition was worse than the public was aware. Schwartz told Dimon that Bear Stearns had run out of cash and needed help. Schwartz stated that Bear Stearns needed $30 billion. After telling Schwartz that JP Morgan could not come up with that amount so quickly, Dimon called Timothy Geithner at the New York Federal Reserve. He informed Geithner that JP Morgan was willing to be a part of the solution. On March 14, the following day, the Federal Reserve funneled a loan through JP Morgan to Bear Stearns that would end the immediate crisis and give Bear Stearns twenty-eight days to arrange a long-term deal. Neither the Fed, nor the Treasury was willing to wait that long, and over the weekend the Federal Reserve and Treasury urged Dimon to acquire Bear Stearns. *Id.* at 77 – 78. Geithner would accept no refusal and pressed Dimon on what terms would be the acquisition of Bear Stearns be acceptable. They finally agreed on a $30 billion loan against Bear Stearns’s difficult-to-value collateral, leaving JP Morgan liable for the first $1 billion in losses. *Id* at 78.

317 Geithner opposed the new rules, but has Volcker has the President's ear, according to Taplin. Chittum also notes that sources, speaking anonymously because Geithner has not spoken publicly about his reservations, said the Geithner is concerned the proposed limits on big banks’ trading and size could impact U.S. firms’ global competitiveness. He also has concerns that limits on proprietary trading do not necessarily get at the root of the problems and excesses that fueled the recent financial meltdown, the sources said. *See Jon Taplin, Volcker In, Geithner Out, TPM, Jan. 22, 2010; see also Ryan Chittum, What Does Tim Geithner Really Think About the Volcker Rule?, COLUMBIA JOURNALISM REVIEW, Jan. 22, 2010. Available at http://www.cjr.org/the_audit/what_does_tim_geithner_really.php:*
structure a bailout loan to AIG if the Federal Reserve were to assist. Thus, despite insisting that the Federal Reserve would not bail out AIG, Geithner capitulated. When Geithner realized a consortium of banks could not raise sufficient capital to rescue AIG, Geithner proposed invoking Section 13(3) of the Federal Reserve Act by suggesting that if the Federal Reserve took a decisive step to backstop AIG it would also have the effect of restoring confidence in the capital markets. Thus, Geithner offered Federal Reserve assistance rather than simply covering the shortfall between what the consortium could raise and what AIG needed. While the supposed intent of the Federal Reserve’s backstopping AIG was to bolster market confidence, the effect of this aspect of the Federal Reserve’s bailout of AIG (and of Bear Stearns) benefitted the counterparties, and the policy effect encouraged counterparty risk. This incident demonstrates that Geithner is vulnerable, at the very least, to fears of systemic collapse precipitated by the failure of a large interconnected entity.

Second, because the Federal Reserve is empowered to oversee large interconnected shadow banks, it could potentially exploit the Dodd-Frank Act. Perhaps one of the more essential powers outlined under the Dodd-Frank Act is the power to impose capital requirements upon financial institutions that are “countercyclical, so that the amount of capital maintained by a financial institution increases in times of

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318 Sorkin notes that when AIG was in the midst of preparing for bankruptcy, Geithner, clearly aware of the vast counterparty exposure that AIG’s failure would cause, essentially reversed course and asked representatives from JP Morgan and Goldman Sachs during a Federal Open Markets Committee meeting, on September 16, 2008, how a loan could be structured to bail-out AIG if the Federal Reserve were to assist. Thus despite days of insisting that the Federal Reserve would not bail-out AIG, Geithner capitulated. Geithner realizing that there was not going to be a private market solution to rescue AIG proposed invoking Section 13(3) of the Federal Reserve Act by suggesting that if the Federal Reserve took a decisive step to backstop AIG it would also have the effect of restoring confidence in the capital markets. See A. SORKIN, supra note 4, at 388 - 390.

319 Id.

320 It is important to note that Geithner, Paulson, and Bernanke were drawing from the LTCM precedent in structuring a bailout for AIG. When LTCM nearly collapsed, the Federal Reserve organized a consortium of Wall Street Banks to raise sufficient capital to rescue it. This precedent was to be the basis for a bailout of AIG. See SORKIN supra note 4 at 375.

321 Id.

322 See supra note 318.

323 See Darrell Issa, Public Disclosure As A Last Resort: How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout From the American People (Special Report) at 3. Available at http://www.zerohedge.com/sites/default/files/aigstaffreportwithcover.pdf. (“One idea presented to FRBNY officials would have allowed the counterparties to keep the underlying assets and the protection provided by the credit default swaps. Under this option, the obligation to perform under the contract would have been transferred from AIG to a special purpose vehicle (“SPV”) funded by the FRBNY, in exchange for the counterparties agreeing to waive any further collateral calls. FRBNY officials cited a lack of statutory authority in rejecting this option. This excuse is problematic, as the Federal Reserve guaranteed assets against losses in bailouts of other firms during the height of the financial crisis.”)
economic expansion and decreases in times of economic contraction,” to ensure the safety and solvency of the financial institution and society.\(^{324}\) This impressive array of specific risk factors gives the Federal Reserve, one of the principal regulators who bailed out Bear Stearns, AIG, and several others is now tasked with setting the limits by which they operate. Giving the Federal Reserve “another” chance after decades of pro-cyclical extremes seems an odd way to begin an era of counter-cyclical policies. This wide degree of discretion could still be exercised in a manner that tilts in favor of pro-market fundamentalism, with the lowest possible contingent capital requirement, short-term debt limits, but high maximum leverage ratio. Neither history nor the law of inertia favors an immediate policy reversal by the Federal Reserve.

Furthermore, because the Council must make recommendations to the Federal Reserve, rather than create its own standards,\(^{325}\) the Federal Reserve retains wide discretion in regulating nonbank financial companies and large interconnected bank holding companies.\(^{326}\) This degree of discretion could allow the Federal Reserve myriad opportunities to implement selectively pro-market policies while working under a countercyclical regime, especially for shadow banks. Given history and the amount of discretion given to the Federal Reserve, a pro-market interpretation of the Dodd-Frank Act is particularly possible given Geithner’s public views on the Volcker Rule.\(^{327}\) It is common knowledge that Geithner had endorsed a very different plan for regulating systemic Political pressure from Congress could certainly influence how the Federal Reserve and Treasury Department exercise their new mandates. A letter from Rep. Spencer Bachus to Geithner illustrates the pressure to interpret and implement the Volcker Rule’s prohibitions narrowly and loosely.\(^{328}\) Sentiments like these could signal a significant weakening of not

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\(^{324}\) See supra note 292.

\(^{325}\) The Council is required to recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies. See H.R. 4173, §§112(a)(2)(F).

\(^{326}\) The Council must make recommendations, to the Board of Governors concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors. Therefore, the Federal Reserve is still retains final decision-making power. See H.R. 4173, § 112(a)(2)(I).

\(^{327}\) See supra note 317; see also Felix Salmon, *The Volcker Rule under threat*, REUTERS, Nov. 10, 2010 at 1. (Salmon notes that if Geithner and hostile Congressional members want to render The Volcker Rule toothless, they almost certainly can.); see also Jan. 11, 2010 letter from Secretary Timothy Geithner to Rep. Ellison. (“Finally, preserving the flexibility of the Federal Reserve and the other U.S. banking agencies to design and calibrate a leverage constraint for U.S. financial firms is essential to enable the agencies to successfully negotiate a robust international leverage ratio that works in all the major jurisdictions and does not leave U.S. firms at a competitive disadvantage to their foreign peers.”)

\(^{328}\) See Felix Salmon, *The Volcker Rule under threat*, REUTERS, Nov. 10, 2010 at 1. Salmon cites a letter from Rep. Spencer Bachus to Secretary Timothy Geithner, which, in pertinent part, states the following:
only how the Federal Reserve and Treasury Department implement the Volcker Rule, but also how the Federal Reserve and Treasury Department exercise other aspects of their authority under the Dodd-Frank Act. Further evidence of Geithner’s divergence of opinion from Volcker and other aspects of the Dodd-Frank Act is a January 11, 2010 letter from Geithner to Rep. Keith Ellison:

Finally, preserving the flexibility of the Federal Reserve and the other U.S. banking agencies to design and calibrate a leverage constraint for U.S. financial firms is essential to enable the agencies to successfully negotiate a robust international leverage ratio that works in all the major jurisdictions and does not leave U.S. firms at a competitive disadvantage to their foreign peers.\(^{329}\)

Geithner’s unusually clear expression of pro-market sympathies should concern the Dodd-Frank Act’s supporters that one of the primary policymakers tasked with implementing and enforcing its major components is more concerned with US banks operating at “a competitive disadvantage” rather than ensuring that another crisis is brewing. The Federal Reserve and Treasury Department’s discretion, tinged with heavy pro-market sympathies, could result in further policy inertia.

Third, critics argue that the coziness of President Obama's top economic advisers, along with Federal Reserve Chairman Ben Bernanke and Treasury Secretary Tim Geithner, with their former Wall Street colleagues makes it unlikely that genuine reform of the Federal Reserve’s and Treasury Department’s entrenched relationships will occur.\(^ {330}\) During the 2008 financial crisis, many of the shadow banks directly lobbied for federal bailouts when their risk-prone investment strategies began to fail, examples include the four attempts to find a buyer for Lehman Brothers, the selling of Bear Stearns (at no

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330 Becker and Posner state that the Dodd-Frank Act gives several government agencies considerable additional discretion to try to forestall another crisis, even though they already had the authority to take many actions. Becker and Posner further state that the Federal Reserve could have tightened the monetary base and interest rates as the crisis was developing, but chose not to do so. Moreover, they note that the SEC and various Federal Reserve banks—especially the New York Fed—had the authority to stop questionable lending practices and increase liquidity requirements. These and other government bodies did not use their authority to try to head off the crisis partly because they got caught up in the same bubble hysteria as did banks and consumers, according to Becker and Posner. In addition, according to Becker and Posner, regulators are often “captured” by the firms they are regulating, not necessarily because the regulators are corrupt, but because they are mainly exposed to arguments made by the banks and other groups they are regulating. See Gary Becker and Richard Posner, Five Major Defects of the Financial Reform Bill, THE BECKER-POSNER BLOG, Jul. 11, 2010 at 1. Available at http://www.becker-posner-blog.com/2010/07/five-major-defects-of-the-financial-reform-bill-becker.html.
risk to JP Morgan), and the massive bailout of AIG.\textsuperscript{331} While it is not surprising that these shadow banks would advocate for themselves, it is disturbing that Geithner, Bernanke, and, largely, former Treasury Secretary Hank Paulson directly advocated on behalf of these shadow banks during potential merger discussions, sales, and even subsidizing their behavior through massive federal bailouts.\textsuperscript{332} That they believed no other option was available indicates that their pro-market ideologies limited the range of possible options, especially in light of the inconsistent treatment of Lehman Brothers and those who benefitted from TARP.\textsuperscript{333} There is little in the Dodd-Frank Act that prohibits the same conflicted relationships from forming.\textsuperscript{334} Given the manner in which decades of pro-market relationships and pro-cyclical policies led to rampant credit expansion, and, ultimately, to federal bailouts,\textsuperscript{335} it is difficult to imagine that the culture within the Federal Reserve and Treasury Departments will change with the passing of the Dodd-Frank Act.

Fourth, placing new agencies within the Treasury Department and Federal Reserve, two of the regulatory culprits in the 2008 financial crisis, is contradictory to the notion of independence and may result in additional pro-market policy inertia. The Dodd-Frank Act places under the aegis of the Federal Reserve an “independent” Bureau of Consumer Financial Protection (the “Bureau”).\textsuperscript{336} The Dodd-Frank Act also places the Council under the aegis of the Treasury Department. There is no question that the Dodd-Frank Act undercuts this notion of independence by placing these supposedly important new agencies under the jurisdiction of the Federal Reserve and Treasury Department.\textsuperscript{337} The Dodd-Frank Act could have actualized this goal of independence simply creating the Bureau and the Council outside the

\textsuperscript{331} See supra note 287.

\textsuperscript{332} Id.

\textsuperscript{333} Id.

\textsuperscript{334} See supra note 330.

\textsuperscript{335} Baily, Litan, and Johnson note that for over 30 years there has been a thrust in U.S. policy towards reduced regulation of private markets: President Reagan was a supporter of deregulation, financial markets have also gradually been deregulated, going back to the ability of money market mutual funds to issue interest-bearing checking accounts, through the ending of Glass-Steagall prohibitions on banks. In addition, Baily, Litan, and Johnson also note the Federal Reserve, like other central banks, stands as the lender of last resort to provide additional liquidity to banks in difficulty, a role that was extended to the investment bank Bear Stearns in March 2008, and since then has effectively been extended to the entire financial system. See Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, \textit{The Origins of the Financial Crisis}, THE BROOKINGS INSTITUTE, at 40. Available at http://www.brookings.edu/~/media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf

\textsuperscript{336} See H.R. 4173, §§111, 152.

\textsuperscript{337} See supra note 330.
purview of the Federal Reserve and Treasury Department, yet it specifically places them in a compromised position under agencies with long pro-market policy histories, run by men with open and obvious pro-market policy leanings. This is a recipe for another financial disaster. The Dodd-Frank Act ultimately not only leaves in place the same characters that articulated the same pro-market policies that contributed to the 2008, but also grants them more power and oversight, when it should have been streamlined.

Fifth, the Dodd-Frank Act was sold as the financial reform to end the moral hazard implicit to the “too big to fail” concept and the federal bailouts associated with it. The Dodd-Frank Act purports to end federal bailouts by providing for liquidation of non-bank financial companies, or shadow banks. If the financial institution’s board of directors does not agree, then provisions are made for judicial appeal, once determined that a financial institution satisfies the criteria for liquidation. The Federal Reserve, however, is tasked with determining whether a financial institution should be placed in receivership. The Treasury Secretary, in consultation with the President, may also determine whether to place financial institution in receivership. The GAO must review the Treasury Secretary's decision and report to Congress, and the GAO’s report must contain various details on the state of the institution, the impact of its default on the institution, and the proposed action. This level of discretion could certainly be problematic if the Federal Reserve has not altered its pro-market leanings, or has discretion to act contrary to the spirit of the Dodd-Frank Act. If so, then the policies and relationships that led to federal bailouts will continue.

The Dodd-Frank Act does little to staunch the inertial flow of pro-market policies by entrusting the Federal Reserve and Treasury Department with more oversight and does nothing to break up the cozy

338 The purpose of the Dodd-Frank Act is “To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” See H.R. 4173, § 1. Short title; table of contents

339 See H.R. 4173, §203.


341 See H.R. 4173, § 203(a)(1)(A). The Securities and Exchange Commission (SEC) and the Federal Reserve jointly or independently, determine by 2/3 vote whether a broker dealer should be placed in receivership. The Federal Insurance Office and the Federal Reserve determine by 2/3 vote whether an insurance institution should be placed in receivership.

342 See H.R. 4173, § 203(b) – (c). When the Treasury Secretary places a financial institution into receivership under these provisions, he must report to Congress within 24 hours, and report to the public within 60 days

343 See H.R. 4173, § 203(c)(5).

344 See H.R. 4173, § 203(a)(2).
relationships that allowed for the negotiation of massive federal bailouts. Thus, the Dodd-Frank Act encourages moral hazard and scores 5-points for this factor.

(4) Principal-Agent Separation

This section describes the propensity of shadow bank executives and managers to use high-risk investment strategies to maximize not only investor and shareholder returns, but also to pursue short-term profit maximization. The LPMH model also analyzes principal-agent separation, where an agent acts on behalf of and controls the property of the principal. The agent usually has more information about his or her actions or intentions than the principal does, because the principal usually cannot completely monitor the agent. From the viewpoint of the principal, the agent may have an incentive to act inappropriately, if the interests of the agent and the principal are not aligned. The misalignment of interests associated with principal-agent separation were clearly present during the 2008 financial crisis, allowing for mortgage lenders, and shadow banks to maximize their profits without being fully accountable for the risks. Shadow banks’ securitized mortgages using complex financial structures and then negotiated high ratings giving these the securities the false benediction of safety. In the wake of the 2008 financial crisis, it became clear these securities were riskier than expected. In essence, shadow banks’ short-term profit maximization contributed to the proliferation of sub-prime mortgages. One of the deepest fears in assessing the 2008 financial crisis was that highly compensated shadow bank managers and executives pursued short-term profit maximization with impunity, despite the known risks.

345 Davidson, Wiseman, and Waggoner note that top executives at the nation's largest banks and financial firms reaped big bonuses for “pumping up” quarterly earnings by buying and selling mortgage-backed securities in the housing bubble. The authors also note that when the subprime mortgage market imploded, it drove the firms into ruin; the government had to bail them out to avert a financial system collapse. See Paul Davidson, Paul Wiseman, and John Waggoner, Will new financial regulations prevent future meltdowns?, USA TODAY, Jun. 28, 2010, at 3. Available at http://www.usatoday.com/money/companies/regulation/2010-06-25-fixed-or-not_N.htm

346 Investopedia defines “asymmetric information” as situation in which one party in a transaction has more or superior information compared to another. This often happens in transactions where the seller knows more than the buyer, although the reverse can happen as well. Potentially, this could be a harmful situation because one party can take advantage of the other party’s lack of knowledge. Definition available at http://www.answers.com/topic/information-asymmetry.

347 Id.

348 Id.

349 McCulley argues that shadow banking needed some seal of approval, so that providers of short-dated funding could convince themselves that their claims were de facto “just as good” as deposits at banks with access to the government’s liquidity safety nets. Conveniently, the friendly faces at the rating agencies, paid by the shadow bankers, stood at the ready to provide such seals of approval, according to McCulley. See McCulley supra note 1 at 1.

350 See supra note 345.
because, short-term profit maximization guaranteed their own bonus-based compensation and the federal government would rescue their companies should calamity threaten.\footnote{Morrison \\& Forrester LLP states that lingering concerns with executive compensation and corporate governance practices at public companies culminated in specific provisions of the Dodd-Frank Act that require new stock exchange listing standards, mandated resolutions for public company proxy statements, and expanded disclosures for all public companies soliciting proxies or consents. As a result of these provisions, companies will potentially have to change the composition and operation of their compensation committees, adopt new governance and compensation policies, and prepare for an advisory vote on executive compensation. \textit{See} Morrison \\& Forrester LLP \textit{supra} note 137 at 22.} This fear exemplifies the principal-agent interest divergence associated with moral hazard. Thus, the 2008 financial crisis exposed the consequences of separating ownership from control as when shareholders and investors, the principals, cede control of their capital to shadow banks, their agents.

The Dodd-Frank Act seeks to align the principal-agent divergence between shadow bank and shareholder interests,\footnote{Davidson, Wiseman, and Waggoner interviewed Jeff Mahoney, general counsel for the Council of Institutional Investors, which represents pension funds. Mahoney stated that giving shareholders a non-binding vote on executive pay would put political pressure on directors to heed their concerns, and allowing shareholders to nominate directors likely would yield boards that are more focused on a company’s long-term growth than short-term profits, he says. \textit{See supra} note 345 at 3.} but it fails to align fully shareholder and shadow-bank interests because it does not prevent short-term profit maximization. The Dodd-Frank Act requires new stock exchange listing standards, mandated resolutions for public company proxy statements, and expanded disclosures for all public companies soliciting proxies or consents. These requirements may require shadow banks to adopt new compensation systems and structures and heighten corporate governance policies. Specifically, the Dodd-Frank Act requires the SEC to issue rules requiring public disclosure of executive compensation, including relationship with the company’s actual performance, whether any director or employee is permitted to purchase financial instruments designed to hedge their equities, and median compensation of all employees (other than the CEO), total compensation of the CEO, and the ratio of these two amounts.\footnote{\textit{See H.R. 4173,} § 953. Enhanced disclosure will be required of a company’s policy on incentive-based compensation that is based on financial information required to be reported under the securities laws.} In addition, stock exchanges are also required to adopt standards requiring that listed companies develop and implement policies providing for the recoupment of compensation in the event of an accounting restatement.\footnote{\textit{See H.R. 4173,} § 954. (“The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.”)}

The Dodd-Frank Act also requires stock exchanges adopt listing standards providing that the members of the compensation committee meet “enhanced independence standards” comparable to what is
required for audit committee members under the Sarbanes-Oxley Act. These listing standards will prescribe that a compensation committee must consider the independence standards established by the SEC before selecting compensation consultants, legal counsel, or other advisers. Moreover, the Dodd-Frank Act also prohibits national stock exchanges from listing securities of firms that do not have independent compensation committees, by mid-July 2011.

It also makes several changes to corporate governance. For the first shareholder meeting occurring after January 21, 2011, SEC registered firms must take the following measures: (1) provide for a non-binding shareholder “say on pay” vote on executive compensation, and a vote on whether to vote

355 H.R. 4173, § 952 requires the SEC, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer, other than an issuer that is a controlled company, limited partnership, company in bankruptcy proceedings, open ended management investment company that is registered under the Investment Company Act of 1940, or a foreign private issuer that provides annual disclosures to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee, that does not comply with the requirements of this subsection. See H.R. 4173, § 952. Robert Sweet of Foley Hoag LLP notes that the Dodd Frank Act mandates that national stock exchanges adopt listing standards requiring that members of a listed company’s compensation committee meet enhanced independence standards, similar to those required for audit committee members under the Sarbanes-Oxley Act. The “enhanced independence standards” will direct boards to consider all forms of compensation received by a compensation committee member from the company, including consulting, advisory, or other compensatory fees, as well as any affiliations between the member and the company, a subsidiary of the company, or an affiliate of a subsidiary of the company. See Robert Sweet, Dodd-Frank Financial Reform Act - Key Corporate Governance and Executive Compensation Provisions (Corporate Finance & Securities Alert), FOLEY HOAG LLP, Jul. 27, 2010 at 1.

356 The compensation committee of an issuer may only select a compensation consultant, legal counsel, or other adviser to the compensation committee after taking into consideration the following factors: (A) the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser; (B) the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser; (C) the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest; (D) any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and (E) any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser. These factors shall be competitively neutral among categories of consultants, legal counsel, or other advisers and preserve the ability of compensation committees to retain the services of members of any such category. See H.R. 4173, § 952(b)(1) and (b)(2).

again in one, two, or three years; and (2) provide for a non-binding vote on “golden parachute” if shareholders are voting on a merger or similar extraordinary transaction.

These measures are incomplete for three reasons. First, it fails to discourage short-term profit maximization through a contingent payment policy. Traditionally, organizations have used contingent payment, or bonus, systems purportedly to align their interests with those of their shareholders. If implemented properly, bonus systems financially incentivize employees to perform optimally, help the business achieve its financial objectives, and, thus, align the interests of the principal and agent. A misaligned compensation system either rewards average employee performance or, even worse, can incentivize an employee to pursue recklessly short-term profit maximization. Either example of a misaligned compensation system is should be anathema to the shareholder’s primary interest in strategies that produce the greatest amount of profit over the long run, or maximize their stock value and dividends. When shadow banks pursued short-term profit maximization, executives and managers could maximize their bonuses by generating huge profits, despite the risk associated with combining a high-leverage ratio, large investments in illiquid assets, and trading in risky derivatives. The consequences of these misaligned compensation systems became evident a few years after when the housing bubble collapsed.

358 A “golden parachute” is an agreement between a company and an employee specifying that the employee will receive certain significant benefits if employment is terminated. Sometimes, certain conditions, typically a change in company ownership, must be met, but often the cause of termination is unspecified. These benefits may include severance pay, cash bonuses, stock options, or other benefits.

359 See H.R. 4173, § 951. The proxy statement for a meeting discussing “golden parachutes” must include a “clear and simple” disclosure of the arrangements or understandings and the amounts payable.

360 Roubini offers a stinging indictment of the short-term profit maximization that free market fundamentalist encourages. He argues that free market fundamentalism led to the subprime disaster in the first place: privatize the profits of greed and unregulated gambling for redemption; and socialize the costs and losses when disaster from free market fundamentalism occurs. Moreover, Roubini argues that free market fundamentalist zealots enjoy private profits in good times and corporate welfare paid by the US taxpayer when their free market greed and excesses lead to nasty financial busts. See Nouriel Roubini, Who is to Blame for the Mortgage Carnage and Coming Financial Disaster? Unregulated Free Market Fundamentalism Zealotry, RGE MONITOR, Mar. 19, 2007 at 8, available at http://www.rgemonitor.com/blog/roubini/184125.

361 Nocera notes that the whole system, from mortgage brokers to Wall Street risk managers, seemed tilted toward taking short-term risks while ignoring long-term obligations. He argues that financial institutions made short-term underwriting fees for packaging mortgage-backed securities that have since become known as “toxic assets.” Traders booked short-term profits trading them (or simply marking them up). Executives pushed their subordinates to take more risk because that would yield more profits, and bigger bonuses. Nobody had any incentive to worry about whether those securities would someday “blow up,” because too much bonus money was at stake. See Joe Nocera, First, Let's Fix the Bonuses, THE NEW YORK TIMES, Feb. 20, 2009 AT 1-2. Morris corroborates this claim by illustrating the how shadow banks, through hedge funds, could collect “hefty fees” through securitization while encumbering “little, if any, of their capital.” Moreover, Morris notes that the largest banks dominate the hedge fund prime brokerage market “with Morgan Stanley, Goldman, J.P. Morgan Chase, and Deutschebank topping most lists.” See MORRIS, supra note 152 at 59 – 61, 108, 111.
and created massive shareholder and investor losses, but the shadow bank bonuses vested. In essence, short-term profit maximization allowed shadow bank managers to profit for actions that caused their principals harm.

In order for the Dodd-Frank Act to end the “too big to fail” concept, it must force shadow banks to create executives and managers compensation systems that address the persistent problems associated with principal-agent separation. A quality executive/manager compensation system depends on tying executive compensation to mid- to long-term company performance. The Dodd-Frank Act establishes greater transparency for understanding the basis of executive compensation, as well as augmenting the independence with which executive compensation is determined, and providing a periodic symbolic shareholder vote on compensation. Most of these changes, however, overlook the incentives to pursue short-term profit maximization. A well-designed executive compensation system links bonuses, not only to employee performance, but also to long-term health and prudential risk management. Thus, the Dodd-Frank Act fails to align fully shareholder and shadow-bank interest because it does not prevent short-term profit maximization.

Second, the *ex post* compensation recoupment provision, ostensibly one of the stronger corporate governance enhancements in the Dodd-Frank Act, is problematic for several reasons. The policy clearly underlying this provision seeks to address the diverging principal-agent interests by disgorging the shadow bank employee’s compensation, if the shadow bank’s restated accounting did not “merit” such compensation, but the Dodd-Frank Act does not define “executive officer.” Additionally, despite

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362 *Id.*

363 Nocera advocates for “smart pay incentives” that encourage sensible risk-taking such as an approach that requires everyone who gets a bonus to have a large chunk of it deferred. Nocera also interviewed said Jaidev R. Iyer, a managing director at the Global Association of Risk Professionals, who supports this approach: “You can have a pool of cash and common equity that would comprise the compensation that is being deferred,” Iyer stated. Nocera states that traders would get the deferred portion of their bonus paid out over a number of years, as the profitability of their trades were assured. And if the trades went sour, traders would have to give some, or all, of their bonus back. That way, traders would have an incentive to act for the long term, instead of churning out short-term, often illusory, profits. *Id* at 2–3; *see also* Jenny Stilwell, *Setting up a bonus system: six mistakes to avoid*, MYBRC, Oct. 31, 2008 at 1. Available at [https://mybrc.com.au/Staffing/Staff-Motivation/Performance-Reward/Pages/Setting_Up_Bonus_System.aspx](https://mybrc.com.au/Staffing/Staff-Motivation/Performance-Reward/Pages/Setting_Up_Bonus_System.aspx). (“If the company doesn’t perform according to plan (refer Mistake # 2 about forecasts…) then there won’t be much excess for a bonus pool. If employees are offered bonus rewards that are contingent only upon their own performance and not the company’s, there may not necessarily be excess funds in the company at the end of the year to pay individual bonuses.”)

364 See *H.R. 4173*, § 954

365 I use the term “merit” because the Dodd-Frank Act provides no intent requirement to trigger the §954. In this regard, Pepper Hamilton LLP characterizes this section as a strict liability law. *See infra* note 371.

366 Roger A. Lane, Courtney Worcester, Katherine B. Hollingsworth (A Publication of Pepper Hamilton LLP), *Dodd-Frank’s Mandatory Executive Compensation Clawback: A Practical Review and Assessment* (Securities...
requiring return of all “incentive-based compensation” that would not have been awarded under the restated financials, the term “incentive-based compensation” is not defined, apart from the express inclusion of stock options.\(^{366}\) Moreover, this \textit{ex post} procedure will suffer from the multiple transaction costs associated with an institution implementing and enforcing this policy.\(^{369}\) For example, the Pepper Hamilton LLP noted that Section 304 of the Sarbanes-Oxley Act\(^{370}\) contains a clawback provision, but that provision applies only if the restatement is the result of misconduct, applies only to the CEO and CFO, and seeks to recoup only those amounts received in the year following the first improper filing.\(^{371}\) In contrast, the Dodd-Frank Act effectively imposes “no fault” strict liability: a company \textit{must} recover from current and former executive officers any excess incentive-based compensation awarded in the previous three years if it restates.\(^{372}\) Thus, this \textit{ex post} procedure assumes that recoupment will be practicable regardless of when the shadow bank restates its accounting.

\begin{footnotesize}
\begin{itemize}
  \item Lane, Worcester, and Hollingsworth state that he Act does not define “executive officer;” that task has been left to the SEC and the exchanges. Lane, Worcester, and Hollingsworth note that the SEC may well turn to Rule 3b-7 of the Securities Exchange Act of 1934, which defines “executive officer” as a company’s president; any vice-president in charge of a principal business unit, division or function; any other officer who performs a policy-making function; or any other person who performs similar policy making functions for the company. Alternatively, the SEC could turn to Section 16 of the Securities Exchange Act of 1934, which has been interpreted to cover any officer of a registered issuer, or it could develop a new definition for this section of the Act. \textit{Id} at 1.
  \item Lane, Worcester, and Hollingsworth note that the term “incentive-based compensation” also is not defined, apart from the express inclusion of stock options. \textit{See supra} note 366 at 1.
  \item Lane, Worcester, and Hollingsworth note that many companies do not presently have clawback policies at all, and among those that do, few have policies that contemplate a mandatory clawback regardless of the reason for restatement or an individual’s responsibility for it, and rarer still are clawback policies that encompass former executives. In addition, Lane, Worcester, and Hollingsworth, note that many companies have not historically identified what portion of an executive’s incentive-based compensation was based solely on mandatorily reported financial metrics, as distinguished from other performance objectives. Lane, Worcester, and Hollingsworth, citing the Corporate Library, 2008 Proxy Season Foresights #11, Analyst Alert “Clawback Policies,” state that as of 2008, of 2,121 companies surveyed, only 13.9 percent had clawback policies. Of those, only 39 percent (5 percent overall) had a policy that applied to all executives, regardless of fault, who received an incentive payment based on errant financials, while 44 percent (6 percent overall) had a clawback policy that applied only to executives who engaged in fraudulent activity that caused a restatement. \textit{See supra} note 366 at 1
  \item Lane, Worcester, and Hollingsworth that while the concept of “clawing back” executive compensation is not new, the Act goes well beyond what has been required before. For example, Section 304 of the Sarbanes-Oxley Act contains a clawback provision, but that provision is only triggered if the restatement is the result of misconduct, applies only to the CEO and CFO, and seeks to recoup only those amounts received in the year following the first improper filing. \textit{See} 15 U.S.C. §7243. In contrast, the Act effectively imposes strict liability— if a company restates for any reason, then it must recover from current and former executive officers any excess incentive-based compensation awarded in the previous three years. \textit{See supra} note 366 at 1.
  \item \textit{See supra} note 371.
\end{itemize}
\end{footnotesize}
Therefore, while the Dodd-Frank Act makes important strides to align shareholder-shadow bank interests it nevertheless encourages moral hazard. As a result, 5-points will be assessed based on the misalignment of shareholder-shadow bank interests.

(5) Institutional Government Intervention

Government taxation and reallocation of tax revenue forces taxpayers to contribute to federal bailouts.\(^{373}\) This “force” takes the form of legislation. It has been argued that moral hazard exists, because legislation allocates resources differently than would otherwise occur in the absence of moral hazard.\(^{374}\) Through taxation and legislation that authorizes federal bailouts, the government intervenes by commanding property owners to use their resources in a manner that they would not choose to use but for the government’s initiative.\(^{375}\) By its nature, government reallocation of tax revenue toward federal bailouts necessitates moral hazard: federal bailouts create a situation where the beneficiaries of the government intervention have an incentive to expropriate the resources subject to government intervention.\(^{376}\) From this, it follows that legislation that provides for bailouts incentivizes shadow banks that are arguably “too big to fail” to invest recklessly and expect that the Federal Reserve and Treasury Department will not allow such an important business to fail.\(^{377}\) As noted above, Title II of the Dodd-Frank Act was sold as the financial reform to end the moral hazard implicit to the “too big to fail” concept

\(^{373}\) Hulsmann argues that an interventionist government commands other property owners to use their resources in a different way than these owners themselves would have used them. In so doing, the interventionist government makes some person or group A (for example itself) the uninvited co-owner of other agent B’s property. The essence of interventionism is precisely this: institutionalized uninvited co-ownership. Government makes itself the uninvited and unwanted co-owner whenever it taxes, regulates, and prohibits. The specific forms of taxation, regulation, and prohibition are myriad. The important fact is that any form of government interventionism, by its very nature, entails a forced separation of ownership and effective control and thus entails moral hazard. Regulation means that the government proscribes a certain use of certain resources. This use is typically not the one that the citizens would have chosen. See Jorg Guido Hulsmann, The Political Economy of Moral Hazard, Universite d Angers, Politika Ekonomie 2006 at 41.

\(^{374}\) Id.

\(^{375}\) Id.

\(^{376}\) Hulsmann argues that government interventionism always and everywhere entails a forced separation of ownership and control. It always and everywhere creates unwanted “partnerships” between the citizens and their government. It follows that, by its very nature, it creates a moral hazard both for the citizens and for the government. Most importantly, it creates a situation in which each of the parties involved (the citizens on the one hand and the government on the other hand) desires to expropriate the resources subject to interventionism at the expense of the other parties. Id at 42.

\(^{377}\) See supra not 160 at 1 (“Too big to fail” is the cancer of moral hazard in the financial system. Moral hazard is a term used in banking circles to describe the tendency of bankers to make bad loans based on an expectation that the lender of last resort, either the Federal Reserve domestically or the IMF globally, will bail out troubled banks.”).
and the federal bailouts associated with it.\textsuperscript{378} The Dodd-Frank Act states that, “[t]axpayers shall bear no losses from liquidating any financial institution under this title and any losses shall be the responsibility of the financial sector, recovered through assessments.”\textsuperscript{379} While Title II’s wind down provision was clearly necessary in light of the fate of Lehman Brothers historic bankruptcy, it is not sufficient to end the “too big to fail” concept.

Title II of the Dodd-Frank Act purports to end federal bailouts by providing for liquidation of non-bank financial companies, or shadow banks.\textsuperscript{380} Title II makes the FDIC responsible for managing the Orderly Liquidation Fund (the “Fund”) which can only be used when a subject financial institution's liquidation\textsuperscript{381} is not covered by FDIC or SIPC.\textsuperscript{382} The Fund is capitalized by collecting risk-based assessment fees on any “eligible financial institution” - which is defined as “[…] any bank holding institution with total consolidated assets equal to or greater than $50 billion and any non-bank financial institution supervised by the Board of Governors.”\textsuperscript{383} The severity of the assessment fees can be adjusted on an as-needed basis\textsuperscript{384} and the relative size and value of a firm is to play a role in determining the fees to be assessed.\textsuperscript{385} A financial institution that does not qualify for fee assessment, would be subject to the fees in the future if it exceeds the $50 billion threshold, or becomes subject to Federal Reserve scrutiny.\textsuperscript{386} Initially, the Fund is to be capitalized over a period no shorter than five years, but no longer than ten years; however, in the event the FDIC must make use of the Fund before it is fully capitalized, the Secretary of the Treasury and the FDIC are permitted to extend the period as determined necessary.\textsuperscript{387}

To the extent that a financial institution subject to the Dodd-Frank Act has a negative net worth and its liquidation creates an obligation to the FDIC as its liquidator, the FDIC shall charge one or more

\begin{footnotesize}
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\item See H.R. 4173, § 1. Short title; table of contents.
\item H.R. 4173, § 214.
\item H.R. 4173, § 201.
\item H.R. 4173, § 210(n)(1).
\item H.R. 4173, § 210(n)(8)(A).
\item \textit{Id}.
\item Id. The severity of the assessment fees depends on economic conditions and other similar factors.
\item H.R. 4173, § 210(n)(8)(A).
\item \textit{Id}.
\item "Dodd–Frank Wall Street Reform and Consumer Protection Act (Enrolled Final Version - HR 4173)." THOMAS. Available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.
\end{enumerate}
\end{footnotesize}
risk-based assessments. The Financial Stability Oversight Council uses a matrix to arrive at these assessments and recommends those assessments to the FDIC. The matrix examines ten factors, including strength of its on-balance sheet and off-balance sheet assets, including, but not limited to, leverage; potential exposure to sudden calls on liquidity precipitated by economic distress with other financial companies; relevant market share; the stability and variety of the institution’s sources of funding; an insurance institution; the amount, maturity, volatility, and stability of the liabilities of the institution, including the degree of reliance on short-term funding; the amount, different categories, and concentrations of liabilities, both insured and uninsured, contingent and non-contingent, including both on-balance sheet and off-balance sheet liabilities, of the financial institution and its affiliates. While the matrix accounts for a financial institution’s economic conditions, it requires higher assessments during favorable economic conditions. When liquidating a financial institution under Title II, the federal government’s liquidation obligation cannot exceed 10% of the total consolidated assets, or 90% of the fair value of the total consolidated assets. In the event that the Fund and other sources of capital are

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388 The assessments are levied against any bank holding institution with consolidated assets greater than $50 billion and any nonbank financial institution supervised by the Federal Reserve. Under certain conditions, the assessment may be extended to regulated banks and other financial institutions. See, H.R. 4173, § 210(o)(1)(A). Assessments are imposed on a graduated basis, with financial companies having greater assets and risk being assessed at a higher rate. See, H.R. 4173, § 210(o)(2). The assessments must be paid within 60 months (5 years) of the issuance of the obligation. See H.R. 4173, § 210(o)(1)(B)

389 See H.R. 4173, § 210

390 Those ten factors are the following: (1) whether institution is an insured depositary institution that is a member of the FDIC, a member of the SIPC; (2) an insured credit union; an insurance institution; (3) strength of its on-balance sheet and off-balance sheet assets, including its leverage; (4) relevant market share; (5) potential exposure to sudden calls on liquidity precipitated by economic distress with other financial companies; (6) the amount, maturity, volatility, and stability of the liabilities of the institution, including the degree of reliance on short-term funding; (7) the stability and variety of the institution’s sources of funding; (8) the institution’s importance as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the financial system; (9) the extent to which assets are managed, rather than owned, by the financial institution and the extent to which ownership of assets under management is diffuse; and (10) the amount, different categories, and concentrations of liabilities, both insured and uninsured, contingent and non-contingent, including both on-balance sheet and off-balance sheet liabilities, of the financial institution and its affiliates. See H.R. 4173, § 210(o)(4).

391 This assessment is pursuant to applicable State law to cover costs of rehabilitation or liquidation. See H.R. 4173, § 210

392 This factor takes into consideration existing systems for measuring an institution’s risk-based capital. See H.R. 4173, § 210

393 H.R. 4173, § 210(o)(4)

394 Id.

395 H.R. 4173, § 210(n)(6)
insufficient, the Dodd-Frank Act authorizes the FDIC to buy and sell securities on behalf of the institution in receivership to raise additional capital.\textsuperscript{396}

From this perspective, Title II acts as a kind of insurance fund for the orderly wind down of insolvent companies and forces the company to liquidate its own assets to provide for this wind down when the fund proves insufficient. When questioned on the topic of how Title II related to ending the moral hazard associated with the “too big to fail” concept, Paul Volcker stated that the crucial difference between banks, which provide important lending functions, and non-banks or shadow banks, which engage in speculative activity, would be the creation this “robust resolution authority” under Title II, with the power and resources to take over and close down a shadow bank.\textsuperscript{397} Volcker stated the following, in pertinent part, regarding bailing out shadow banks:

> The whole point of this is importantly to get at the moral hazard problem... these non-banks, if they get in trouble, are not going to be saved. Their creditors can’t sit there and say, I’m going to be protected. The management can’t expect to stay in office. The stockholders can expect to lose ... euthanasia rather than life support and that’s a big difference.\textsuperscript{398}

Despite Volcker’s assurances to the contrary, the Dodd-Frank Act taxpayers will nevertheless be forced to insure future failures of shadow banks.\textsuperscript{399} Title II of the Dodd Frank Act has a glaring loophole that could still allow shadow banks to force the Federal Reserve to provide the massive bailouts similar to those given in 2008. The assurances in H.R. 4173, § 210(n)(6) that taxpayers will not be forced to subsidize the recklessness of shadow banks and other financial entities are contradicted by Title XI §§ 121 and 1101 of the Dodd-Frank Act, which alter Section 13(3) of the Federal Reserve Act that only further enshrines federal bailouts.\textsuperscript{400}

\textsuperscript{396} Moreover, Title II requires liquidation for all financial institutions put into receivership and all funds expended in the liquidation of a financial institution under this title are to be recovered from the disposition of assets or assessments on the financial sector. \textit{See, “Dodd-Frank Wall Street Reform and Consumer Protection Act (Enrolled Final Version - HR 4173)” THOMAS. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf}

\textsuperscript{397} \textit{See} Chrystia Freeland and Francesco Guerrera, \textit{“Volcker rule” gives Goldman stark choice}, THE FINANCIAL TIMES, Feb. 12, 2010 at 1. (Volcker “argued that a key to drawing this distinction between banks and non-banks would be the creation of a robust ‘resolution authority’ with the power and resources to take over and close down a non-bank. ‘The whole point of this is importantly to get at the moral hazard problem... these non-banks, if they get in trouble, are not going to be saved. Their creditors can’t sit there and say, I’m going to be protected. The management can’t expect to stay in office. The stockholders can expect to lose.’”)

\textsuperscript{398} \textit{Id.}

\textsuperscript{399} \textit{H.R. 4173}, §1101(c)(III) states that if Section 13(3) of the Federal Reserve Act is authorized the expected or final cost to the taxpayers of such assistance must be determined. This section directly contradicts the stated purpose of the Dodd Frank Act.

\textsuperscript{400} \textit{Id.}
The analysis and actions authorized by §121 is somewhat retrospective, because the four factors assume that a shadow bank “poses a grave threat to the financial stability of the United States.”401 Thus, the wording of this section presupposes that shadow banks can grow to a size or grow so interconnected that one or may threaten the integrity of the U.S. financial system. Moreover, §121, paragraph (5) states that if the Federal Reserve determines that actions described in paragraphs (1) through (4) are inadequate to mitigate a threat to the United States’ financial stability, it may require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities.402 In essence, this section allows the Federal Reserve to engage in the same ad hoc sales, mergers, and consortiums that the Federal Reserve forced in the bailouts of LTCM, Bear Stearns, and Lehman Brothers.403 Should the threat of financial crisis loom, there is little reason to think that Congress would behave any differently than it did when it passed the TARP legislation in 2008.

Second, far from ending the “too big to fail” concept, Title XI, §1101 of the Dodd-Frank Act amends section 13(3) of the Federal Reserve Act to allow the Federal Reserve to bailout shadow banks, pursuant to a program or facility that features “broad-based eligibility.”404 Indeed, the Act directs the Federal Reserve and Treasury Department to create emergency lending programs and facilities “as soon

401 See H.R. 4173, §121 gives the following four factors: (1) limit the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (2) restrict the ability of the company to offer a financial product or products; (3) require the company to terminate one or more activities; and (4) impose conditions on the manner in which the company conducts one or more activities.

402 Id.

403 For a very good discussion on the ad hoc nature of the Federal Reserve and Treasury Department’s forced sales of mergers during the Bear Stearns and attempted bailout of Lehman Brothers, see Steven M. Davidoff and David Zaring’s article, Big Deal: The Government’s Response to the Financial Crisis (available at http://ssrn.com/abstract=1306342) and A. SORKIN, supra note 4.

404 Title XI, §1101 amends the section 13(3) of the Federal Reserve Act as follows:

(3)(A)In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for participant in any program or facility with broad-based eligibility, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank: Provided, That before discounting any such note, draft, or bill of exchange the Federal reserve bank shall obtain evidence that such participant in any program or facility with broad-based eligibility is unable to secure adequate credit accommodations from other banking institutions. All such discounts for any participant in any program or facility with broad-based eligibility shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe. H.R. 4173,§1101.

See also supra note 52.
as practicable.” The only limitations imposed on this emergency lending power is that borrowers cannot already be in bankruptcy or receivership and the loan cannot be made with the “purpose of” assisting a “single and specific company.” Under the Dodd-Frank Act, spectacular single bailouts of specific companies like Bear Stearns and AIG may no longer occur, but the Dodd-Frank Act specifically contemplates bailouts for groups of shadow banks in the same predicament as AIG and Bear Stearns. The Act specifically contemplates that the Federal Reserve may become an unsecured or at least under-secured creditor. Thus, federal bailouts have become more deeply codified in the American financial system, gaining another formal legal authorization.

As a result of the Dodd-Frank Act’s institutionalized governmental intervention into the natural fate of shadow bank allowing federal bailouts, moral hazard is encouraged, because shadow banks will now have an incentive cooperate and form a united front of systemic risk to convince the Federal Reserve that it should use its emergency power under Section 13(3), rather than angle for their own individual benefit. Because the use of section 13(3) has not been effectively limited in a way that will prevent reliance on government bailouts, there is a distinct likelihood that more federal bailouts will again be authorized. Therefore, 6–points will be assessed.

Conclusion

With all five of the LPMH model factors being present, the Dodd-Frank Act scores a 28 out of 28 on the ratings metric. The Dodd-Frank Act dangerously encourages moral hazard, because of the following conclusions: (1) it fails to impose size limits or break up those shadow banks that are too big to fail, allows for several information asymmetries, leaves undisturbed the principal-agent separation that allows for short-term profit maximization, trusts the most critical aspects of reform with the pro-market

405 Ramirez notes that §1101 of the Dodd-Frank Act amends section 13(3) of the Federal Reserve Act in a way that paves the way for the Fed to bailout large banks so long as it does so pursuant to a program or facility that features "broad-based eligibility." Indeed, Ramirez points out that the Dodd-Frank Act directs the Fed and the Treasury to create emergency lending programs and facilities “as soon as practicable.” The only limitations the Act imposes on this emergency lending power is that borrowers cannot already be in bankruptcy or receivership and the loan cannot be made with the "purpose of" assisting a "single and specific company." The Act specifically contemplates that the Fed may become an unsecured or at least undersecured creditor. The bottom line, according to Dodd-Frank Act, is that while high profile bailouts of specific companies like AIG and Bear Stearns are out, regulations that would authorize bailouts of many companies in the same straits as AIG and Bear Stearns are in, and so those kinds of bailouts now have formal legal authorization. See Steven Ramirez, Dodd-Frank II: Revisioning Section 13(3) of the Federal Reserve Act, , Jul. 22, 2010. Available at http://corporatejusticeblog.blogspot.com/2010/07/dodd-frank-ii-revisioning-section-133.html. See also H.R. 4173,§1101.

406 Id.

407 Id.

408 Id.
leaning Federal Reserve and Treasury Department, and makes only cosmetic changes to the infamous bailout provision, section 13(3) of the Federal Reserve Act.

Recommendations

During the last three decades, there was a push for deregulation, but after the 2008 financial crisis, there was a general push for stricter regulation. The passage of the Dodd-Frank Act stands as recognition that there must be a shedding of the excesses of over-securitization, over-leveraging, and over-speculation built over a decade. Framing regulation to discourage moral hazard would require that policymakers acknowledge that lax regulation and ineffective regulators, in part, caused the 2008 financial crisis by allowing, if not encouraging, shadow banks to become overly interconnected Ponzi units. The Dodd-Frank Act seems to acknowledge the roles that unbalanced pro-market policies and regulators played in contributing the crisis, but it is unwilling or unable to close the myriad exceptions and opportunism that led to the 2008 financial crisis. While the Dodd-Frank Act promotes counter-cyclical policymaking to reverse the decades of moral hazard, innovation will always outpace regulation. This section contains broad based recommendations in three categories that could assist in the successful implementation of the Dodd-Frank Act: (1) regulatory modification; (2) executive compensation; (3) securities standardization; and (4) credit rating agency.

Regulatory

The Dodd-Frank Act must focus on prudentially regulating the use of leverage, which relates to capital, and speculation. Three measures could have dramatically boosted the Dodd-Frank Act’s ability to discourage the moral hazard implicit to the “too big to fail concept.” First, if the Dodd-Frank Act had required all financial institutions, regardless of classification, to maintain a certain percentage of capital for all securitized debt, regardless of type, then the financial system would not have been afraid of a few collapsing shadow banks precipitating a panic. For example, if Bear Stearns had been forced to provide $5 billion on $50 billion of derivatives liability, and place that $5 billion in an escrow account or clearinghouse, the public would have known that there existed a fund to absorb losses. In the absence of such a fear, regulators would not have to delve into arcane matters such as what shadow banks are “too big to fail.” Second, the Dodd-Frank missed the opportunity to provide consistent rules on trading. Third,

409 See supra note 16.

410 See generally H.R. 4173.

411 Such a clearinghouse could be used to collect a similar capital cushion from all counterparties to a transaction. The existence of such a clearinghouse could have helped calmed any fears of widespread financial collapse.
the Dodd-Frank should have imposed a capital charge for short-term borrowing. Any financial institution that relies on short-term financing, like shadow banks,412 are inherently vulnerable to credit disruptions regardless of whether the financial institution holds long-term assets. Long-term assets usually appreciate over time, but often their present value can be hard to determine, particularly during a period of massive defaults, as Minsky noted.413 Had the Dodd-Frank Act implemented these three rules, it would strongly discourage the moral hazard underlying the “too big to fail” concept, because there would clear and consistent regulations and mechanisms that would have prevented shadow banks from freezing credit. With this regulatory framework in mind, the following six (6) recommendations are proposed:

1. Loans to highly leveraged parties should carry penalty capital charges.
2. Prime broker loans to hedge funds should cease.
3. Bank-like capital requirements to should apply to all lending entities.
4. Loan originators should always retain first losses, and put-back agreements should get stiffer capital hits.
5. Accounts should not recognize credit insurance purchases from thinly capitalized entities
6. High-volume instruments like credit derivatives should trade in exchange environments rather than over the counter, with exchange –managed margining to eliminate counterparty risk and facilitate settlements in difficult times.414
7. The risk retention requirement complicates syndication and reduces liquidity, and should be eliminated.

Executive and Managerial Compensation

One possible measure would be to make all bonuses stock bonuses, and require that they be held for least four to five years. Moreover, the bonus should be contingent upon executive performance in a certain range of years. In this manner, shadow banks are even more inclined to move away from short-term strategies. This will force them to focus on the long-term benefit of the company. In turn, this should improve stock value. Uncertainty aside, executive performance can improve the value of this bonus significantly. Last, risk managers must have a louder voice with regard to setting the strategic vision

412 See supra note 123 at 2. As a pure investment bank, there were no rules to force Bear Stearns to maintain a fixed level of cash-like assets or to limits its use of overnight funds.

413 See Minsky supra note 46 at 7 – 10.

414 The main consequence is a rise in the price of credit, but it is worth the cost.
within shadow banks, allowing for better control of and selection of risk that is more beneficial for the long term profitability of the institution.

**Standardization**

To make the shadow banking less risky overall, standardized securities would allow easier calculation of risk. Such standardization would allow for comparisons of securities between shadow banks. This will make it easier for shadow banks to assess their own risk.