REVIEW OF CURRENT SCHOLARSHIP ON THE FISCAL CLIFF

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Most of the speakers at the Indiana Law Review Symposium: "Law and the Financial Crisis," held on April 5, 2013 at the Indiana University Robert H. McKinney School of Law, focused on the 2008 financial crisis, causes (including the law), and various concurrent responses. We sit here now thinking we have made it through the crisis and this will not happen again. Yet, the veneer of stability is probably just that. As recently as last week, Federal Reserve (the "Fed") chairman, Ben Bernanke, responded to an attempt at gutting Dodd-Frank by stating, "'[t]oo big to fail' is not solved and gone. . . . It's still here."[1] He went on to add that "'too big to fail' was a major source of the crisis, and we will not have successfully responded to the crisis if we do not address that successfully."[2] In fact, this narrative played out in a *Rolling Stone* article by Matt Taibbi, discussing Sen. Bernie Sanders' new bill in the spring of 2013.[3]

Many academic scholars seem to think that the question to ask is not whether another crisis like this will occur, but when.[4] Are we just over reacting? Is 2008

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1. James Downie, *The White House's Dangerous Stance on 'Too Big to Fail,'* WASH. POST (Mar. 27, 2013), http://www.washingtonpost.com/blogs/post-partisan/wp/2013/03/27/the-white-houses-dangerous-stance-on-too-big-to-fail/ *archived at* http://perma.cc/U9TM-9D2Q.

2. *Id.*

3. Matt Taibbi, *Growing Sentiment on the Hill for Ending 'Too Big to Fail,'* ROLLING STONE (Apr. 3, 2013), http://www.rollingstone.com/politics/blogs/taibblog/the-growing-sentiment-on-the-hill-for-ending-too-big-to-fail-20130403, *archived at* http://perma.cc/4YFD-5J4L.

4. Mehrsa Baradaran, *Banking and the Social Contract*, 89 NOTRE DAME L. REV. 1283, 1285-86, 1326-30 (2014); H. Rodgin Cohen, *Preventing the Fire Next Time: Too Big to Fail*, 90 TEX. L. REV. 1717, 1722 (2012); Simon Johnson, *Keynote Address: The Continuing Problem of "Too Big To Fail,"* 18 N.C. BANKING INST. 1 (2013); Roberta S. Karmel, *An Orderly Liquidation Authority Is Not the Solution to Too-Big-To-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 1, 44-45 (2011); Tom C.W. Lin, *The New Financial Industry*, 65 ALA. L. REV. 567, 585-89 (2014); Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 463-64 (2011); Steven L. Schwartz, *Ring Fencing*, 87 S. CAL. L. REV. 69 (2013); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951, 954 (2011); Jim Tankersley, *As Washington's Top Risk Seeker, Richard Berner Crunches Numbers to See Around Dark Corners In the Economy*, WASH. POST, Apr. 5, 2013, http://www.washingtonpost.com/business/wall-street-veteran-heads-new-federal-office-tasked-with-making-better-economic-forecasts/2013/04/05/bc9c912e-9ad6-11e2-9a79-eb5280c81c63_story.html, *archived at* http://perma.cc/TLE6-4DYW; *see also* Lawrence A. Cunningham, Symposium, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698 (2006); Mira Ganor, *Agency Costs in the Era of Economic Crisis: The Enhanced Connection Between CEO Compensation and Corporate Cash Holdings*, 55 ARIZ. L. REV. 105 (2013); M. Todd Henderson & Fredrick Tung, *Pay*

still close enough that we project our failings of 2008 on today's structures? Are we contrarians for the sake of being contrarians? Personally, I do not think so, and neither does Neil Barofsky, who served as Special Inspector General for the Trouble Asset Relief Program that bailed out the U.S. banking system in 2008.[5] He has stated that another financial crisis is inevitable and that the cost will be even higher than the 2008 financial crisis.[6] Why is this inevitable? We still have the primary problem with the current U.S. financial system having a few large institutions, or what have been called the "too big to fail banks," that are incentivized to take risks, and ensure that the executives will never be accountable for their actions.[7] As we can see from such recent actions as the London Whale problem (a mere $6 billion mistake),[8] and Barclay's rate manipulation,[9] among others, we are far from ending the risk taking of big banks.

The problem on a go-forward basis for dealing with another potential crisis is that the dynamic has now been shifted because the government introduced a safety net to the risk takers: bailouts.[10] Bailouts give bank executives an incentive to take short-term risks in order to maximize profits, because if the bank fails, the taxpayers will bear the burden of the bailout.[11] This is what is known in

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for Regulator Performance, 85 S. CAL. L. REV. 1003 (2012); M. Todd Henderson & Frederick Tung, *Reverse Regulatory Arbitrage: An Auction Approach to Regulatory Assignments*, 98 IOWA L. REV. 1895 (2013); Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262 (2013); Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575 (2013); David Min, *How Government Guarantees Promote Housing Finance Stability*, 50 HARV. J. ON LEGIS. 437 (2013); Pierre-Hugues Verdier, *The Political Economy of International Financial Regulation*, 88 IND. L. J. 1405 (2013); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951 (2011) [hereinafter Wilmarth, *Dodd-Frank*]; Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving In to Wall Street*, 81 U. CIN. L. REV. 1283 (2013) [hereinafter Wilmarth, *Blind Eye*].

5. NEIL BAROFSKY, BAILOUT: AN INSIDE ACCOUNT OF HOW WASHINGTON ABANDONED MAIN STREET WHILE RESCUING WALL STREET 221-23, 225 (Free Press 2012).

6. *Id.* at 225.

7. *Id.* at 216-18.

8. Jessica Silver-Greenberg, *Withering Questions at Senate Hearings on JPMorgan Loss,* N.Y. TIMES, Mar. 15, 2013, http://dealbook.nytimes.com/2013/03/15/jpmorgan-executives-face-withering-questions-at-senate-hearing/, *archived at* http://perma.cc/WZ4E-9EPU; Wilmarth, *Blind Eye*, *supra* note 4, at 1429-37.

9. Mark Scott, *British Regulators Slow to Respond to Libor Scandal, Audit Says*, N.Y. TIMES, Mar. 5, 2013, http://dealbook.nytimes.com/2013/03/05/audit-faults-british-regulators-response-to-libor-scandal/, *archived at* http://perma.cc/K2JP-V5QD; Wilmarth, *Blind Eye*, *supra* note 4, at 1324; Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 190-93 (2013).

10. Verdier, *supra* note 4, at 1460-61.

11. Anat R. Admati et al., *Liability Holding Companies*, 59 UCLA L. REV. 852, 855-56 (2012); Andrea Freeman, *Payback: A Structural Analysis of the Credit Card Problem*, 55 ARIZ. L. REV. 151, 196-98 (2013); Stavros Gadinis, *From Independence to Politics in Financial Regulation*,

economic parlance as a "moral hazard." A moral hazard is where one party is responsible for the interests of another, but has an incentive to put his or her own interests first.[12] The standard example is a worker with an incentive to shirk on the job.[13]

Financial examples include the following: (1) I might sell you a financial product (e.g., a mortgage) knowing that it is not in your interests to buy it;[14] (2) I might pay myself excessive bonuses out of funds that I am managing on your behalf; or (3) I might take risks that you will have to bear. Moral hazards such as these are a pervasive and inevitable feature of the financial system and of the economy more generally.[15] Dealing with them—by which I mean, keeping them under reasonable control—is one of the principal tasks of institutional design to be discussed later.

This does not reflect the principles of a traditional free market because bailouts eliminate the deterrence of taking on an excessive amount of risk.[16] Because of the size of the financial institutions, the government is forced to bail them out or otherwise they will bring the entire financial system down with them.[17] Additionally, the U.S. government refuses to impose criminal sanctions on theses institutions or executives, because, again, their criminalization would collapse the entire financial market.[18] Thus, the main problems with the U.S.

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101 CAL. L. REV. 327, 387 (2013); Jonathan R. Macey, *The Regulator Effect in Financial Regulation*, 98 CORNELL L. REV. 591, 598 (2013); Min, *supra* note 4, at 439-42; Erica A. Posner & E. Glen Weyl, *An FDA For Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First-Century Financial Markets,* 107 NW. U. L. REV. 1307, 1345 (2013); Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO. L.J. 387, 441-42 (2013).

12. BLACK'S LAW DICTIONARY 786 (9th ed. 2009).

13. Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure and Relocation,* 136 U. PA. L. REV. 1349, 1384-85 (1988).

14. Mark Klock, *The Virtue of Home Ownership and the Vice of Poorly Secured Lending: The Great Financial Crisis of 2008 as an Unintended Consequence of Warm-Hearted and Bone-Headed Ideas*, 45 ARIZ. ST. L.J. 135, 163-64 (2013); Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. 63 (2012); *see generally* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 204-10 (2009) (describing when an actor does not bear all of the consequences of his action.).

15. Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 254 (2010); Robert J. Jackson, Jr., *Stock Unloading and Banker Incentives*, 112 COLUM. L. REV. 951 (2012).

16. *See, e.g.*, Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 Fla. L. Rev. 1349, 1376-77 (2011); Simone M. Sepe, *Regulating Risk and Governance in Banks: A Contractarian Perspective*, 62 EMORY L.J. 327, 381 (2012).

17. Anat R. Admati et al., *Liability Holding Companies*, 59 U.C.L.A. L. REV. 852 , 896-97 (2012); Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1385-86 (2011).

18. *See, e.g.*, Samuel W. Buell, *Is the White Collar Offender Privileged?*, 63 DUKE L.J. 823,

financial market all stem from size of its financial institutions.

Further, the economic literature has supported that not only did we fail from a regulatory, law-making, and policy standpoint, but we failed with our modeling.[19] For example, in an ex poste examination of the 2008 crisis, Òscar Jordà, Moritz HP. Schularick, and Alan M. Taylor's recent working paper posits that excess credit is to blame.[20] They claim it was a historical mishap that, just as the largest credit boom in history engulfed Western economies, consideration of the influential of financial factors on the real economy had dwindled to the point where they no longer played a central role in macroeconomic thinking.[21] Standard models were ill equipped to handle financial factors, so the warning signs of increased leverage in the run-up to the crisis of 2008 were largely ignored.[22]

This all leads to the frame of this panel: is there really any way to regulate the financial market in order to prevent the next financial crisis? The post mortem has been undertaken by many. For example, Wladimir Kraus highlights that

> Judge Richard Posner bears the distinction of having published two books within little more than a year: *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009) and *The Crisis of Capitalist Democracy* (2010), both from Harvard University Press. The first and the shorter of the two, *A Failure of Capitalism*, introduces the reader, in fairly broad strokes, to Posner's overall understanding of the

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849 (2014) ("To 'hold Wall Street criminally responsible' for marketing derivative products that unleashed mayhem in 2007 and 2008 would require, at the least, two sharp departures from the traditions and architecture of Anglo-American criminal law."); Brandon L. Garrett, *Globalized Corporate Prosecutions*, 97 VA. L. REV. 1775, 1794-95 (2011) (discussing that deferred prosecution agreement is overly lenient to corporate crime); Gregory M. Gilchrist, *The Special Problem of Banks and Crime*, 85 U. COLO. L. REV. 1 (2014) (stating that regulators fail to use criminal tools which fails to introduce deterrence and expressive costs); Mary Kreiner Ramirez, *Criminal Affirmance: Going Beyond the Deterrence Paradigm to Examine the Social Meaning of Declining Prosecution of Elite Crime*, 45 CONN. L. REV. 865, 885 n.79 (2013) (arguing that failure to prosecute causes deadweight loss and perverse incentives); Scott A. Schumacher, *Magnifying Deterrence by Prosecuting Professionals*, 89 IND. L.J. 511 (2014) (discussing that an increase in the off-shore prosecutions has had a chilling effect on tax shelters); Rena Steinzor, *Introduction: Connecting the Dots Between Two Parallel Worlds*, 72 MD. L. REV. 1145, 1160 (2013) (stating that deterrence to corporate criminality is eliminated by the failure of routine criminal charges); Editorial, *Too Big to Indict*, N.Y. TIMES, Dec. 11, 2012, at A38, *available at* http://www.nytimes.com/2012/12/12/opinion/hsbc-too-big-to-indict.html?_r=0.

19. *See e.g.*, Òscar Jordà et al., *When Credit Bites Back: Leverage, Business Cycles, and Crisis* (Nat'l Bureau of Econ. Research, Working Paper No. 17621, 2011), http://www.bde.es/investigador/papers/sie1126.pdf, *archived at* http://perma.cc/W68A-47PS.

20. *Id.*

21. *Id.*

22. *Id.*

> manifold causes of the crisis and provides a critical assessment of intellectual and policy reactions to it. The second book, though in many respects a valuable stand-alone contribution, stays squarely within the analytical framework laid down in *A Failure of Capitalism* and constitutes largely an ''effort to deal in greater depth, and from a longer perspective, with a crisis that has continued to evolve, to elicit new response measures and new proposals for regulatory reform, to engender new concerns about the future and spawn new controversies about the past.''[23]

The normative target proposed by Posner, which I think is the theme of this panel, is systemic risk reduction.[24] After researching many scholarly writings on the subject, it appears that most proposals for this risk reduction fall under four categories: 1) changing the scope of the agencies regulating the financial market, e.g., granting more agency power; 2) creating a new agency to regulate the market; 3) establish a new statute aimed at regulating the financial market, like the Dodd-Frank Act; or 4) an approach that focuses more on judicial activism and the notion that courts should be more involved in the regulation of financial markets.

I. CATEGORY 1—AGENCY SCOPE

The first category involves changing the scope of the administrative agencies charged with regulating areas of the financial market.[25] Essentially, these proposals suggest that more power should be given to administrative agencies.[26]

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23. RICHARD A. POSNER, THE CRISIS OF CAPITALIST DEMOCRACY (Harvard Univ. Press, 2010); Wladimir Kraus, *The Financial Crisis: A Crisis, Too, For Law and Economics?*, CRITICAL REV. Vol. 23, Nos. 1-2, 147-48 (2011), *available at* http://wladimirkraus.net/resources/Kraus.pdf, *archived at* http://perma.cc/S7RQ-HRXK.

24. *Id.* at 148.

25. Colleen M. Baker, *Regulating the Invisible: The Case of Over-The-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287 (2010); Arthur W.S. Duff & David Zaring, *New Paradigms and Familiar Tools in the New Derivative Regulation*, 81 GEO. WASH. L. REV. 677 (2013); Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivative Clearinghouses*, 61 EMORY L.J. 1153 (2013); Richard E. Mendales, *Fitting an Old Tiger with New Teeth: Protecting Public Employee Funds Investing in Complex Financial Instruments*, 96 MARQ. L. REV. 241 (2012); Saule Omarova & Adam Feibelman, *Risks, Rules and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009); Omarova, *supra* note 4; Steven A. Ramirez, *Taking Economic Human Rights Seriously After the Debt Crisis*, 42 LOY. U. CHI. L.J. 713 (2011); Michael S. Solender, *How the Obama Administration Should Regulate the Financial Sector*, 26 YALE J. ON REG. 471 (2009); Manuel A. Utset, *Complex Financial Institutions and Systemic Risk*, 45 GA. L. REV. 779 (2011); Yesha Yadav, *Looking for the Silver Lining: Regulatory Reform After the "Credit Crunch,"* 15 STAN. J.L. BUS. & FIN. 314, 351-74 (2010).

26. *See, e.g.*, Utset, *supra* note 25, at 837-39 ("To effectively monitor the risk within particular institutions and the financial system, a regulator will need to deal with three levels of complexity: the institutional level, system level, and regulatory level. Identifying, on a timely basis,

By giving the agency more powers through access to the financial institutions and their information, the agency can manage the risk instead of the institution.[27] Thus, the agencies will have a better understanding on the amount of risk relative to the amount of capital that institutions are taking. Another popular broad suggestion is to increase the enforcement power of regulatory agencies so that institutions are more threatened from wrongdoing and excessive risk taking.[28]

A specific proposal by Yesha Yadav suggests that there should be a more multi-peaked rather than a unitary regulator in the mold of the Financial Services Authority (FSA).[29] She explains that this will enhance regulatory competition and create checks and balances within the oversight frame work.[30] One regulator can be prone to defending too many competing interests, such as confidentiality, clear regulatory objectives, and setting effective precedents.[31] Rather, she argues that having a small set of separate agencies managing different regulatory goals may help limit one dominating interests.[32] She breaks it down further by charging different regulation into three separate categories: 1) financial stability and monetary policy,[33] 2) market conduct,[34] and 3) consumer protection.[35] She then explains the scope of each agency, although she does not specifically designate a specific agency for categories two and three.[36]

Yadav charges the regulation of financial stability and monetary policy to the Fed.[37] She explains that because of the Fed's expertise on matters of prudential and risk regulation, that it would be perfect as regulator proscribing rules in respect of capital and liquidity requirements to manage externalities for the market.[38] These rules would assure the sufficiency of for all types of financial institutions that pose risks and be required to take steps to mitigate those risks through appropriate reserves of capital and available liquidity.[39] Market Conduct would be regulated by a completely new agency, which Yadav calls the Financial

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changes in the risk profile of a group of complex institutions interacting with each other along numerous dimensions creates much greater challenges for regulators than monitoring each of those institutions as single, isolated entities.").

27. *See, e.g.*, Omarova & Feibelman, *supra* note 25, at 483-91 ("The nature of the risk in the financial sector necessitates vigilant government oversight of the industry's self-regulatory process.").

28. *See, e.g.*, Mendales, *supra* note 25, at 296-311(arguing that regulatory "teeth" provide deterrence).

29. Yadav, *supra* note 25, at 351-74.

30. *Id.* at 373.

31. *Id.* at 367.

32. *Id.*

33. *Id.* at 368-69.

34. *Id.* at 369-70.

35. *Id.* at 370-71.

36. *Id.*

37. *Id.* at 368-69.

38. *Id.* at 368.

39. *Id.*

Services Regulator (the "FSR").[40] She emphasizes that the FSR be independent, with a mandate for creating and making rules to regulate and supervise firms, except for stability and monetary policy regulation.[41] The FSR would be more effective as it would involve less sector-based regulation and a greater focus on objectives-based approach to regulation, specifically evaluating firms' relationships with the market.[42] The FSR's responsibilities would include admitting firms into the financial market, oversee management structure, regulating conduct of business rules for the market, and oversee proper compliance of firms with customer-specific rules, disclosures, fraud, market manipulation, and insider trading.[43] Yadav proposes that the third category of consumer protection be regulated by a separate agency, which she refers to as the consumer protection agency.[44] She explained that this agency would be strictly focused on monitoring the proper application of and adherence to consumer protection standards.[45] It would "oversee consumer protection issues affecting the market as a whole, complementing the FSR." [46] She ensures that this will keep the FSR and Fed properly mindful of consumer interests against harmful behavior by financial institutions.[47]

Overall, Yadav asserts that by organizing agency regulation into this multi-peaked structure with proper interaction and contact between agencies, regulators would be better suited for each responsibility, and there would be a specialized degree of oversight without the serious structural impediments that keep these agencies from working together effectively.[48]

In their recent article, Saule Omarova and Adam Feibelman, discuss a "three-peak" structure changing the scope of regulators in the industry.[49] However, under this model, the agencies would not split up tasks vertically based on subject matter of regulation, as Yadav proposes.[50] Instead, the agencies' scope would be determined horizontally, based on different markets.[51] One agency would regulate and supervise the wide variety of retail financial service providers and markets.[52] A smaller, more nimble agency would regulate the wholesale financial services providers and markets in complex financial instruments.[53] These two agencies would aim at ensuring safety and soundness of financial institutions and

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40. *Id.* at 369.
41. *Id.*
42. *Id.* at 369-70.
43. *Id.* at 369.
44. *Id.* at 370.
45. *Id.*
46. *Id.*
47. *Id.* at 371.
48. *Id.*
49. Omarova & Feibelman, *supra* note 25.
50. *See* Yadav, *supra* note 25.
51. Omarova & Feibelman, *supra* note 25.
52. *Id.*
53. *Id.*

market conduct.[54] The third agency would then exercise general oversight aimed at preventing system-wide disruptions and ensuring regulatory consistency and general market integrity in both markets.[55] The third agency would also be responsible for regulating issuance of securities, operation of trading platforms, rating agencies, payment systems, and monitoring compliance with anti-money laundering laws.[56]

The authors also briefly mention other ways to shape the scope of regulators. The institutional or function approach would split up agencies to regulate based on the function of the institution, which is basically the current structure in the United States.[57] An integrated regulatory structure would give regulatory and supervisory power to one single super agency.[58] Lastly, a twin-peak approach would divide responsibilities between a prudential regulator of the safety and soundness of financial institutions, and a market conduct regulator.[59]

Omarova and Feibelman ultimately decide that regardless of the specific structure, first the government needs to decide what and whom should be regulated as well as why and how regulation should occur.[60] They argue that once this framework is decided, that the scope of the financial regulators will emerge logically.[61]

II. CATEGORY 2—NEW AGENCY

The second category focused primarily on establishing a new agency for regulation.[62] This was actually the most popular type of proposal by scholars. The argument is that currently, the United States does not have an agency that could effectively monitor financial markets, but, rather, financial regulation

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54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.*
62. *See* Eric C. Chaffee, *Finishing the Race to the Bottom: An Argument for the Harmonization and Centralization of International Securities Law*, 40 SETON HALL L. REV. 1581 (2010); Kristin N. Johnson, *Macroprudential Regulation: A Sustainable Approach to Regulating Financial Markets*, 2013 U. ILL. L. REV. 881 [hereinafter Johnson, *Regulation*]; Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167 (2011); Roberta S. Karmel, *The Future of the Securities and Exchange as a Market Regulator*, 78 U. CIN. L. REV. 501 (2009); Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349 (2011); Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537 (2009); Steven L. Scharcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549 (2009); Michael Simkovic, *Competition and Crisis in Mortgage Securitization*, 88 IND. L.J. 213 (2013); Yadav, *supra* note 11.

consists of several dissimilar agencies with other primary objectives.[63] Thus, a completely new agency should be specifically designed to regulate the financial market.[64]

For example, Colleen Baker, in a recent article, suggested establishing a joint venture between the SEC and the Commodities Future Trading Commission, which she called the Derivatives Supervision Initiative (the "DSI").[65] The DSI would be designed to maximize regulatory strengths of both the SEC and CFTC.[66] The three objectives of the DSI would be "disclosure based regulation, market integrity and surveillance, and enforcement."[67] She argues that this will solve the problem with jurisdictional exemption of over-the-counter derivatives.[68]

Other authors have also lobbied for some sort of integration between the SEC and CFTC.[69] In his recent article, Robert S. Karmel proposed that doing so would have several advantages.[70] First, he argues, it would eliminate the jurisdictional squabbling in financial market regulation between these two agencies.[71] Second, it would operate as a bigger, more powerful agency, which would be better positioned to guard against agency capture.[72] Third, he recognizes the problems associated with putting all regulatory functions in one or two agencies; however he believes that some consolidation is necessary in order to hold certain regulators at fault who played a role in the financial crisis.[73] Fourth, the consolidation of the SEC and CFTC might lead to better coordination among regulators.[74]

On the other hand, Jeffrey Manns proposes to establish an independent agency called the Federal Government Investment Corporation (the "FGIC").[75] "The FGIC [would] serve as an investor of last resort, [and] would make bailout monies contingent on beneficiaries sharing both risks and long-term returns with

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63. *See generally* Karmel, *supra* note 62 (discussing that SEC could be a regulator of the market with more powers); Manns, *supra* note 62 (discussing establishment of an "independent agency, the Federal Government Investment Corporation (FGIC), to serve as an investor of last resort, which would make bailout monies contingent on beneficiaries sharing both risks and long-term returns with taxpayers.").

64. *See* Johnson, *Regulation*, *supra* note 62; Markham, *supra* note 62.

65. Baker, *supra* note 25, at 1338; *see also* U.S. SEC & EXCHANGE COMM'N & U.S. COMMODITY FUTURES TRADING COMM'N, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION (2009), http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/opacftc-secfinaljointreport101.pdf, *archived at* http://perma.cc/UAE2-SRF3.

66. Baker, *supra* note 25, at1345.

67. *Id*.

68. *Id*. at 1342-45.

69. *See* Karmel, *supra* note 62; Markham, *supra* note 62.

70. Karmel, *supra* note 62.

71. *Id*. at 533.

72. *Id*. at 533-34.

73. *Id.*

74. *See id*.

75. Manns, *supra* note 62.

taxpayers."[76] Essentially, it would be aimed at "handl[ing] bailouts in a structured way."[77] "The FGIC would establish express, ex ante conditions for providing aid that would temper corporate risk taking, protect taxpayers, and establish bounds to bailouts."[78] Overall, "the FGIC would provide taxpayers with long-term returns commensurate with the risks they assume in offering financing to [financial institutions crucial to the financial market] and to deter those companies from over-reliance on government aid in the process."[79] The key to deterrence is the reduction in stakes of shareholders and creditors as an exchange for government aid, so that shareholders do not have an interest of taking on too much risk without consequences.[80]

III. CATEGORY 3—STATUTORY APPROACH

This approach is focused on adding a statute that better regulates the financial market, like the Dodd Frank Act.[81] Advocates of this type of solution often state that it is more effective because it specifically addresses the conduct that the government wishes to prevent.[82] However, often times a statute like this is thousands of pages long, contains many loopholes, and is just patchwork on the top of other regulations.[83]

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76. *Id*. at 1349.

77. *Id*. at 1383.

78. *Id*. at 1349; *see generally* Louis Kaplow & Steven Shavelle, *Fairness Versus Welfare* 114 HARV. L. REV. 961 (2001).

79. Manns, *supra* note 62, at 1383-84.

80. *Id*. at 1388; *see* Richard L. Kaplan, *Enron, Pension Policy, and Social Security Privatization*, 46 ARIZ. L. REV. 53, 57 (2004) (provides an example of deterrence in bail-out situations).

81. Eric C. Chaffee, *The Role of the Foreign Corrupt Practices Act and Other Transnational Anti-Corruption Laws in Preventing or Lessening Future Financial Crises*, 73 OHIO ST. L.J. 1283 (2012); John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795 (2011); Michael Faure & Klaus Heine, *Insurance Against Financial Crisis,* 8 N.Y.U. J. L. & BUS. 117 (2011); Macey & Holdcroft, *supra* note 17; Omarova, *supra* note 14; Wilmarth, *Dodd-Frank*, *supra* note 4.

82. *See* Chaffee, *supra* note 81; Macey & Holdcroft, *supra* note 17.

83. *See generally* Jan Bisset & Margi Heinen, *Are You Occupied by Dodd Frank*, 91 MICH. B.J. 50 (2012) (arguing that Dodd-Frank Act is unwieldy); Kathryn Reed Edge, *Only a Framework*, 46 TENN. B.J. 28 (2010) (arguing that Dodd-Frank's 2,139 pages are only a framework and more than 5,000 pages of regulations are needed); Steven A. Ramirez, *Dodd-Frank as Maginot Line*, 15 CHAP. L. REV. 109 (2011) (arguing that Dodd-Frank is not responsive and "encourages complacency, represents a massive diversion of resources and encourages bank managers to strategically flank its proscriptions"); David Enrich, *Banks Find Loophole on Capital Rule*, WALL ST. J. (Feb. 17, 2011), http://online.wsj.com/article/SB10001424052748704657704576150443241518166.html, *archived at* http://perma.cc/NS95-PRSJ (ruling making allows banks to plan round rules); Anna Timone, *Banks Find Comfort in Dodd-Frank Loopholes*, FOREXLIVE (Sept. 22, 2012, 2:46 PM), http://www.forexlive.com/blog/2012/09/22/banks-find-comfort-in-dodd-frank-

Todd Henderson has co-authored an article with Frederick Tung,[84] where they acknowledge the widespread concept "that executive compensation arrangements encouraged the excessive risk taking by banks that led to the recent Financial Crisis."[85] However, instead of calling for the reform on banker pay practices like most scholars, they "argue that regulator pay is to blame as well, and that fixing it may be easier and more effective than reforming banker pay."[86] They focus on the notion that there was a lack of similar incentives for bank regulators to prevent the risk the banks were engaging.[87] If a bank examiner is paid a flat wage at government wage rates, let's use $100,000, and their incentive is to follow protocol and not get fired, what incentive do they have for challenging the banks? Meanwhile, the bankers have huge incentive to take risk since their compensation is tied to the profitability. Therefore, they propose that regulators like "bank examiners, be compensated with a debt-heavy mix of phantom bank debt and equity, as well as a separate bonus linked to the timing of the decision to take over a bank."[88] By incentivizing the regulators to examine the risk by compensating them for uncovering bad deeds, they would prevent improper risk taking by the institution.[89] Specifically, the authors contend that the portfolio would provide a "variable compensation component based on the market value of a mix of the regulated bank's debt and equity-based securities."[90] The regulator would also become eligible for a "bonus [based] on the timing of the decision to take over a failing bank."[91] This would eliminate the current problem of regulators having too many incentives to wait too long before putting a failing bank into resolution.[92]

Jonathan R. Macey and James P. Holdcroft, Jr. suggest imposing a bright-line limit on the "too big to fail banks."[93] This "rule would limit the total liabilities

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loopholes/, *archived at* http://perma.cc/5JRC-HBNF (arguing that banks enjoy rules because they are easier to plan around); Karen Weise, *A $4 Trillion Dodd-Frank Loophole*, BLOOMBERG BUSINESSWEEK (Sept. 11, 2012), http://www.businessweek.com/articles/2012-09-11/a-4-trillion-dodd-frank-loophole, *archived at* http://perma.cc/AT4X-ZK8M (arguing that as rules are made, banks and investors move around rules).

84. Henderson & Tung, *supra* note 4.

85. *Id.* at 1003.

86. *Id.*

87. *Id.*; *see also* Ryan Grim, *Elizabeth Warren Embarrasses Hapless Bank Regulators at First Hearing*, HUFFPOLITICS BLOG (Feb. 14, 2013, 6:59 PM), http://www.huffingtonpost.com/2013/02/14/elizabeth-warren-bank-regulators_n_2688998.html *archived at* http://perma.cc/KKV5-4Q7J; David McMillin, *Bank Regulators Under Fire in DC*, BANKING BLOG (Feb. 20, 2013, 9:00 AM), http://www.bankrate.com/financing/banking/bank-regulators-under-fire-in-dc/ *archived at* http://perma.cc/F5MJ-H8V9.

88. Henderson & Tung, *supra* note 4, at 1003.

89. *Id*. at 1041.

90. *Id*.

91. *Id*. at 1050.

92. *Id*. at 1050-56.

93. Macey & Holdcroft, *supra* note 17.

of any [financial institution] to 5% of the targeted level of the FDIC's Deposit Insurance Fund for the current year as reported by the FDIC."[94] This way, liabilities would be limited to a metric based on the actual funds devoted to resolving failing banks.[95] This "approach does not require any restrictions on activities of banks or on the location of those activities of any kind," but focuses "on the size of financial institutions."[96] This rule would "require [institutions]. . . to comply with the size rule or [go through] a government-mandated breakup plan."[97] It does not rely on the notion of permitting large institutions to fail, but rather takes corrective action before the crises can occur.[98]

Another proposal of this type was again by Michael Faure and Klaus Heine.[99] Their proposal recognizes that one of the consequences of the 2008 crisis was that shareholders of the financial institutions receive additional protections of bailouts, without paying for them.[100] They propose a multi-layered statute that would require financial institutions to pay insurance premiums for the protection they receive.[101] Under the first layer, firms would be required to "hold enough equity to compensate temporary loses," which acts as the equivalent of a self-insurance requirement.[102] The second layer is that "private insurers offer risk-adjusted insurance contracts" to these financial institutions where they, the insurer, undertake investigations in order to calculate the risk-adjusted premiums.[103] The final layer is where the "public steps in as a re-insurer of last resort and may grant subsidies."[104] This "diversifies the third-layer risks over the entire population of firms and . . . future taxpayers."[105] The major advantage that the authors contend from this solution is that "insurance companies can monitor financial institutions" and "that the role of insurers in that respect [will] be far more promising than the [United States'] current practice of bailing out financial institutions."[106]

There has also been some focus among scholars to reenact the Glass-Steagall Act.[107] In, October 1929, the Glass-Steagall Act was enacted to stop banks from

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94. *Id*. at 1403-04.

95. *Id.* at 1404.

96. *Id.* at 1404.

97. *Id*. at 1372.

98. *Id.* at 1373.

99. Michael Faure & Klaus Heine, *Insurance Against Financial Crisis?*, 8 N.Y.U. J.L. & BUS. 117 (2011).

100. *Id*. at 136-37.

101. *Id*. at 137.

102. *Id*.

103. *Id.* at 137-39.

104. *Id*. at 139.

105. *Id*. at 140.

106. *Id*. at 150.

107. Connie Crawford, *The Repeal of The Glass-Steagall Act and the Current Financial Crisis*, 9 J. BUS. & ECON. RES. 127 (2011), http://www.unarts.org/H-II/ref/949-3747-1-PB-1.pdf, *archived at* http://perma.cc/N8QM-6CPK; Daniel K. Tarullo, Governor, Fed. Reserve System, Speech at the Brookings Institution Conference on Structuring the Financial Industry to Enhance

being involved in the trading and owning of speculative securities, which is what led to the Great Depression.[108] The Glass-Steagall Act prohibited commercial banks from engaging in investment banking activities and also made it illegal for a bank to be affiliated with an investment organization.[109] In the 1980s and 1990s, sections of the Glass-Steagall Act were reinterpreted to loosen its restrictions and it was officially repealed by the Gramm-Leach-Bliley Act in 1999.[110]

Since the most recent financial crisis, there has been much discussion of the reenactment of the Glass-Steagall Act.[111] Former Chairman of the Federal Reserve, Paul Volcker, has stated that he was in favor of restoring the Act.[112] Other scholars agree that this Act should have never been repealed.[113] The idea behind these proposals is that having a clear divide between banks and investment companies will prevent banks from becoming "too big to fail" because banks will no longer have the opportunity or incentive to engage in investment activities and take unjustified risks.[114]

IV. CATEGORY 4—JUDICIAL ACTIVISM

The last type of approach that seems popular among scholars is judicial activism, which focuses on courts having a bigger role in the regulation of financial markets.[115] Currently, the judiciary plays little to no role in regulating

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Economic Growth and Stability, Washington, D.C.: Industry Structure and Systemic Risk Regulation (Dec. 4, 2012) (transcript available at http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.htm, *archived at* http://perma.cc/57GM-P9YS).

108. Crawford, *supra* note 107.

109. Roshni Banker, *Glass Steagall Through the Back Door: Creating a Divide in Bank Functions Through use of Corporate Living Wills*, 2010 COLUM. BUS. L. REV. 424, 429-30.

110. *Id*. at 432-36.

111. Thomas J. Schoenbaum, *Saving The Global Financial System: International Financial Reforms and United States Financial Reform, Will They Do The Job?*, 43 No. 1 UCC L.J. ART 3 (2010); R. Rex Chatterjee, *Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders it Ineffective and a New Solution is Needed to Adequately Regulate Proprietary Trading*, 8 B.Y.U. INT'L L. & MGMT. REV. 33 (2011).

112. Statement by Paul A. Volcker Before the Committee on Banking and Financial Services of the House of Representatives (Sept. 24, 2009) (transcript available at http://financialservices.house.gov/media/file/hearings/111/volcker9_24_2010.pdf, *archived at* http://perma.cc/9R-YTFH).

113. Filip C.J. Reinholdson & Henril S. Olsson, *The Separation of Commercial and Investment Banking: A Literature Review*, UNIV. GOTHENBERG SCH. BUS., ECON. & L. (2012), https://gupea.ub.gu.se/bitstream/2077/29503/1/gupea_2077_29503_1.pdf, *archived at* http://perma.cc/Z4W2-9JMR.

114. *Id*.

115. George M. Cohen, *The Financial Crisis and the Forgotten Law of Contracts*, 87 TUL. L. REV. 1 (2012); Diane Lourdes Dick, *Confronting the Certainty Imperative in Corporate Finance Jurisdiction*, 2011 UTAH L. REV. 1461 (2011); Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. CHI. L. REV. 1613 (2009); David A. Skeel, Jr., *Institutional Choice in an Economic Crisis*, 2013 WIS. L.

financial institutions, because of the general problem of trying to make shareholders liable for their excessive risk taking.

Eric Posner & Adrian Vermeule, propose that "judicial review of governmental action, in the name of the Constitution, should be relaxed or suspended during an emergency."[116] This argument relies on three major premises. First, an unavoidable tradeoff exists between security and liberty, since "[n]either good can simply be maximized without regard to the other." Second, the government is "not more likely" to engage in opportunism or oppress minorities "during emergencies than during normal times."[117] Third, "courts are less able to police such behavior during emergencies than during normal times."[118] The judiciary lacks the institutional competence to define the limits of executive power in national emergencies because judges are "generalists" and their "political insulation . . . deprives them of information," especially relating to "novel security threats."[119] Most importantly, Posner and Vermuele argue, "the expected costs of judicial review rise sharply in times of emergency" because judicial error "can produce large harms."[120] Meanwhile, the executive has the advantages of "relative decisiveness, secrecy, [and] centralization;" as a result, "political constraints on the executive are associated with increased terrorism[, so] shackling the executive has real security costs."[121]

In a recent article, Diane Dick, proposes two modifications to court methodologies.[122] "First, courts should consider the present-day economic substance of each party's claims. Second, courts should be empowered to allocate legal rights and remedies in a manner that is consistent with the actual economic arrangement of the parties."[123] Specifically, this article focuses on implementing a judicial decisional paradigm of legal certainty.[124] She asserts that "in the realm of [the financial industry]," stable financial markets are "best achieved when courts exercise considerable restraint, narrowly tailoring opinions to strict and construction and passive enforcement of contracts."[125] This advances the belief that "financial markets are vital to the national interests."[126]

Additionally, George Cohen proposes that courts should look to contract law doctrines to better put liability on institutions in the financial industry.[127] Many

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REV. 629.

116. ERIC A. POSNER & ADRIAN VERMUELE, TERROR IN THE BALANCE: SECURITY, LIBERTY, AND THE COURTS 5, 15-17 (2007).

117. *Id*. at 22.

118. *Id*. at 31.

119. *Id*.

120. *Id*. at 45.

121. *Id*. at 55.

122. Dick, *supra* note 115, at 1518.

123. *Id*.

124. *Id*. at 1465.

125. *Id*.

126. *Id*.

127. Cohen, *supra* note 115.

of the causes of the financial crisis are directly traceable to the actions of financial institutions and their poor management of financial risks.[128] By imposing contract law doctrines to the institutions, courts will "better able to control, prevent against, foresee, and mitigate these risks."[129]

128. *Id*. at 19.
129. *Id.*