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Joel Seligman
University of Rochester

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TYRELL WILLIAMS LECTURE

KEY IMPLICATIONS OF THE DODD-FRANK ACT FOR INDEPENDENT REGULATORY AGENCIES

JOEL SELIGMAN*

The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] both transcends and transforms financial regulation. The immediate setting of the law is by now a familiar one. By 2008, there was an urgent need for a fundamental restructuring of federal financial regulation, primarily based on three overlapping causes. First, an ongoing economic emergency initially rooted in our housing and credit markets, which has been succeeded by the collapse of several leading investment and commercial banks and insurance companies, dramatic deterioration of our stock market indices, and a rapidly deepening recession.[2] Second,

* Joel Seligman is President of the University of Rochester and coauthor with the late Louis Loss and Troy Paredes of Securities Regulation (4th ed. 2006–present).

1. Pub. L. No. 11-203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Act*]. In July 2010 Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act on nearly party line votes, in the House with a 237–192 vote (with three Republicans in the majority) and the Senate by a 60–39 vote (with three Republicans, Senators Brown, Collins, and Snow, joining the majority). President Obama signed the Act into law on July 21, 2010, asserting "[p]assing this bill was no easy task." Jesse Lee, *President Obama Signs Wall Street Reform: 'No Easy Task'*, THE WHITE HOUSE BLOG (July 21, 2010, 2:22 PM), http://www.whitehouse.gov/blog/2010/07/21/president-obama-signs-wall-street-reform-no-easy-task.

2. In 2007, the housing bubble perceptibly began to burst. In August 2007 Countrywide, the largest United States mortgage originator, drew down $11.5 billion from bank backup lines. Bradley Keoun, *Countrywide Taps $11.5 Billion Credit Line from Banks*, BLOOMBERG (Aug. 16, 2007, 6:34 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax4Hih1unXTs; Bing El-Boghdady, *No. 1 Home Lender Taps $11.5 Billion Line of Credit*, WASH. POST., Aug. 17, 2007, at D1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/08/16/AR2007081601122.html.

In October Merrill Lynch recognized a $2.3 billion loss and its CEO, Stan O'Neal, resigned. David Ellis, *O'Neal Out at Merrill*, CNNMONEY.COM (Oct. 31, 2007, 4:50 PM), http://money.cnn.

serious breakdowns in the enforcement and fraud deterrence missions of federal financial regulation, as illustrated by matters involving Bear Stearns and the other four then independent investment banks subject to the SEC's former Consolidated Supervised Entities program,[3] led to the

com/2007/10/30/news/companies/merrill_oneal/index.htm; *Merrill CEO: 'Mistakes' Led to Huge Write-Downs*, CNBC.COM (Oct. 24, 2007, 1:47 PM), http://www.cnbc.com/id/21447591/Merrill_CEO_Mistakes_Led_To_Huge_Write_Downs.

In November Citigroup wrote down $11 billion on top of $5.9 billion in October and its CEO Chuck Prince resigned. Walden Siew, *Citi Losses Expose Tip of Billion-Dollar Iceberg*, REUTERS (Nov. 5, 2007, 3:49 PM), http://www.reuters.com/article/2007/11/05/us-citigroup-losses-idUSN0517748920071105; *Embattled Citigroup CEO Resigns*, CBSNEWS.COM (Apr. 17, 2009, 4:00 PM), http://www.cbsnews.com/stories/2007/11/04/business/main3450641.shtml. Congress particularly focused on subprime mortgages and the crisis in housing. In July 2008 the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654, was adopted, authorizing the United States government to have broad discretion to provide financial support to Fannie Mae and Freddie Mac. By 2008 several leading investment and commercial banks were subject to SEC and States Attorneys General lawsuits concerning Auction Rate Securities. In 2008 the Commission, NASAA, and New York Attorney General Cuomo regulated settlements with Citigroup to redeem $7.3 billion in illiquid ARS and pay a $100 million penalty. *Citigroup to Buy Back Billions of ARS in Deals With SEC, State Regulators*, 40 SEC. REG. & L. REP. (BNA) 1249 (2008).

3. The inadequacy of the Commission's consolidated supervised entity program was depicted in painful detail in a September 2008 Report from the SEC Off. of Inspector Gen., SEC's Oversight of Bear Stearns and Related Entities: Consolidated Supervised Entities Program (Report No. 446-A (2008)). On the failure of the Commission's Consolidated Supervisory Entities Program, *see* 6 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION ch. 8.A.3.d.(ii) (4th ed. 2010).

Simultaneous with the release of the damning SEC Inspector General report, the Commission terminated the CSE program. *See* Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program, SEC Press Rel. 2008-230 (Sept. 26, 2008), *available at* http://www.sec.gov/news/press/2008/2008-230.htm. The Release stated in part:

Chairman Cox made the following statement:

> The last six months have made it abundantly clear that voluntary regulation does not work. When Congress passed the Gramm-Leach-Bliley Act, it created a significant regulatory gap by failing to give to the SEC or any agency the authority to regulate large investment bank holding companies, like Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. . . .
>
> As I have reported to the Congress multiple times in recent months, the CSE program was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness.
>
> The Inspector General of the SEC today released a report on the CSE program's supervision of Bear Stearns, and that report validates and echoes the concerns I have expressed to Congress. The report's major findings are ultimately derivative of the lack of specific legal authority for the SEC or any other agency to act as the regulator of these large investment bank holding companies.
>
> With each of the major investment banks that had been part of the CSE program being reconstituted within a bank holding company, they will all be subject to statutory supervision by the Federal Reserve. Under the Bank Holding Company Act, the Federal Reserve has robust statutory authority to impose and enforce supervisory requirements on those entities. Thus, there is not currently a regulatory gap in this area.

government creation of conservatorships for Fannie Mae and Freddie Mac[4] and the Bernard Madoff case.[5] Third, a misalignment between

The CSE program within the Division of Trading and Markets will now be ending.

Id.

4. On September 7, 2008, Fannie Mae and Freddie Mac were placed in conservatorship. At that time, they owned approximately 50 percent of residential mortgages, or approximately $4 trillion in mortgages. The United States ultimately would provide $145 billion to backstop Fannie Mae and Freddie Mac capital shortfalls. *$145 Billion and Counting*, WALL ST. J. (May 11, 2010), http://online.wsj.com/article/SB10001424052748703880304575236270385307174.html; Tamara Keith, *Panel Examines Fannie Mae, Freddie Mac Collapse*, NPR (May 26, 2010), http://www.npr.org/templates/story/story.php?storyId=127128805.

On September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection after the U.S. Department of the Treasury indicated that emergency funding would not be available to stabilize the firm. *Lehman Brothers Holdings Files Ch. 11 Petition After Gov't Denies Funding*, 40 SEC. REG. & L. REP. (BNA) 1476 (2008). At the time, Lehman was the fourth largest investment bank in the United States, with more than 25,000 employees. Three days later, SIPC placed Lehman in SIPA liquidation. *To Ease Accounts Transfer to Barclays, SIPC to Place Lehman in SIPA Liquidation*, *id.* at 1477.

The turmoil accelerated. The day after Lehman Brothers was allowed to fail, the Department of the Treasury orchestrated what was then an $85 billion rescue package for insurance giant AIG. *Id.* at 1476. *See also Fed Again Invokes Emergency Powers With $37.8 Billion in New Loans to AIG*, *id.* at 1643. Subsequently this would grow to approximately $182 billion. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-975, Troubled Asset Relief Program: Status of Government Assistance Provided to AIG (2009), at 27.

On the same day Lehman Brothers failed, Bank of America acquired Merrill Lynch for $50 billion in an all stock deal. *Bank of America Buys Merrill Lynch; Experts See More Concentrated Sector*, 40 SEC. REG. & L. REP. (BNA) 1480 (2008).

Breathtakingly, in six months, three of the five largest independent investment banks (Bear Stearns, Lehman, Merrill) were gone as independent entities. Within a few days, Goldman Sachs and Morgan Stanley converted from investment banks to commercial bank holding companies. Among other things, this meant that the Federal Reserve Bank of New York could extend credit "to provide increased liquidity support." *Goldman, Morgan Become Banks in Radical Change to Face of Wall Street*, *id.* at 1534.

On October 3, 2008, Congress adopted a $700 billion financial bill, the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765, a few days after the House of Representatives had initially defeated a similar bill. *Financial Bailout Package Signed Into Law, Though Doubts Remain About Effectiveness*, *id.* at 1581.

The Emergency Economic Stabilization Act of 2008 was most notable for its Troubled Assets Relief Program ("TARP"), which can provide up to $700 billion "to restore liquidity and stability to the financial system of the United States." Emergency Economic Stabilization Act of 2008, § 2(1) 122 Stat. 3765, 3766.

5. In December 2008 former NASDAQ stock market chair Bernard Madoff was charged by both the SEC and the United States Attorney with perpetrating a massive fraud on his investors. Complaint, SEC v. Madoff, 08 Civ. 10, 791 (S.D.N.Y. Dec. 11, 2008) (alleging $50 billion Ponzi scheme); Complaint, United States v. Madoff, 08 Mag. 2735 (S.D.N.Y. Dec. 2008) (related criminal complaint).

The Madoff case proved a major embarrassment to the SEC. Later in December 2008 SEC Chair Christopher Cox issued a release which stated in part:

> I am gravely concerned by the apparent multiple failures over at least a decade to thoroughly investigate these allegations or at any point to seek formal authority to pursue them. Moreover, a consequence of the failure to seek a formal order of investigation from the Commission is that subpoena power was not used to obtain information, but rather the staff relied upon information voluntarily produced by Mr. Madoff and his firm.

federal financial regulation firms and intermediaries. The structure of financial regulation that was developed during the 1930s did not keep pace with fundamental changes in finance.

- In the New Deal period, most finance was atomized into separate investment banking, commercial banking, or insurance firms. By 2008 finance was dominated by financial holding companies, which operated in each of these types of firms and cognate areas such as commodities.
- In the New Deal period, the challenge of regulating finance was domestic. By 2008, when credit markets were increasingly reliant on trades originating from abroad, the fundamental challenge was increasingly international: major financial institutions traded simultaneously throughout the world and information technology made international money transfers virtually instantaneous.

Press Release, SEC, Statement Regarding Madoff Investigation, SEC Press Rel. 2008-297 (Dec. 16, 2008), *available at* http://www.sec.gov/news/press/2008/2008-297.htm; *see also* Stephen Labaton, *SEC Image Suffers In a String of Setbacks*, N.Y. TIMES, Dec. 15, 2008, at B6, *available at* http://www.nytimes.com/2008/12/16/business/16secure.html, quoting the senior author.

Subsequently the *New York Times* reported:

> There were 133 prosecutions for securities fraud in the first 11 months of this fiscal year. That is down from 437 cases in 2000 and from a high of 513 cases in 2002, when Wall Street scandals from Enron to WorldCom led to a crackdown on corporate crime, the data showed.
>
> At the S.E.C., agency investigations that led to Justice Department prosecutions for securities fraud dropped from 69 to 2000 to just 9 in 2007, a decline of 87 percent, the data showed.

Eric Lichtblau, *Federal Cases of Stock Fraud Drop Sharply*, N.Y. TIMES, Dec. 25, 2008, at A1, *available at* http://www.nytimes.com/2008/12/25/business/25fraud.html.

The Commission's Office of Inspector General subsequently released three reports related to the Madoff debacle.

The first, Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme (Public Version) (OIG No. 509 Aug. 31, 2009), concluded in part:

> The OIG investigation did find . . . that the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Finally, the SEC was also aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent returns. . . .

Id. at 20–21 (footnotes omitted).

- In 1930, approximately 1.5 percent of the American public directly owned stock listed on the New York Stock Exchange.[6] A report estimated that in the first quarter of 2008, approximately 47 percent of U.S. households owned equities or bonds.[7] A dramatic deterioration in stock prices affected the retirement plans and the livelihood of millions of Americans.
- In the New Deal period, the choice of financial investments was largely limited to stocks, debt, and bank accounts. By 2008 we lived in an age of complex derivative instruments, some of which experience had shown were not well understood by investors and on some occasions by issuers or counterparties.
- Most significantly, our system of finance was more fragile than earlier believed. The web of interdependency that was the hallmark of sophisticated trading meant that when a major firm such as Lehman Brothers went bankrupt, cascading impacts had powerful effects on the entire economy.

The primary enduring response to the 2008–2009 financial meltdown was the enactment of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act is long—the statutory material in H.R. 111-517, the Conference Report that included the final bill, is approximately 845 pages. But the length is explicable given there are sixteen titles addressing fundamental aspects of bank and bank holding company securities, commodities, and mortgage regulation, with detailed new material on orderly liquidation authority, creation of a new Bureau of Consumer Financial Protection, regulation of such previously unregulated areas as investment advisers to hedge funds and OTC derivatives, significant strengthening of payment clearance and settlement, investor protection, credit rating agencies, asset-backed securities, corporate governance, and the Public Company Accounting Oversight Board.

As with the 2008–2009 financial crisis itself, the regulatory response was systemic rather than solely focused on specific financial sectors such as securities regulation or banking. Notably, the Dodd-Frank Act attempts to reduce systemic risk to the United States economy by establishing the Financial Stability Oversight Council, which includes members from the Department of the Treasury, the Federal Reserve Board, the Comptroller of the Currency, the newly created Bureau of Consumer Financial

6. S. Rep. No. 1455, 73d Cong., 2d Sess. 9 (1934).
7. Investment Company Institute, Equity and Bond Ownership, 2008, at 1.

Protection, the SEC, the FDIC, CFTC, the Federal Housing Funding Agency, and the National Credit Union Administration Board. The Act grants the Council authority to require new capital, liquidity, and risk management standards for banks and nonbank financial companies.[8]

The Dodd-Frank Act directly addresses perceived critical gaps or omissions in financial regulation by extending SEC jurisdiction to investment advisers to hedge funds and other private equity funds,[9] authorizing the CFTC and SEC to regulate OTC derivatives,[10] and enhancing SEC authority to regulate credit rating agencies.[11] The enactment of the Dodd-Frank Act ushers in a new period in United States financial regulation in which the regulatory departments and agencies will be less independent of each other, the White House, and Congress. By emphasizing financial stability and risk reduction as paramount goals, the new legislation stresses the need for regulatory coordination, virtual elimination of gaps and omissions, and sufficient regulatory tools to optimize early warning and prompt response to a burgeoning crisis.

But the new general approaches to financial regulation largely build on the structure of the old financial regulatory agencies. The Dodd-Frank Act strengthens the SEC, the CFTC, the Department of the Treasury, the Office of the Comptroller of the Currency, and especially the Federal Reserve System and FDIC. Indeed, much of the lengthy text of the Act appears to have been written by the staff of these agencies and departments. Only one agency—the late unlamented Office of Thrift Supervision—has been abolished. Only one new agency—the Bureau of Consumer Financial Protection—has been established, although within existing agencies and departments, there are a plethora of new required offices, as well as broadened jurisdiction.

This, then, is the paradox of the new financial order: Since the stock market crash of 1929–1933, no set of financial regulators was so incompetent in predicting a financial catastrophe, so slow in response, so rigid in regulatory approach, so inadequate in enforcing existing law as the regulators in charge during the 2008 crisis. Yet the principal winners in the Dodd-Frank Act are the very same set of financial regulators who so spectacularly failed.

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8. *See* discussion LOSS, SELIGMAN & PAREDES, *supra* note 3, at ch. 8.A.1.

9. *Id.* at ch. 8.C.2.

10. LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION ch. 7.A.5. (4th ed. 2010).

11. LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION ch. 3.B.2.b (4th ed. 2008).

How is it possible to enact more powers for regulators who had previously failed? One answer is that the financial meltdown of 2008 and 2009 was a failure of leadership, not a failure of law. There is some truth to this. The abysmal performance of executive branch and Congressional leadership has been the subject of much harsh comment. This criticism reached an apogee in September 2008 when presidential candidate John McCain called for the firing of SEC Chair Christopher Cox, explaining in part, "Mismanagement and greed became the operating standard while regulators were asleep at the switch."[12] In that instance, I agreed with the *Wall Street Journal* that this assault was "false and deeply unfair."[13]

While Cox's performance will do little to commend itself to financial historians, to single him out and ignore much broader causes for the financial dysfunction is neither accurate nor fair. Let me suggest a more nuanced view that explains more fully why matters went so terribly wrong and why the Dodd-Frank Act is a constructive step forward. In the spirit of the best work of the SEC, let us go back to Genesis and pose the Talmudic question: Why regulate finance?

The basic answer is that we do not always trust financial markets to either avoid financial meltdowns, or to achieve non-fraudulent and acceptable outcomes for investors and consumers. Our methods for achieving this objective largely have been shaped by a history of episodic financial crises. The Federal Reserve System, for example, was established in 1913 as a response to the Financial Panic of 1907.[14] The state securities law system was popularized by fraud in Kansas circa 1911.[15] The New Deal's six federal securities laws were a response to the 1929–1933 stock market crash.[16]

Episodic, specialized financial legislation has the virtue of employing focused responses to immediate problems. Hence, federal banking regulation addressed the safety and solvency of depository institutions as a means to reduce banks runs; the Securities Acts of 1933 and 1934 emphasized disclosure to investors and antifraud enforcement as key mechanisms to restore confidence in securities markets. Congress also emphasized regulatory agencies as the key enforcement mechanism of its

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12. *McCain's Scapegoat*, WALL ST. J., Sept. 19, 2008, at A22, *available at* http://online.wsj.com/article/SB122178318884054675.html.

13. *Id.*

14. ALLAN MELTZER, A HISTORY OF THE FEDERAL RESERVE (2004 & 2009).

15. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 44–45 (3d ed. 2003).

16. *See id.* chs. 1–7.

20th century financial regulatory order with the explicit hope that the regulatory agencies would bring the virtues of expertise and dynamic rulemaking to address new problems as they evolved. That system failed early in the 21st century for many reasons, but I want to emphasize three. Part I will address a failure of objectives. Part II will address a failure of structure. Finally, Part III will address a failure of resources.

I. THE NEW OBJECTIVE OF FINANCIAL REGULATION

The Dodd-Frank Act is most transformative in changing the basic objective of federal financial regulation from agency-specific purposes to an overarching objective of reducing systemic risk.

Title I of the Act establishes the Financial Stability Oversight Council[17] and charges the Council in §112(a)(1) of Dodd-Frank:

> (A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;
>
> (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and
>
> (C) to respond to emerging threats to the stability of the United States financial system.

The emphasis in the Council's duties[18] is on monitoring and deterrence rather than crisis management, which is largely delegated to the Federal Reserve Board and Federal Deposit Insurance Corporation.

Section 113(a)(1) authorizes the Council on a vote of no fewer than two-thirds of the voting members then serving, including an affirmative vote of the Chairperson, to require that a *United States nonbank financial company*, such as an investment bank or stock market, be supervised by the Federal Reserve Board of Governors and subject to prudential standards as defined in § 115 *if* "the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the

17. § 111 of the Dodd-Frank Act.
18. § 112(a)(2).

activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."[19]

This represents a significant, but uncertain, power for the Council. If exercised broadly, the powers of the Council will be concomitantly greater. If not exercised or exercised sparingly, the Council largely will focus on banks and bank holding companies.[20]

Enhanced prudential standards are a pivotal risk reduction technique in the Dodd-Frank Act. Section 115(b)(1) provides:

The recommendations of the Council . . . may include—

(A) risk-based capital requirements;

(B) leverage limits;

(C) liquidity requirements;

(D) resolution plan and credit exposure report requirements;

(E) concentration limits;

(F) a contingent capital requirement;

(G) enhanced public disclosures;

(H) short-term debt limits; and

(I) overall risk management requirements.[21]

There will be considerable uncertainty as to how effective the Council will be until these prudential regulatory standards are developed, implemented, and sustained over time. To put it simply, the Council will either be a more effective coordinator of federal financial regulation, or a more narrowly focused coordinator, depending largely on its rulemaking, particularly concerning prudential regulatory standards.

In a crisis, the Federal Reserve Board and the FDIC become the operational executors of the Dodd-Frank Act's provisions to reduce systemic risk. Upon an affirmative vote of two-thirds of the voting members of the Council then serving, § 121 of the Dodd-Frank Act

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19. § 113(q)(1). Section 113(a)(2) elaborates on the considerations the Council must consider in making this determination.

20. Section 113(b) provides a similar aproach to foreign nonbank financial companies. See definition of a *foreign nonbank financial company* in § 102(a)(4)(A).

Section 113(c) authorizes the Federal Reserve to supervise the financial activities of any company incorporated or organized in the United States or abroad when the Council on a two-thirds vote, including an affirmative vote of the Chairperson, determines that that company's material financial distress "would pose a threat to the financial stability of the United States."

21. § 115(b)(1).

authorizes the Federal Reserve Board to take actions to mitigate risks posed by a covered bank holding company or nonbank financial company when such a company "poses a grave threat to the financial stability of the United States."[22]

Title II buttresses the ability of the Financial Stability Oversight Council and federal financial regulatory agencies to reduce systemic risk by vesting both the FDIC generally with respect to *covered financial companies*, and the Securities Investor Protection Corporation[23] with respect to a subset of financial companies that are *covered broker-dealers*, with orderly liquidation authority.[24] The purpose of Title II is "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."[25]

Section 619 of the Dodd-Frank Act separately amends §13 of the Bank Holding Company Act of 1956, to establish a modified version of what is popularly known as the Volcker Rule.[26] As enacted, the Volcker Rule

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22. § 121(a). The Board is directed to:

> (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;
>
> (4) impose conditions on the manner in which the company conducts 1 or more activities; or
>
> (5) if the Board of Governors determines that the actions described in paragraphs (1) through (4) are inadequate to mitigate a threat to the financial stability of the United States in its recommendation, require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities.

Id. Section 165 authorizes the Federal Reserve Board to establish more stringent prudential standards for nonbank financial companies supervised by the Board and bank holding companies with total consolidated assets of $50 billion or more "[i]n order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions."

Significantly, § 165(j) directs the Federal Reserve to require each covered bank holding company or each supervised nonbank financial company to maintain a debt to equity ratio of no more than 15 to 1, but the Federal Reserve Board only is required to do so, "upon a determination by the Council that such company poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States. Nothing in this paragraph shall apply to a federal home loan bank."

23. 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION ch. 8.B.5 (3d ed. rev. 2003).

24. §§ 204, 205.

25. § 204(a).

26. Specifically, § 619 (§ 13(a)(1) of the Bank Holding Company Act of 1956) provides:

> Unless otherwise provided in this section, a banking entity shall not—
>
> (A) engage in proprietary trading; or
>
> (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.

limits banks and bank holding companies from much proprietary trading and participating in private equity funds above a 3 percent *de minimis* threshold.[27]

The Dodd-Frank Act also addresses several key omissions or gaps in the earlier financial order. Title IV of the Act requires most investment advisers to hedge funds and other private funds to register with the SEC under the Investment Advisers Act.[28] Title VII of Dodd-Frank divides regulation of swap transactions between the SEC (for security-based swaps) and the Commodity Futures Trading Commission (for other covered swaps).[29]

The objective of the Dodd-Frank Act, while complex in articulation and implementation, is straightforward conceptually: All important financial activities in the United States should be subject to an ultimate financial regulator for the purpose of significantly reducing systemic risk.

There is much to commend in this approach. In contrast to the increasingly makeshift approach before Dodd-Frank, the new Act provides more effective coordination,[30] establishes pivotal new powers for the

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Section 13(a)(2) solely is addressed to nonbank financial companies supervised by the Federal Reserve Board and provides:

> 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.

This is not the Volcker Rule, but a specification of potential additional capital requirements. A former investment bank holding company that became a bank holding company such as Goldman Sachs does gain greater access to Federal Reserve Board support, but must comply with the Volcker Rule.

The different treatment of nonbank financial companies creates uncertainty as to how effective this provision will be. A bank or bank holding company apparently can reconstitute some or all of its assets in a separate nonbank entity or be subject to new regulation standards but not the Volcker Rule. In a formal sense this may be logical—a nonbank entity does not receive FDIC guarantees (although it may receive SIPC guarantees). But this approach begs the question: if the Volcker Rule, as modified, is intended to reduce systemic risk, is this the wisest way to do so?

27. § 619 (§ 13(d)(4) of the Bank Holding Company Act of 1956).

28. 7 LOSS & SELIGMAN, *supra* note 23, at ch. 8.C.2.

29. 5 LOSS, SELIGMAN & PAREDES, *supra* note 10, at ch. 7.A.5.

30. Before the Dodd-Frank Act, the President's Working Group on Financial Markets (PWG) did provide some coordination.

The PWG, chaired by the Treasury Secretary and consisting of the chairmen of the Federal Reserve Board, the SEC, and the Commodity Futures Trading Commission, for example, in 2007 issued a set of principles and guidelines concerning private pools of capital, which include hedge funds. A copy of the Agreement Among PWG and U.S. Agency Principals on Principles and

Financial Stability Oversight Council, reduces gaps and omissions that had proven quite problematic, and enacts some substantive limits, such as that on debt-to-equity ratios, which should, in fact, reduce financial risk.

How well the Act will work will turn on the skill of the Council and an enduring array of regulatory agencies in implementing the complex and as yet largely undefined rulemaking and enforcement processes created under the new law. Over time, there will be several challenges to the wisdom of focusing on systemic risk.

First, this is today's crisis. How well will the Financial Stability Oversight Council adjust to future crises? This is a nontrivial question. The next great risk to our financial order is most likely to concern international coordination in response to a future crisis. There is precious little in the Act which addresses any international dimension of finance.

Second, despite all its new powers and authority, will the Council prove to be simply a study group with the real power remaining in the Department of the Treasury and the subsidiary regulatory agencies? Again, this question is nontrivial. The Council will meet only occasionally, does not have the type of staff that the agencies typically do, is chaired by the Secretary of the Treasury rather than an independent individual, and is entirely dependent upon other agencies for enforcement. As with the much criticized Director of National Intelligence, who supervises United States intelligence agencies but has relatively little power of his or her own,[31] at its worst, the Financial Stability Oversight Council could become a relatively toothless watchdog.

Third, how do the constituent Department of the Treasury and regulatory agencies effectively harmonize their enduring and typically industry specific objectives with those of the Dodd-Frank Act? Here, the new Act is not particularly helpful.

Section 119 does authorize the Council to make recommendations to resolve a dispute among two or more of its members, when "a member agency has a dispute with another member agency about the respective jurisdiction over a particular bank holding company, nonbank financial company, or financial activity or product. . . ."[32] Recommendations under

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Guidelines Regarding Private Pools of Capital is available on the Treasury Department's Web site at http://www.treasury.gov/resource-center/fin-mkts/Documents/hp272_principles.pdf.

31. An overview of the United States Intelligence Community Prepared by the Director for the 111th Cong. (2009) highlights that, although the Director oversees and directs the implementation of the National Intelligence Program and serves as the head of the Intelligence Community, he currently has no direct powers to address hiring or firing the leaders of constituent intelligence agencies such as the Central Intelligence Agency or to address their budgets.

32. § 119(a)(1).

§ 119(c)(3) require an affirmative vote of two-thirds of the voting members of the Council then serving, but are not binding "on the Federal agencies that are parties to the dispute."[33]

The Council, in other words, is a mediator, not an arbitrator. How much effect this provision will have in reducing the disputes that have bedeviled the SEC, the CFTC, and depository regulatory institutions in resolving competing jurisdictions is uncertain.[34] This heavily compromised provision may end up delivering far less than anticipated. For example, the Bureau of Consumer Financial Protection, the most controversial part of the Dodd-Frank Act, is intended to address areas where the federal and state banking agencies woefully failed. The financial meltdown of 2008–2009 started with mortgage practices which in retrospect no serious person is prepared to defend. But a new agency whose focus is on protecting consumers "from unfair, deceptive, or abusive acts and practices and from discrimination"[35] runs a substantial risk of conflict with the long established banking regulators whose mission is quite different, namely, protecting the safety and solvency of banks. Here, a more effectively empowered Financial Stability Oversight Council would have been wiser.

II. THE NEW STRUCTURE

To put this in different terms, what the Dodd-Frank Act implicitly envisions is a new form of regulatory federalism. Will this new structure work?

In March 2008 the Department of the Treasury published "Blueprint for a Modernized Financial Regulatory Structure."[36] At the time I thought the Blueprint was unrealistic.[37] The Report proposed short-term recommendations, intermediate-term recommendations, and an optimal long term regulatory framework for the United States insurance industry holding assets totaling $6 trillion at the end of 2006, the United States banking sector with total assets of $12.6 trillion, and the United States securities sector with gross assets of $12.4 trillion, as well as the United States commodities industry, among other cognate topics.[38]

33. § 119(d).
34. *See, e.g.*, LOSS, SELIGMAN & PAREDES, *supra* note 10, at 442–48.
35. § 1021(b)(2) of the Dodd-Frank Act.
36. The Department of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008).
37. *See* Joel Seligman, *The SEC in a Time of Discontinuity*, 95 VA. L. REV. 667 (2009).
38. *See supra* note 34, at 165.

The most significant short-term recommendations proposed include:

- Modernization of the President's Working Group on Financial Markets (PWG) to enhance its effectiveness as a coordinator of financial regulatory policy, primarily by (1) broadening its focus to include the entire financial sector, rather than only financial markets; (2) facilitating better inter-agency coordination and communication in mitigating systemic risk to the financial system, enhancing market integrity, promoting consumer and investor protection, and supporting capital markets' efficiency and competitiveness; and (3) expanding the PWG membership, which currently includes the Secretary of the Treasury, who acts as Chair of the PWG, and the chairs of the Federal Reserve, the SEC, and the CFTC, with the proposed addition of the heads of the Office of the Comptroller of the Currency, the FDIC, and the Office of Thrift Supervision.[39]
- A new Mortgage Origination Commission to address the high levels of delinquencies, defaults, and foreclosures among subprime borrowers in 2007 and 2008 and develop uniform minimum licensing qualifications for state mortgage market participants.[40]

The intermediate-term recommendations notably included:

- Within two years, phasing out the federal thrift charter and requiring thrifts to secure a national bank charter and closing the Office of Thrift Supervision.[41]
- Creating a new system of federal regulation administered by the Federal Reserve to address payment and settlement systems.[42]
- Establishing an optional federal charter for insurers which would solely be subject to federal regulation and supervision while continuing state insurance regulation for those insurers who did not elect to be regulated at the national level.[43]

39. *Id.* at 5–6, 75–77.
40. *Id.* at 11–13, 106–26.
41. *Id.* at 8–9, 89–100.
42. *Id.* at 9, 100–06.
43. *Id.* at 9–11, 126–33.

- Merging the SEC and CFTC, both in the sense of a structural merger and a merger of regulatory philosophies.[44]

This alone was a breathtaking agenda, but there were even more ambitious proposals for an optimal long term regulatory structure. This proposed structure was inspired by the objectives-based approach used in Australia and the Netherlands,[45] and ultimately would restructure the financial structure to:

- Transform the Federal Reserve into the Market Stability Regulator, continuing its current role with respect to monetary policy and the provision of liquidity to the financial system and adding new responsibilities to supervise federal insured depository institutions, federal insurance institutions, and federal financial services providers.[46]
- Create a new Prudential Financial Regulatory Agency to supervise financial institutions with some type of explicit government guarantees, including federal deposit insurance and state-established insurance guarantee funds, and assume the role of current federal prudential regulation now conducted by the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[47]
- Create a new Conduct of Business Regulatory Agency to monitor business conduct regulation across all types of financial firms, including federal insured depository institutions, federal insurance institutions, and federal financial services providers, and to be responsible for consumer protection, business practices, standards for entry into the financial services industry, and for sales and service practices. The new Agency would also address broker-dealers, hedge funds, private equity funds, venture capital funds, and mutual funds, and would develop standards that address such topics as net capital, public disclosures, testing, training, fraud, manipulation, and such duties to customers as best execution and suitability.[48]

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44. *Id.* at 6–7, 78–83.
45. *Id.* at 13–14, 137–46.
46. *Id.* at 15–17, 146–56.
47. *Id.* at 17–19, 157–70.
48. *Id.* at 19–21, 170–80. There would remain a role for self-regulatory organizations. The standards developed by the Conduct of Business Regulatory Agency would apply both to nationally-chartered and state-chartered firms.

- The SEC would be succeeded by a new Conduct of Business Regulatory Agency and by a new Corporate Finance Regulator to assume the Commission's current responsibilities with respect to corporate disclosures, corporate governance, accounting, and similar issues.[49]

The Dodd-Frank Act is similar in some respects to the Treasury Department Blueprint—it does modernize the President's Working Group on Financial Markets and terminates the Office of Thrift Supervision—but strikingly different in avoiding comprehensive restructuring of federal financial regulation.[50]

I believe that this makes good sense. For as dreadful as the performance of the regulatory agencies was in the period up to and including the 2008–2009 financial meltdown, the Dodd-Frank Act deserves some credit for preserving what did generally work in the earlier system. There are powerful advantages to focused agencies such as the Securities and Exchange Commission, or more recently, the Public Company Accounting Oversight Board (PCAOB).[51]

The broader an agency's jurisdiction, the more likely it is to lack the resources or focus to address all appropriate priorities. A significant illustration of this involved the SEC during the late 1990s. Given a challenging political context and inadequate budget, the Commission's ongoing review of periodic disclosure documents such as Form 10-Ks badly deteriorated. In October 2002 a staff report of the Senate Governmental Affairs Committee, for example, found that in FY 2001 the Division of Corporation Finance was able to complete a full review of only 2,280 of 14,600 Form 10-K annual reports, roughly 16 percent, far short of the Division's stated goal to review every company's annual report at least once every three years. "Of more than 17,300 public companies, approximately 9200 or 53%, have not had their Form 10-Ks reviewed in the past three years."[52] Enron, by then a notorious example of staff neglect, had last received a partial review of its Form 10-K annual report in 1997, and had been last subject to a full review in 1991.[53] The

49. *Id.* at 21.

50. The Dodd-Frank Act, in contrast, is much more similar to the June 2009 proposals of the Obama Administration. *See* The Department of the Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation (2009).

51. *See* SELIGMAN, *supra* note 15, at 97–100, concerning the creation of the SEC.

52. Report of the Staff to the Senate Comm. On Gov't Affairs, Financial Oversight of Enron: The SEC and Private-Sector Watchdogs 13, 31–32 (Oct. 8, 2002).

53. *Id*. at 13, 31–32.

argument can be made that had the SEC had the resources available to run the Division of Corporation Finance at more appropriate levels, the PCAOB might not have been needed.

The creation of the PCAOB, however, ensured that there would be one federal agency solely responsible for audit quality. The Board, unlike the SEC of the 1990s, had a narrow and focused agenda and did not have to balance using resources for audit review with a broad array of other priorities, such as market regulation, broker-dealer and investment adviser regulation, new securities offerings, municipal and governmental securities dealers, and enforcement. The first SEC Chair, Joseph Kennedy, memorably observed in 1935 that "I'd hate to go out of here thinking I had just made some changes in accounting practices."[54] It is reasonable to assume that no one at the PCAOB has ever derogated improving auditing practices.

This point should not be overstated. The narrower an agency's agenda, the less likely it will be to galvanize White House or Congressional support for its budget and administrative priorities. A well-focused agency runs the risk of being lost in the alphabet of federal agencies, subject, like the SEC too often has been, to a boom and bust cycle of budgetary and legislative support, with effective support most likely only in times of crisis.

The challenge is to find the right balance between expertise, which is a consequential virtue of a well-run regulatory agency, and effectiveness, which often can be better achieved by reducing the number of responsible agencies and increasing resources for each. There is no algebraic formula to achieve this balance.

The Dodd-Frank Act retains and strengthens most of the earlier regulatory agencies but attempts to coordinate them through the Financial Stability Oversight Council. Throughout the Act, the SEC, for example, is defined to be the *primary financial regulatory agency* for each person or function earlier subject to its jurisdiction or added by Dodd-Frank.[55] To analogize to European history, what appears to be present in Dodd-Frank is a weak monarch-strong noble system of governance. But that analogy misses the other big winner in the Act: Congress. Never in the history of financial regulation has Congress been so insistent on micromanaging financial regulatory agencies. Let me illustrate by focusing on the SEC.

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54. SELIGMAN, *supra* note 15, at 116–17.
55. *See* § 2(12)(B).

The Dodd-Frank Act specifies several new Commission committees, offices, and studies. Under § 39 of the Securities Exchange Act, the Commission is directed to establish an Investor Advisory Committee with not fewer than ten or more than twenty members in addition to an Investor Advocate, a representative of state securities commissions and a representative of senior citizens.[56]

As added by § 915 of the Dodd-Frank Act, § 4(g) of the Securities Exchange Act establishes a new Office of the Investor Advocate who reports directly to the Chairman.[57] Section 919D of the Dodd-Frank Act adds a new § 4(g)(8) to the 1934 Act to direct the Investor Advocate to appoint an ombudsman who reports directly to the Investor Advocate.[58]

Section 15E(p), as amended by § 932 of the Dodd-Frank Act, establishes an Office of Credit Ratings, which, among other things, must conduct an examination of each nationally recognized statistical rating organization at least annually.[59] Section 979 of the Dodd-Frank Act establishes an Office of Municipal Securities.[60]

Section 967 of the Dodd-Frank Act directs the SEC not later than ninety days after the Act's enactment to hire an independent consultant

> of high caliber and with expertise in organizational restructuring and . . . capital markets to examine the internal operations, structure, funding, and the need for comprehensive reform of the SEC, as well as the SEC's relationship with and the reliance on self-regulatory organizations and other entities relevant to the regulation of securities and the protection of securities investors that are under the SEC's oversight.[61]

Section 968 directs the Comptroller General of the United States to conduct a study of the "revolving door," that is, employees who leave the SEC to work for financial institutions, and to submit a report on the results of that study to specific Congressional Oversight Committees not later than one year after enactment of the Dodd-Frank Act.[62]

Section 961 of the Dodd-Frank Act requires the SEC, not later than ninety days after the end of each fiscal year, to submit to the Congressional Oversight Committees a report on the conduct of

56. Securities Exchange Act § 39(b) 15 U.S.C. § 78pp (added by § 911 of the Dodd-Frank Act).
57. § 915.
58. § 919D.
59. § 932(a)(8).
60. § 979.
61. § 967(a)(1).
62. § 968.

examinations of registered entities, enforcement investigations, and review of corporate financial securities filings.[63] Notably, this includes an assessment of the effectiveness of the internal supervisory controls of the SEC.[64]

Section 962 of the Dodd-Frank Act requires the Comptroller General report on the quality of SEC personnel management once every three years.[65]

Section 963(a)(1) of the Dodd-Frank Act requires that, "not later than six months after the end of each fiscal year," the SEC submit a report to Congress that:

> (A) describes the responsibility of the management of the Commission for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
>
> (B) contains an assessment of the effectiveness of the internal control structure and procedures for financial reporting of the Commission during that fiscal year.[66]

Section 4D of the 1934 Act was added by § 966 of the Dodd-Frank Act to add a hotline to receive:

> (A) suggestions by employees of the Commission for improvements in the work efficiency, effectiveness, and productivity, and the use of resources, of the Commission; and
>
> (B) allegations by employees of the Commission of waste, abuse, misconduct, or mismanagement within the Commission.[67]

Section 989A of the Dodd-Frank Act authorizes $8 million per year to support a program of senior investor protection, including grants to states for enhanced protection of seniors (those sixty-two years old or older).[68]

Section 989F of the Dodd-Frank Act directs the Comptroller General, within one year of enactment, to conduct a study of person-to-person lending and to submit a report on that study to Congressional Oversight Committees, "with particular attention to":

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63. § 961.
64. § 961(b).
65. § 962.
66. § 963(a)(1). The Comptroller General is directed to conduct essentially the same study in § 963(b).
67. § 966, adding § 40 to the Securities Exchange Act (15 U.S.C. § 78d-4); quoted language from § 40(a)(1).
68. § 989A.

(i) the application of the Securities Act of 1933 to person to person lending platforms;

(ii) the posting of consumer loan information on the EDGAR database of the Commission; and

(iii) the treatment of privately held person to person lending platforms as public companies.[69]

Section 989E of the Dodd-Frank Act establishes a Council of Inspectors General on Financial Oversight, including the SEC's Inspector General.[70]

From the Commission's point-of-view, the Inspector General has evolved into a veritable "spy in the house of love," to paraphrase an Anaïs Nin title. During six months in 2010, the Commission's Inspector General completed six audit investigations and evaluations and thirty-four reports.[71] Some, like the Inspector General's report on Bear Stearns,[72] were important and prompted long overdue corrective action. Cumulatively, the total number of Inspector General reports and recommendations is wearisome, prompting the Commission to spend a great deal of time defending itself which could better be spent preventing securities fraud. Nevertheless, the Inspector General now appears to be here to stay and will continue to command Commission resources long into the future.

On top of this, the most striking of all the Dodd-Frank Act demands was the number of new rulemakings required by the Act. In all, the law firm of Davis Polk & Wardwell calculated that Dodd-Frank will require the SEC to engage in at least ninety-five separate rulemakings.[73]

III. THE DODD-FRANK ACT'S BIGGEST FAILURE: RESOURCES

The significance of the Dodd-Frank Act's demands for new offices, new rules, new studies, and seemingly endless responsibilities to comply with a reenergized SEC Inspector General would resonate differently if the Act had provided the Commission with sufficient resources to take on its

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69. § 989F (quoted language from subsection (a)(3)).

70. § 989E.

71. SEC Off. of Ins. Gen., Semiannual Rep. to Cong., Apr. 1, 2010–Sept. 30, 2010, at 87–99.

72. *See supra* note 3, Report No. 446-A.

73. Davis Polk & Wardwell, Summary of The Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010, at ii.

new responsibilities and adjust its staff size in times of greater financial activity. Here, the Act most conspicuously failed.

For a considerable period, it has been clear that the largest reason independent regulatory agencies are not consistently independent nor sufficiently effective involves their budgets.[74] A core issue during Arthur Levitt's 1993–2000 Chairmanship, for example, was resources. Between FY 1993 and FY 2000, the SEC budget grew from $253.2 million to $382.4 million or an average of 6% per year.[75] Staff positions grew from 3,083 to 3,235 or an average of less than 1% per year.[76] During the 1990s' bull market, virtually every significant measure of securities activity grew far faster. Between 1993 and 2000, for example, the dollar value of securities filed for registration grew from $868 billion to $2.3 trillion,[77] an average increase of 24% per year; the number of underwritten securities more than doubled in the shorter period of 1993 to 1999 (increasing from 6,443 to 13,923).[78] Similarly, the dollar value of investment companies grew from $2.4 trillion in 1993 to $6.7 trillion in 2002,[79] an average annual increase of 21.3%; and the number of investment company portfolios grew from 21,200 to 31,100 during the same period, an average annual increase of 5.1%.[80] "In calendar year 1992, the [SEC] supervised over 8,200 broker-dealers with 34,000 branch offices and 427,000 registered representatives . . . ."[81] By 2001, the number of registered broker-dealers had declined to 7,900, but the number of branch offices had increased to approximately 87,765 (an average annual increase of 17.6%) and the number of registered representatives had grown to approximately 683,240 (an average annual increase of 6.7%).[82] The value of stock listed on all exchanges approximately tripled between 1992 and 2000 (increasing from $3.97 trillion to $11.73 trillion).[83]

74. *See, e.g.*, Joel Seligman, *Self-Funding for the Securities and Exchange Commission*, 28 NOVA L. REV. 233 (2004).

75. 1993 SEC Ann. Rep. 150; 2000 SEC Ann. Rep. 159.

76. 1993 SEC Ann. Rep. 150; 2000 SEC Ann. Rep. 159.

77. *Compare* 1993 SEC Ann. Rep. 51, *with* 2000 SEC Ann. Rep. 70.

78. Sec. Indus. Ass'n. Securities Industry Fact Book 12 (2002), *available at* http://archives2.sifma.org/research/pdf/2002Fact_Book.pdf.

79. *Compare* 1993 SEC Ann. Rep. 38, *with* 2002 SEC Ann. Rep. 53.

80. *Id.*

81. 1993 SEC Ann. Rep. 24.

82. 2001 SEC Ann. Rep. 34.

83. 2001 SEC Ann. Rep. 169.

In 2009 the Commission's Draft Strategic Plan for FY 2010–2015 highlighted that the binge-purge approach that had characterized the SEC's budget in the post-World War II period has continued:

> Between FY 2001 and FY 2005, Congress more than doubled the SEC's funding level to increase significantly the agency's workforce and technology program after the enactment of the Sarbanes-Oxley Act of 2002. Then, the SEC experienced flat or declining budgets between FY 2005 and FY 2007, resulting in a 10 percent reduction in its workforce and curtailing its investments in new or enhanced information technology systems. Although the FY 2008 and FY 2009 budgets enacted by Congress have permitted the agency to begin restoring these losses, as of FY 2009 the SEC is still operating below the levels of staff and new IT investments from earlier in the decade.[84]

Because the Commission is financed by Congressional appropriations, it has long been trapped in a budgetary vise, frequently without enough staff members to police illegal activity. After a legendary start in the New Deal era, when the Commission was considered a model independent regulatory agency, its staff declined from 1,678 in 1941 to 667 in 1955.[85]

The SEC's capacity to review corporate filings and market activity deteriorated, and predictably, the late 1950s were marked by a resurgence of fraud, particularly on the American Stock Exchange. In response, Congress added 250 staff members in 1961 and broadened the Commission's jurisdiction, including a new program to investigate insider trading, which helped lead to a significant rebound in its performance.[86]

The SEC, like most independent regulatory agencies, submits its budget to the White House Office of Management and Budget, which consolidates several agency budgets into a single request. Congress ultimately must both "authorize" and "appropriate" agency expenditures.[87] The pre-Dodd-Frank Act budget model was fairly criticized for underfunding the SEC, particularly during periods of surges in market activity.[88] It was an erratic model. After periods of crisis, such as that

84. SEC Draft Strategy Plan for FY 2010–2015 (2009), at 6.

85. *See* Seligman, *supra* note 74, at 255.

86. SELIGMAN, *supra* note 15, at chs. 9–10.

87. *See generally* 2 CHARLES H. KOCH, JR., ADMINISTRATIVE LAW & PRACTICE § 7.22 (Supp. 1997).

88. *See generally* Seligman, *supra* note 74, at 253.

which eventuated in the 2002 Sarbanes-Oxley Act,[89] Congress and the President have been willing to make dramatic adjustments to the SEC's budget. In July 2002, for example, Congress "authorized," but did not subsequently appropriate, a 66% increase in the Commission's budget.[90] To Chairman Levitt, the answer to boom-bust budgeting was agency self-funding, such as that which has long operated at the most effective independent regulatory agency, the Federal Reserve Board.[91]

The SEC already had in place an effective fee collection mechanism which in 2000 and 2001, for example, collected over $2 billion each year.[92] Each of these year's collections exceeds even the most ambitious SEC budget proposals for 2003 and 2004. If they did not, fee levels could have been adjusted. A movement to self-funding does not raise questions of feasibility. SEC self-funding would likely reduce the extremes that have been evident in the appreciable OMB-Congressional process, and to some extent depoliticize budgeting.

A difficult question is not feasibility nor need, but accountability. Who would watch the guardians? At the Federal Reserve Board, a straightforward accountability system is in place.[93]

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89. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 750.

90. Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 510 n.139 (2002).

91. A Federal Reserve website usefully explains:

> How is the Federal Reserve funded?
>
> The Federal Reserve's income is derived primarily from the interest on U.S. government securities that it trades through open market operations. Other sources of income are the interest on foreign currency investments held by the System; fees received for services provided to depository institutions, such as check clearing, funds transfers, and automated clearinghouse operations; and interest on loans to depository institutions (the rate on which is the so-called discount rate).
>
> After it pays its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury.

FAQs, Federal Reserve Bank of Richmond, http://www.richmondfed.org/faqs/frs/ (last visited Sept. 27, 2011). *See generally* 12 U.S.C. § 243 (2000). About 95 percent of the Reserve Banks' net earnings have been paid into the Treasury since the Federal Reserve System began operations in 1914. (Income and expenses of the Federal Reserve Banks are included in the annual report of the Board of Governors).

92. 2001 SEC Ann. Rep. 170, tbl. 16.

93. Under 12 U.S.C. § 243, the Federal Reserve Board is empowered to:

> levy semiannually upon the Federal reserve banks, in proportion to their capital stock and surplus, an assessment sufficient to pay its estimated expenses and the salaries of its members and employees for the half year succeeding the levying of such assessment, together with any deficit carried forward from the preceding half year and such assessments may include amounts sufficient to provide for the acquisition by the Board in its own name of such site or building in the District of Columbia as in its judgment alone shall be necessary for the purpose of providing suitable and adequate quarters for the performance of its functions.

Congress has two accountability mechanisms. First, under 12 U.S.C. § 248(a), there is an annual independent audit of the financial statement of the Board (as well as each Federal Reserve Bank).[94] Second, Congress retains its general oversight and legislative powers with respect to the Board.[95]

The Federal Reserve Board's self-funding has been the key to its historic high level of performance, its professionalism, and its ability to withstand political pressures. The alternative approach would require the Fed to seek annual budget approval from Congress. At that point, its ability to maintain independence would be reduced.

The Senate initially was persuaded by this type of argument, and would have enacted a form of self-funding for the SEC in § 991 of the Senate bill of what became the Dodd-Frank Wall Street Reform and Consumer Protection Act.[96] Specifically, the Commission would have been authorized to prepare and deliver its own budget to Congress, which would not have been "a request for appropriations."[97]

In the Dodd-Frank Act, Congress rejected self-funding for the SEC in the enacted version of § 991. Congress did authorize significant increases to the SEC's budget in amended § 35 of the Securities Exchange Act: for fiscal year 2011, $1,300,000,000; growing in steps to $2,250,000,000 in fiscal year 2015.[98] The Commission also was granted up to $100 million in a reserve fund to be established in the Department of the Treasury. These funds may be directly obligated by the Commission.[99]

The frailty of the post-Dodd-Frank Act SEC budget process is already evident. It is clear that Congress will not appropriate the amounts authorized in the Dodd-Frank Act during the 112th Congress. SEC officials have begun explaining how budget pressures are already

94. *See* 12 U.S.C. § 2480(a).

95. *See id.* § 248.

96. S. 3217, 111th Cong., 2d Sess. (Apr. 29, 2010).

97. *Id.* § 991(a)(1).

98. § 991(c).

99. Securities Exchange Act § 4(i)(3), amended by § 991(e)(1). The Conference report, H.R. Rep. 111-517, at 874 (2010) (Conf. Rep.), stressed:

> Securities and Exchange Commission Match Funding maintains the role of the Appropriations Committees in setting the Securities and Exchange Commission's annual budgets on and after FY2012. Transaction fee receipts would be treated as offsetting collections equal to the amount of the appropriation. Any excess collections would go to the Treasury as general revenue and not offset any current or future appropriations.

hamstringing the Commission's ability to address its current responsibilities.[100]

IV. CONCLUSION

The Dodd-Frank Act will succeed, at least as long as memory lasts,[101] in reducing systemic risk. It is still too early to tell whether the Act will also chill capital formation and how well modulated the costs of the Act are to its benefits. But the Act provides a more intelligent structure to address our current system of finance than the New Deal model which served us so long and so well.

The lesson for historians is less sanguine. During the 2008–2009 financial meltdown, the economy went horribly, unexpectedly, wrong. There were multiple fail-safes in place. None of them individually or collectively worked well enough.

How could this occur? Academics and other students of finance have already begun to describe the mechanics of what went wrong, the inept regulatory responses, the blinders caused by political conviction, the overwhelming affect of new technology on previously effective systems, less transparent systems, and more internationalization.[102]

But all this does not seem sufficient to explain the second great financial catastrophe of the past one hundred years. I speculate that part of the crisis may have been the result of both a political and financial system that over-rewarded optimism. I can imagine how difficult it must have been for any political figure in early 2008 to have insisted that this is a terrible crisis, that we cannot persist in business as usual. But that was the latest such cries should have occurred. Instead, animal spirits prevailed.[103]

I am left with a resigned sense that we will never be able to eliminate financial cycles as we once thought we could. Indeed, in an increasingly

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100. *See, e.g.*, *Budget Could Hamstring SEC's Handling Of Whistleblower Cases, Lawyer Suggests*, 42 SEC. REG. & L. REP. (BNA) 2332 (2010). Editorial, *Running on Empty*, N.Y. TIMES, Feb. 14, 2011, at A22, *available at* http://www.nytimes.com/2011/02/14/opinion/14mon2.html.

101. John Kenneth Galbraith memorably wrote:

> "As protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and memory serves the same purpose as the SEC and, on the record, is far more effective."

The Great Crash, quoted in SELIGMAN, *supra* note 15, at 1.

102. *See, e.g.*, ROGER LOWENSTEIN, THE END OF WALL STREET (2010), for one of many popular accounts.

103. To paraphrase John Maynard Keynes.

interconnected globalized economy, we are now less able to do so than we were before.

This ultimately fortifies me in supporting the risk-reduction dimensions of the Dodd-Frank Act. While the Act is not perfect, it moves in the right direction. Let us draw what consolation we can from the French legislative admonition, "let not the perfect be the enemy of the good."