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Built to Scale: Small Business Policy and the Meltdown

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INTRODUCTION

This Article examines the root causes and pervasive impact of the subprime mortgage market meltdown[1] and the subsequent global financial crisis.[2] It seeks to demonstrate that government responses to the crisis, both in terms of timing and in terms of substance, neglected small business operations and community banks, which continued to feel the impact of the meltdown.[3] The Article concludes that supervisory and regulatory authority exists to address these concerns and needs to be invoked effectively.[4]

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1. On the subprime mortgage market meltdown, see MICHAEL P. MALLOY, ANATOMY OF A MELTDOWN (2010).

2. *See infra* Part I. On the global financial crisis that emerged in the wake of the U.S. subprime mortgage market meltdown, see 3 MICHAEL P. MALLOY, BANKING LAW AND REGULATION § 15.06 (2d ed. 2011).

3. *See infra* Part II.

4. *See infra* Part III.

I. ROOT CAUSES OF THE FINANCIAL CRISIS

A. The Subprime Mortgage Meltdown

The financial crisis that has persisted since 2008 is now often referred to generically as the "Great Recession," but this is no more than a clever label suggesting a connection between the current situation and the Great Depression of 1929-1935. The grim reality is, of course, that there is a complex of causes that contributed to the present financial crisis, and sorting them out will be a formidable task.[5] Acknowledging the subtleties of the problem should not distract us from the central narrative of the crisis[6]—that unrestrained marketing of certain financial services morphed into a capital markets failure in the United States and eventually into a transnational disaster. To begin with, then, it is worthwhile to pluck out those narrative strands that may lead us to the root causes of the crisis, which may then enhance our understanding of the continuing impact of the crisis on small business.

In the early 2000s,[7] mortgage loan originators began to make residential mortgage loans based on lower underwriting standards, often referred to as subprime loans.[8] In the first half of the decade, there were no apparent

5. For a very useful preliminary analysis of those causes, see Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2009).

6. Congress, for example, seems to be in danger of losing sight of that central narrative, as legislative debate turns to the possible economic harm that previous congressional responses to the crisis may impede recovery by imposing burdensome externalities on business growth. *See, e.g.*, Edward Wyatt, *Dodd-Frank Act a Favorite Target for Republicans Laying Blame*, N.Y. TIMES, Sept. 21, 2011, at B1 (reporting on political arguments characterizing post-meltdown reform legislation as "government overreach that is killing jobs.").

7. Portions of this discussion are based upon the Federal Housing Finance Board's remarks concerning the subprime mortgage crisis in connection with its proposal to establish affordable housing homeownership set-aside programs, for the purpose of refinancing or restructuring eligible nontraditional or subprime owner-occupied mortgage loans. Affordable Housing Program Amendments, 73 Fed. Reg. 20,552, 20,552-53 (proposed Apr. 16, 2008); Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212 (proposed June 25, 2008).

8. In general, a subprime loan may be understood as a "residential mortgage loan[] based on lower underwriting standards." 2 MALLOY, *supra* note 2, at 6-38. The Securities and Exchange Commission has characterized subprime loans according to the following features

> a mortgage loan that does not conform to the underwriting standards required for sale to the government sponsored enterprises (non-conforming loans) and are made to borrowers who: (1) have weakened credit histories such as payment delinquencies, charge-offs, judgments, and bankruptcies; (2) have reduced repayment capacity as measured by credit scores (e.g., FICO), debt-to-income ratios, loan-to-value rations, or other criteria; (3) have not provided documentation to verify all or some

negative repercussions from this increasingly common lending practice, but by mid-2006 "home values had leveled off and were beginning to decline."[9] This trend led to a gradual increase in delinquencies and defaults in subprime mortgage loans.[10] This increase in subprime loan delinquencies and defaults had substantial adverse effects on the market for securities backed by subprime loans and on the collateralized debt obligations (CDOs) linked to such loans.[11]

The situation was further exacerbated by the adjustable rate feature that was characteristic of the subprime mortgages.[12] Not surprisingly perhaps, the interest rates on subprime ARMs and other nontraditional mortgages increased substantially over time.[13] As these mortgages reset, many of the mortgagors confronted "an unaffordable increase in their mortgage

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> of the information, particularly financial information, in their loan applications; or (4) have any combination of these factors.

Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212, 36,212 n.1 (2009).

9. *Id.* at 36,212.

10. *Id.* (citing *Testimony of John C. Dugan Before the U.S. S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 8-12 (2008) (testimony of John C. Dugan, Comptroller of the Currency)); *The State of the Banking Industry Before U.S. S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 5-6 (2008) (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.).

11. *Id.* at 36,212.

12. *See* Affordable Housing Program Amendments, 73 Fed. Reg. 20,552, 20,552-53. According to the Federal Housing Finance Board, typical features of subprime adjustable rate mortgages (ARMs) include:

> "2/28" and "3/27" loans, in which the [mortgagor] pays an introductory, often a low "teaser" interest rate, fixed for the first two or three years, after which the rate becomes adjustable, usually on an annual basis. Principal and interest payments increase because they are typically "recast" on two common types of nontraditional loans: Interest-only loans and option ARMs. For an interest-only loan, the [mortgagor] pays only interest for a specified period, e.g., five years. Payments are then recast to include the loan's principal, which is amortized over the remaining term of the loan. With an option ARM, the [mortgagor] has the monthly option of paying less than the fully amortizing principal and interest payment, and it may pay as little as a minimum payment that includes no principal and less than the full amount of interest. Unpaid interest is added to the loan balance resulting in "negative amortization." In most option ARMs, the lender recasts the payment to re-amortize the increased principal and interest either periodically, e.g., every 5 years, or whenever the negative amortization reaches a specified cap, typically 125% of the original loan amount. Nontraditional loans may have adjustable interest rates, which can compound the increase in the amount of the monthly payments and the amount of negative amortization.

Id. at 20,553 n.1.

13. *Id.* at 20,553 ("About 1.5 million subprime ARMs [were] scheduled to reset upward in 2008." (citing Ben S. Bernanke, Chairman, Fed. Reserve Bd., Fostering Sustainable Homeownership, at the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008))).

payments."[14] Many were "not able to sustain homeownership without a reduction in their monthly mortgage payments."[15] However, given current market conditions, subprime mortgagors found themselves in a position where they could neither sell the property and pay off the subprime loan, nor refinance the property in a more affordable mortgage arrangement, because there was insufficient equity in the property to make sale or refinancing feasible.[16] This phenomenon of "payment shock"[17]—high cost-to-income ratio and an inability to liquidate or refinance—increasingly led to foreclosure as the only option available to many mortgagors. "More than 20 percent of the roughly 3.6 million subprime ARMs outstanding at the end of 2007 either were in foreclosure or [were] 90 days or more past due."[18]

Geographic concentration of subprime mortgages further exacerbated the economic crisis in regions of the country.[19] Large numbers of foreclosed and unoccupied properties would as a result negatively affect property values throughout entire neighborhoods.[20] Beyond the subprime problem, however, as the crisis deepened in the last three quarters of 2008, mortgage foreclosures and delinquencies in lower-risk prime loans more than doubled.[21]

What gradually became apparent was that these foreclosures were not isolated incidents but part of a systemic breakdown in the mortgage market.[22] In another context, I have described the system that eventually failed as

> an "origination-to-distribution" model of debt securitization, a mark-to-market system, believed to be a more robust way of spreading risk than the more conservative investment analysis of the 1960s. While the subprime mortgage market emerged as a result of aggressive marketing by non-bank lenders such as "lightly regulated"

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14. *Id.* at 20,553; *see also* CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2008 TO 2018 23 (2008), *available at* http://www.cbo.gov/ftpdoc.cfm?index=8917&type=1 (estimating subprime-related losses).

15. Affordable Housing Program Amendments, 73 Fed. Reg. at 20,553.

16. For a description of the broad impact of subprime foreclosures on the economy, see Press Release, U.S. Dep't of the Treasury, Remarks by Henry M. Paulson, Jr. on Current Housing and Mortgage Market Developments Georgetown University Law Center (Oct. 16, 2007), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp612.aspx.

17. *See* Bar-Gill, *supra* note 5, at 1076 (discussing "payment shock").

18. Affordable Housing Program Amendments, 73 Fed. Reg. at 20,553; *see also* Ben S. Bernanke, Chairman, Fed. Reserve Bd., Fostering Sustainable Homeownership, at the National Community Reinvestment Coalition Annual Meeting (Mar. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080314a.htm.

19. Affordable Housing Program Amendments, 73 Fed. Reg. at 20,553.

20. *Id.*

21. Mike Ferullo, *Regulators Finds More Prime Mortgages Under Stress, Problems With Modifications*, BNA BANKING DAILY, Apr. 3, 2009, at D24.

22. *See* Michael P. Malloy, *The Subprime Mortgage Crisis and Bank Regulation*, BANKING & FIN. SERVS. POL'Y REP., Mar. 1, 2008, at 1-2 (discussing systemic aspects of subprime mortgage crisis).

mortgage finance companies (MFCs) to less credit-worthy borrowers, larger depository institutions responded to the increased MFC market share by easing credit standards, often through state-chartered MFC subsidiaries. Lenders of all types vigorously sold these loan products to subprime mortgagors, and then packaged the portfolios of mortgages into such securitized products as collateralized debt obligations (CDOs) that were analyzed and rated by credit rating agencies and marketed to institutional investors by investments banks. Securitization of these portfolios ameliorated lending risk, and the net proceeds of CDO placements provided lenders with funding to expand the subprime mortgage market itself. The cycle continued to operate, expanding as it drew more investors into the system and encouraged ever-increasing competition for subprime products and programs. When the cycle eventually wobbled—as the inherent counterparty risk manifested itself in the inability of the mortgagors to sustain markedly increasing levels of indebtedness—the system began to break down as the value of the CDO portfolios dramatically contracted.[23]

The failure of this market has led to more than waves of foreclosures and losses for the financial institutions tied to the system.[24] The failure has also called into question the efficacy of basic regulatory programs intended to support safety and soundness in banking. For example, the chair of the Basel Committee on Banking Supervision at the Bank for International Settlements[25] suggested that bank capital adequacy requirements,[26] newly revised at the time under the auspices of the Basel Committee itself, might need to be reevaluated.[27] In fact, a lengthening series of delays has ensued in light of the collapse of the capital markets,[28] and the revised requirements have yet to be implemented.[29]

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23. *Id.* at 1.

24. *See* Daniel Pruzin, *Subprime Crisis Signals Need for More Work on Capital Accord, Basel Panel Head Says*, BNA BANKING DAILY, Mar. 6, 2008, at D13 (discussing U.S. banking sector losses).

25. On the role of the Basel Committee in the establishment of international capital adequacy standards, see 3 MALLOY, *supra* note 2, § 15.02[C][1].

26. On capital adequacy requirements, see 2 MALLOY, *supra* note 2, § 7.03[C][4].

27. *See, e.g.*, Pruzin, *supra* note 24 (reporting on public remarks by Basel Committee Chair, Nout Wellink).

28. *See, e.g.*, Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890 (Jan. 11, 2011) (proposing revisions to market risk capital rules); BASEL COMMITTEE ON BANKING SUPERVISION, STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR: CONSULTATIVE DOCUMENT (2009), *available at* http://www.bis.org/publ/bcbs164.pdf (proposing changes to definition of capital, introduction of leverage ratio, and changes to treatment of counterparty credit risk); BASEL COMMITTEE ON BANKING SUPERVISION, REVISIONS TO THE BASEL II MARKET RISK FRAMEWORK (2009), *available at* http://www.bis.org/publ/bcbs148.pdf (discussing changes); Capital Adequacy Guidelines: Trust Preferred Securities and the Definition of Capital; Delay of Implementation Date, 74 Fed. Reg. 12,076 (Mar. 23, 2009) (announcing decision of Federal Reserve Board to delay implementation of Basel revisions).

29. *See* BASEL COMMITTEE ON BANKING SUPERVISION, PROGRESS REPORT ON BASEL III IMPLEMENTATION (2011), *available at* http://www.bis.org/publ/bcbs203.pdf (indicating United States lagging in adopting regulatory requirements under existing Basel II accord as well as recently adopted Basel 2.5 and Basel III supplementary agreements).

What may be most revealing about initial governmental responses to the crisis, however, is the relative lack of attention to its impact on individuals and small businesses. At first, the U.S. Government seemed to deny that there was a crisis. For example, in April 2008, Federal Reserve chairman Ben Bernanke was still suggesting that "[t]hese problems notwithstanding, the originate-to-distribute model has proven effective in the past and with adequate repairs, could be so in the future."[30] Throughout the first half of 2008, U.S. regulatory response to the subprime crisis was inconsequential, consisting only of "guidance" to lenders.[31]

It reveals much about the regulators' collective responses that it was not the mortgage crisis itself, as it affected borrowers, that prodded the regulators into action, but the near failure of investment firms involved in the CDO market. Historically, U.S. regulators have characteristically been slow to respond to financial deprivation affecting retail consumers but prompt to support large institutional participants in the financial markets. Thus, on March 13, 2008, when Bear Stearns & Co. Inc. saw its liquidity fall from approximately $12.4 billion to $2 billion as a result of the dissipation of the market's confidence in the firm and the refusal of its counterparties to act, the Federal Reserve and the Treasury Department swiftly facilitated a loan to Bear Stearns through bank holding company JPMorgan Chase & Co.[32] This was followed by a loan to JPMorgan to support its outright acquisition of Bear Stearns at a price of $2.00 per share (later raised to $10.00).[33]

Attention to those aspects of the crisis affecting home mortgage borrowers did not receive such swift attention, and it is here that we can discern a linkage to small business performance. Not only was the small business sector impacted by the general effects of the significant economic downturn, but it also began to lose access to a traditional funding source—personal credit of small business principals and lines of credit linked to residential

30. Jeff Day, *Bernanke Touts Fed's Action in Credit Crunch, Contrasts It With 1929's Passive Central Bank*, BNA BANKING DAILY, Apr. 11, 2008, *available at* http://pubs.bna.com/ip/bna/bbd.nsf/eh/A0B6H3F9T2 (quoting Chairman Bernanke).

31. *See, e.g.*, Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007) (*Interagency Statement*) (providing interagency guidance "to clarify how [depository] institutions [could] offer certain adjustable rate mortgage (ARM) products in safe and sound manner"); Final Guidance-Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products, 73 Fed. Reg. 30,997 (May 29, 2008) (publishing four documents that set forth illustrations "intended to assist institutions in implementing the consumer protection portion of," and "in providing information to consumers on hybrid [ARM] products as recommended by," the Interagency Statement).

32. Aaron Lorenzo, *Regulators Defend Bear Stearns Decision; Senators Ask If Fed Needs Additional Powers*, BNA BANKING DAILY, Apr. 4, 2008, at D9.

33. Aaron Lorenzo, *New York Fed, JPMorgan Chase Agree on Details in Deal for Bear Stearns*, BNA BANKING DAILY, Mar. 25, 2008, *available at* http://www.bna.com.

mortgages of the principals.[34] It was not until the very end of April 2008 that a bipartisan housing stimulus package could be scheduled for legislative consideration in the Senate.[35] Even here there was little agreement between the House and Senate as to the appropriate way to address the crisis as it affected countless citizens. The House Ways and Means Committee emphasized home-buyer tax credits,[36] while the House Financial Services Committee considered a foreclosure prevention bill, H.R. 3221, that included authorization for wholesale refinancing of mortgages in danger of default, a provision much maligned by White House policy advisers.[37] By late July 2008, however, the legislative tide had turned decisively in favor of H.R. 3221, with the passage of the bill in the House by a substantial margin and Senate passage expected.[38]

Of course, the subprime mortgage crisis is not just about the personal financial tragedies triggered by improvident mortgage lending. Fueling the dramatic expansion of this sector was the facility of the investment markets in securitizing these mortgages into CDOs sold to a wide range of institutional investors.[39] The existence of the CDO market had the apparent effect of moderating the risk of lenders and feeding their liquidity levels, with the result that the subprime mortgage market experienced growth at significant rates.[40] The poor quality of the underlying mortgage obligations has now had serious adverse effects on the value of CDO portfolios, to the great distress of many institutional investors.[41] The Chairman of the Securities and Exchange Commission made it clear during remarks at a February 2008 conference[42] that the Commission was investigating possible securities fraud

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34. *See, e.g.*, David D. Chait, *Small Business Financing and the Post-2008 Credit Paradigm: the U.S. Small Business Administration and Key Factors to Support Traditional Credit Markets*, 6 OHIO ST. ENTREPREN. BUS. L.J. 411, 417 (2011) ("[S]mall businesses faced a new world in 2008 with increasing cost of capital as well as tightening credit standards, coupled with decreased housing values and uncertain sales.").

35. Thecla Fabian, *Senate Starts Housing Stimulus Debate; Bankruptcy Amendment on Indefinite Hold*, BNA BANKING DAILY, Apr. 7, 2008, at D9.

36. Heather M. Rothman, *Ways and Means Set to Consider $11 Billion Housing Tax Measure*, BNA BANKING DAILY, Apr. 9, 2008, at D11.

37. Richard Cowden, *Frank, White House Advisers Exchange Barbs over Features of Foreclosure Prevention Bill*, BNA BANKING DAILY, Apr. 11, 2008, at D10.

38. Mike Ferullo, *House Approves Massive Housing Aid Bill with Financial Backstop for Fannie, Freddie*, BNA BANKING DAILY, July 24, 2008, at D15.

39. Chait, *supra* note 34, at 416.

40. *Id.* at 415.

41. *See id.* at 416 ("[E]xposure to these products extended deep into the financial system, leading to fundamental changes in the entire market as defaults grew.").

42. Christopher Cox, Chairman, Sec. & Exch. Comm'n, Remarks to the 'SEC Speaks in 2008' Program of the Practicing Law Institute: the SEC Agenda for 2008 (Feb. 8, 2008), *available at* http://www.sec.gov/news/speech/2008/spch020808cc.htm.

and breaches of fiduciary duty in the marketing of CDOs.[43] In its investigation, the Commission was considering whether the banking enterprises that packaged the mortgages and the securities firms that marketed the CDOs made appropriate public disclosures concerning the valuation of CDOs and the risks involved.[44] By June 2008, these investigations had already resulted in civil charges by the Commission,[45] and criminal indictments,[46] against two former portfolio managers in the asset management division of Bear Stearns. Nevertheless, it was not until a March 2008 Senate Banking Committee hearing that the regulators grudgingly admitted that they had not "fully appreciated all [the] risks out there" and acknowledged the gravity of the dramatic reductions in bank earnings, the mounting foreclosures, and the difficulties still to be faced in restoring liquidity in the credit markets.[47]

The broadened responses of the Administration and the regulators still tended to be somewhat unfocused. With much fanfare, the Administration announced in mid-March 2008 proposed measures intended to prevent a *future* financial crisis, rather than to respond to the present one.[48] These measures represented a call to states and market participants to tighten market supervision. Thus, states were urged to establish nationwide licensing standards for MFCs, while lenders would be required to improve the quality of the disclosure that they provide to borrowers about payment terms, and stronger conflict-of-interest rules would apply to credit rating agencies that assess the risk of CDO offerings.[49] The proposals were widely dismissed as ineffective and limited, though they were praised by industry representatives.[50]

43. Rachel McTague, *Cox Outlines SEC Agenda for 2008, Including Initiatives Related to Subprime*, BNA BANKING DAILY, Feb. 11, 2008, at D10.

44. *Id.* In addition, one can expect the Commission to consider whether broker-dealers complied with suitability requirements in selling CDOs and other debt-related derivatives to their customers. *Id.*

45. Complaint at 1-4, SEC v. Cioffi, 2008 WL 4693320 (E.D.N.Y. June 19, 2008) (No. 08CV2457), 2008 WL 2446253.

46. *See, e.g.*, Indictment, United States v. Cioffi, 2008 WL 2448463 (E.D.N.Y. Jun. 18, 2008) (No. 08CR00415).

47. Richard Cowden, *Senators Grill Financial Regulators on Failure To Supervise Banks During Mortgage Crisis*, BNA BANKING DAILY, Mar. 5, 2008, *available at* http://pubs.bna.com/ip/bna/bbd.nsf/eh/A0B6D6Q7U1 (quoting Federal Reserve Governor, Donald Kohn).

48. *See* Stephen Labaton, *White House Offers Plan To Ward Off Credit Crisis*, N.Y. TIMES, Mar. 14, 2008, at A1.

49. *Id.*

50. *Id.* By contrast, the SEC has proposed additional requirements on "nationally recognized statistical rating organizations" to deal with "concerns about the integrity of their credit rating procedures" and methods for determining CDO credit ratings linked to subprime mortgages. Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212 (June 25, 2008) (to be codified at 17 C.F.R. pts. 240, 249b).

At the same time, the regulators were initiating modest tweaks to the system to address the crisis. In March 2008, for example, the OCC issued an interim final rule to add a provision to the lending limits regulation that addressed temporary funding arrangements in emergency situations such as critical financial markets stability.[51] The rule enabled the OCC to establish a special lending limit for loans and extensions of credit if it determined that such loans and extensions of credit (i) were "essential to address an emergency"; (ii) would be relatively short in duration; (iii) would decrease in amount on a schedule and in a manner acceptable to the OCC; and, (iv) would "not present unacceptable risk" to the lending national bank.[52] Given these predicate conditions, it is understandable that the rule mandated supervisory oversight and reporting requirements that the OCC determined to be appropriate to monitor compliance with the conditions.[53] The rule was effective March 20, 2008, with comments due by April 21, 2008.[54] Similarly, in April 2008, the Federal Housing Finance Board proposed an amendment to its Affordable Housing Program (AHP) authorizing the FHLBanks to establish set-aside programs to refinance or restructure nontraditional or subprime owner-occupied mortgage loans of eligible households. Efforts at systemic reform were very slow in coming. Proposals prior to the meltdown of the capital markets in the fall of 2008 appeared to be both ambitious and without any serious prospect of realization. It would be two years before serious legislative efforts would finally materialize. In March 2008 the President's Working Group on Financial Markets (PWG), chaired by the Treasury Secretary, offered a broader and more detailed set of proposals.[55] In its report the PWG identified short-term recommendations, designed to be implemented immediately;[56] intermediate-term recommendations, designed to be implemented in the intermediate term to increase the efficiency of financial regulation;[57] and a long-term "Optimal Regulatory Structure," intended to reform and strengthen the regulation of U.S. financial institutions.[58] The Treasury recommendations were ambitious and complex, but they ultimately fed into the recommended long-term "optimal regulatory structure." This structure was itself a model of simplicity, based on fundamental principles

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51. 12 C.F.R. § 32.8 (2011).
52. *Id.*
53. *Id.*
54. Lending Limits, 73 Fed. Reg. 14,922 (Mar. 20, 2008).
55. U.S. DEP'T OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter TREASURY BLUEPRINT], *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.
56. *Id.* at 75-86.
57. *Id.* at 89-133.
58. *Id.* at 137-79.

of functional regulation.[59] In contrast to the current thicket of institutional regulators that now supervise financial services in the United States, the recommended structure would include a relatively small core group of specialized regulators.

Unfortunately, the Treasury *Blueprint* followed in a long tradition of broad studies of the structure of financial services regulation that have never come to fruition.[60] Particularly for a study that emerged in the last months of a presidential term, the prospects for adoption of its recommendations seemed rather limited. What we were left with were the current responses to the subprime mortgage crisis as they then existed, responses that so far have done little to assuage the markets or bring significant relief to borrowers.

The sad irony is that the Administration's March 13 plan—as well as the *PWG Blueprint*—relied on two basic elements that were simply no longer reliable. One was the notion of market discipline and voluntary restraint as a protection against disaster,[61] features that had obviously not been very efficacious in the present crisis. The other was the assumption that state regulation of MFCs and the mortgage markets could be harnessed to

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59. On functional regulation, which establishes regulatory structures relating to functions and activities to be regulated rather than the nature of the particular institution being regulated, see TASK GROUP ON REGULATION OF FINANCIAL SERVICES, BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 39-40 (1984) [hereinafter BLUEPRINT FOR REFORM], *available at* http://ia600402.us.archive.org/11/items/blueprintforrefo01unit/blueprintforrefo01unit.pdf. *See generally* 1 MALLOY, *supra* note 2, §§ 1.04[A]-[B] (discussing and contrasting institutional and functional regulation).

60. *See, e.g.*, BLUEPRINT FOR REFORM, *supra* note 59, at 44-52 (recommending fundamental changes to U.S. regulatory structure); U.S. DEP'T OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: U.S. TREASURY DEPARTMENT TREASURY RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 61-63 (1991); *see also* 1 MALLOY, *supra* note 2, §§ 1.04[A], [D] (discussing Task Group and Modernizing, respectively). The Treasury Blueprint itself notes,

> Over the past forty years, a number of Administrations have presented important recommendations for financial services regulatory reforms. Most previous studies have focused almost exclusively on the regulation of depository institutions as opposed to a broader scope of financial institutions. These studies served important functions, helping shape the legislative landscape in the wake of their release.

TREASURY BLUEPRINT, *supra* note 55, at 3 (footnote omitted). For background on the prior Administration studies referred to in the quotation, see *id.* at 197-206.

61. The *Treasury Blueprint* itself looks favorably on market discipline as a complement to supervisory policy. TREASURY BLUEPRINT, *supra* note 55, at 137-38. At one point, it notes that the "PWG, the Federal Reserve Bank of New York, and the OCC have previously stated that market discipline is the most effective tool to limit systemic risk." *Id.* at 15 n.2 (citing AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPALS ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL (2007); PWG, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 24-25, 30 (1999); PWG, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 34-35 (1999)).

"tighten their oversight of financial markets."[62] In the wake of the sweeping preemption of state consumer-protection-based supervision of mortgage bankers resulting from long-standing preemption initiatives of the OCC[63] and the decision of the Supreme Court in *Watters v. Wachovia Bank, N.A.*[64] broadly confirming the Comptroller's policy, it would be foolish to expect state-based supervision of MFCs and mortgage banking to be effective in the current legal environment. This is the second linkage between the crisis and the small business sector. With the aggressive preemption of state consumer protection law as applied to financial services, small business lost the free rider benefits of the externalities of consumer protection. We may agree with the *PWG Blueprint* that vigorous change is needed, but the roots of the subprime mortgage crisis are to be found in the aggressively preemptive, market-oriented policies of the Bush Administration.

The effects of the subprime mortgage market meltdown in 2008 continued to deepen and spread in 2009. As of year-end 2009, 140 banks had been placed under Federal Deposit Insurance Corporation receivership, at a likely cumulative cost to the Deposit Insurance Fund (DIF) of more than $1.8 billion.[65] In the first quarter of 2010 (Q1 2010), the FDIC was appointed receiver for forty-one failed banks and savings associations with a total exposure for the DIF of more than $320 million.[66] By contrast, five credit unions failed during approximately the same period.[67] By Q1 2011, "more than 3.5 million home mortgages were 90 or more days delinquent or in foreclosure . . . , and estimates indicate that more than one in five mortgage

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62. Labaton, *supra* note 48, at A1.

63. *See, e.g.*, Bank Activities and Operations, 69 Fed. Reg. 1895 (Jan. 13, 2004) (codified at 12 C.F.R. § 7.4000(a)(3), (b)) (adopting regulations asserting broad preemptive authority). For an analysis by the OCC of preemption principles post-Dodd-Frank Act, see 76 Fed. Reg. 43,549, 43,554-558 (2011).

64. 550 U.S. 1, 7 (2007). *But cf.* Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2717 (2009) (distinguishing Watters). For an exhaustive analysis of the role of state regulation and enforcement in effective consumer protection, see Arthur E. Wilmarth, Jr., *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893 (2011) (arguing that, particularly as compared with failure of federal consumer protection in relation to sub-prime mortgage market, Dodd-Frank Act Title X enables states to construct additional safety measures and to identify and counteract emerging threats to consumers of financial services).

65. Thecla Fabian, *Failed Federally Insured Banks Now 140; Insurance Fund Falls by $1.8 Billion Dec. 18*, BNA BANKING DAILY, Dec. 22, 2009, at D9.

66. Thecla Fabian, *Banks Fail in Georgia, Florida, Arizona; 2010 Now at 41 and DIF Loses $320 Million*, BNA BANKING DAILY, Mar. 30, 2010, at D11.

67. Thecla Fabian, *Small Connecticut Credit Union Fifth 2010 Failure; State Regulator Sees Many Problems*, BNA BANKING DAILY, Apr. 9, 2010, at D17.

borrowers owe[d] more on their mortgages than their homes [were] worth."[68]

B. Transnational Aspects

The crisis quickly spread transnationally as well. By Q2 2009, lending by internationally active banks had declined by 1.1 percent (to $30.37 trillion), according to the Bank for International Settlements (BIS).[69] In its latest manifestation, the crisis has significantly affected the economies of many states that are members of the European Union, and in particular the economy of states that participate in the common currency of the Euro Zone. Member states like Greece and Ireland, and to a lesser extent Portugal, have been driven by financial distress into political crisis as well.[70] The situation remains decidedly in a state of flux. As the United States struggled to formulate an appropriate response to the crisis,[71] other states—and particularly EU member states—faced the necessity of dealing with the spill-over effects of the U.S. crisis in their own economies. At the EU level, in the early stages of the crisis there was an effort towards increased union-wide supervision in financial services markets, while at the member-state level,

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68. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-656, MORTGAGE REFORM: POTENTIAL IMPACTS OF PROVISIONS IN THE DODD-FRANK ACT ON HOMEBUYERS AND THE MORTGAGE MARKET 1 (2011).

69. Daniel Pruzin, *BIS Cites Continued Decline in Large Global Banks' Lending*, BNA INT'L BUS. & FIN. DAILY, Oct. 23, 2009, at D6. The data reflect reporting by banks in forty-two countries, including most of the world's major financial centers, but not China, Russia, or Saudi Arabia. *Id.* A survey of the twenty-one largest banks receiving financial assistance from the Treasury indicated that loan balances were trending downward beginning in March 2009, and declining in June 2009 by one percent. Mike Ferullo, *Loans Balances Among TARP Recipients Declined in June, Treasury Reports*, BNA BANKING DAILY, Aug. 18, 2009, at D9. However, there was a thirteen percent increase in new loan originations. *Id.* Likewise, the percentage of "nontraditional," subprime or Alt-A loans and securities used as collateral to support FHLBank advances to member savings associations and banks had declined during 2008, accounting for approximately twenty percent of collateral securing advances as of December 31, 2008. Federal Home Loan Bank Collateral for Advances and Interagency Guidance on Nontraditional Mortgage Products, 74 Fed. Reg. 38,618 (Aug. 4, 2009).

70. *See, e.g.*, Landon Thomas, Jr. & Christine Hauser, *S.&P. Ranks Greece's Debt World's Lowest*, N.Y. TIMES, June 14, 2011, at B1 (discussing Greek collapse); Joe Kirwin, *EC OKs New Bailout for Failed Irish Bank As Talks Over Restructuring Plan Continue*, BNA INT'L BUS. & FIN. DAILY, Aug. 11, 2010, at D3 (discussing Irish crisis); Bengt Ljung, *EC, IMF, ECB Say Portugal Rescue Package Offers Balanced, Demanding, Realistic Path*, BNA INT'L BUS. & FIN. DAILY, May 6, 2011, at D9 (outlining Portuguese rescue).

71. On the initial U.S. responses to the crisis, see Robert R. Bliss & George G. Kaufman, *Resolving Insolvent Large Complex Financial Institutions: A Better Way*, 128 BANKING L.J. 339 (2011); John L. Ropiequet, Christopher S. Naveja & Jason B. Hirsh, *An Introduction to the Dodd-Frank Act—The New Regulatory Structure for Consumer Finance Emerges*, BANKING & FIN. SERVS. POL'Y REP., Aug. 2010, at 1.

the individual member states were repudiating legislative proposals to establish enhanced regional supervision in the insurance sector of the financial services market[72] and the banking sector.[73] The result was a "shared approach" in which the twenty-seven EU member states agreed in mid-December 2008 to a $256 billion economic stimulus response that set parameters for individual member states to increase domestic spending and reduce taxes, with EU-wide measures covering matters other than financial services regulation.[74] Hence, direct EU policy concern was limited to safeguarding against anti-competitive effects of member state rescue efforts and bailouts. Most, if not all, of the twenty-seven EU member states sought approval of bank rescue plans from the European Commission, although some of these requests for approval may only be pursued as a precaution.[75]

The crisis continued to mutate towards a systemic crisis. In response, in May 2009 the European Commission outlined a plan calling for a new European Systemic Risks Council (ESRC) and new agencies to replace the committees that dealt with prudential issues of cross-border banking, insurance, and financial services.[76] To avoid a repetition of the crisis, the Commission plan contemplated that the ESRC would keep a continuous watch on macroeconomic conditions in the EU and would issue warnings when problems such as undercapitalized banks or real estate bubbles appeared to threaten economic fundamentals.[77]

Also in May 2009, the European Parliament voted overwhelmingly in favor of amendments to the EU Capital Requirements Directive to establish a new "college of supervisors" to oversee approximately forty-four banks with cross-border operations, strengthen banking supervision, and prevent future financial meltdowns.[78] The Directive mandated a "five-percent" retention rule requiring a banking institution selling securitized products to

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72. Joe Kirwin, *EU Finance Ministers Reject Enhanced Supervision in Insurance, Banking Sectors*, BNA INT'L BUS. & FIN. DAILY, Dec. 3, 2008, at D8 (reporting that EU member state agreement to new insurance regulatory regime conditioned on omission of EU-wide insurance supervision).

73. Joe Kirwin, *Despite G-20 Stance, EU Members Resist EU-Wide Supervision of Insurance, Banking*, BNA BANKING DAILY, Nov. 24, 2008, at D19. *But see* Joe Kirwin, *EU, U.S. Should Work to Forge Joint Economic Recovery Package, Barroso Says*, BNA INT'L BUS. & FIN. DAILY, Dec. 10, 2008, at D6 (reporting that France and United Kingdom had embraced commission plan for EU-wide stimulus package, with Germany still dissenting).

74. Joe Kirwin, *EU Leaders Back $256 Billion Package of Economic Stimulus*, BNA INT'L BUS. & FIN. DAILY, Dec. 15, 2008, at D7.

75. *Sweden, Portugal Latest Nations to Receive EC Approval of Financial Rescue Plans*, BNA INT'L BUS. & FIN. DAILY, Oct. 31, 2008, *available at* http://bna.com.

76. Joe Kirwin, *EC to Outline Plan for New Council to Monitor Banking, Financial Services*, BNA BANKING DAILY, May 26, 2009, at D25.

77. *Id.*

78. Joe Kirwin, *EU Parliament OKs Plan to Tighten Supervision of Cross-Border Banking*, BNA BANKING DAILY, May 7, 2009, at D28.

retain ownership over a portion of the offering.[79] It also limited any large exposure of a banking institution to a single client or group of clients (including interbank lending) to twenty-five percent of "own funds."[80]

In December 2009, a galvanizing event occurred, as the Austrian Government was forced to nationalize Hypo Alpe-Adria, one of the leading Austrian banks, to prevent the bank's collapse as result of bad loans to Eastern European companies and the debt-ridden balance sheet of its parent, the German regional bank, BayernLB.[81] "[T]he Austrian government took over the shares for a token amount."[82] The Munich-based BayernLB, "the second largest state-owned bank," was required "to write off more than $3 billion in losses" resulting from its purchase of Hypo Alpe-Adria.[83] "The Austrian Government also agreed to [inject] approximately $1 billion" into Hypo.[84] The crisis was worsening, and its spill-over effects were making its systemic dimension clearer.

In December 2009, EU finance ministers approved a new EU-wide banking and financial services supervisory structure designed to prevent future financial crises, with a sovereignty concession demanded by the UK.[85] The structure included a "macro-prudential" European Systemic Risk Board and a "micro-prudential" cluster of three new agencies supervising cross-border activities in banking, insurance, and pensions.[86] These sectoral agencies would not have the authority to require a member state to rescue a particular financial institution with its headquarters in the member state.[87] However, it was unclear whether the European Parliament, where there was

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79. *Id.*

80. *Id.* The twenty-five percent limit may be exceeded only for exposures between credit institutions and then only up to €150 million (approximately $200 million). *Id.* For these purposes, the term *own funds* refers to "[a] bank's available capital and reserves for the purposes of capital adequacy rules." *"Own Funds" Definition, Financial Markets Glossary*, MARKETS INTERNATIONAL LIMITED, http://www.markets-international.com/glossary/glossary4.html#o.

81. Joe Kirwin, *European Banking Crisis Erupts Again; Austria Forced to Nationalize Leading Bank*, BNA BANKING DAILY, Dec. 15, 2009, D12.

82. *Id.*

83. *Id.*

84. *Id.* The European Commission gave temporary approval to the rescue plan because of the systemic role that Hypo Alpe-Adria plays both in Austria and in other southeastern European countries. *EC Gives Temporary OK to Nationalized Bank in Austria, but Asks New Restructuring Plans*, BNA BANKING DAILY, Dec. 24, 2009, at D8 (reporting on rescue). The Commission also indicated that it was extending its in-depth investigation of state aid not only to cover the rescue, but also BayernLB, which had already received almost $40 billion in bailout funds through capital injections and risk guarantees from the German Government. *Id.*

85. Joe Kirwin, *EU Finance Ministers Reach Compromise on Bank Supervision, but Parliament Objects*, BNA BANKING DAILY, Dec. 3, 2009, at D23.

86. *Id.*

87. *Id.*

considerable sentiment for a single EU banking and finance supervisory authority with broad powers, would approve the structure as compromised.[88]

In April 2010, faced by unsustainable servicing costs for $400 billion in public debt, the Greek Government became the first Euro Zone member to request comprehensive assistance—as opposed to specific approval of an individual bank rescue measure—from the Commission, the European Central Bank, and the International Monetary Fund to provide a loan arrangement worth approximately $58 billion.[89] The announcement of the EU-IMF plan helped to lower Greek sovereign debt interest rates over the short term, but doubts about it emerged as some Euro Zone countries, led by Germany, insisted that parliamentary approval would be required before bilateral loans included in the plan would be authorized if Greece should request them.[90]

At this point, one might argue that the financial crisis was beginning to transform itself from a banking crisis into a challenge to the integrity of the Euro itself. The implications of such a challenge were denied by EU authorities. On May 10, 2011, for example, Economics Commissioner Olli Rehn said, "'We don't have a crisis of the [E]uro. We have a sovereign debt crisis in some [E]uro member states.'"[91] A tenuous distinction, some might argue, particularly in light of the events that followed. Yet the threat to the integrity of the Euro does seem to be "collateral damage" stemming from national financial crises gone systemic.

In August 2010, the European Commission approved an Irish Government bailout of approximately €9 billion ($13 billion) for Anglo Irish Bank, one of Ireland's leading financial institutions, to "'preserve financial stability'" in the country.[92] So far as can be ascertained at present, Anglo Irish Bank's difficulties were a result of the collapse of the commercial real estate market in Ireland, in which the bank was aggressively invested, but also a result in part of its portfolio investments in securitized assets funds tied to the U.S. subprime mortgage market.[93] By November 2010, however, the banking crisis had so overwhelmed the Irish economy that the collapse of the banking system pushed the Irish Government into bankruptcy, requir-

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88. *Id.*

89. Joe Kirwin & Andrea Schuessler, *Greece Succumbs to Market Pressure, Requests EU-IMF Public Finance Bailout*, BNA INT'L BUS. & FIN. DAILY, Apr. 26, 2010, at D8.

90. *Id.*

91. Bengt Ljung, *EU Official: Portugal to Pay Interest Rate Above 5.5 Percent on Emergency Loans*, BNA INT'L BUS. & FIN. DAILY, May 11, 2011, at D5 (quoting Commissioner Rehn).

92. Kirwin, *supra* note 70. Since that initial rescue effort, the Irish Government has required Anglo Irish Bank and Irish Nationwide Building Society (INBS) to merge, and the resulting entity will unwind over the next ten years. Joe Kirwin, *EC Clears Plan to Wind Down Two Irish Banks, Creating Banking Duopoly*, BNA INT'L BUS. & FIN. DAILY, July 1, 2011, at D5. This leaves only the two largest Irish banks standing, Bank of Ireland and Allied Irish Bank, and they are each waiting approval of their own rescue plan. *Id.*

93. Kirwin, *supra* note 70.

ing it to obtain a $113 billion bailout from the European Financial Stability Facility (EFSF) and the International Monetary Fund, which was approved in early December 2010.[94]

In mid-May 2011, EU finance ministers formally agreed to a €78 billion ($111 billion) loan package for Portugal, requiring fiscal consolidation, privatization conditions, and "re-profiling" of private investors.[95] Sponsored by the International Monetary Fund, the European Commission, and the European Central Bank, the three-year austerity plan requires Portugal to reduce its budget deficit to three percent of gross domestic product by 2013.[96] Within that time, Portugal is also required to open up more of its economy to competition, to privatize public entities, and to freeze public-private infrastructure projects.[97] In the financial sector, banks would be required to reduce their debt levels and to increase capital levels, through capital injections from the state, with the core "tier-one" capital-assets ratio[98] required to increase to nine percent in 2011 and to ten percent in 2012.[99]

At this juncture, however, Greece was clearly experiencing difficulty in implementing the terms of its expanded €100 billion (approximately $150 billion) rescue package, and the EU was beginning to consider a re-profiling of Greek sovereign debt, in exchange for, *inter alia*, a sweeping privatization of more than €45 billion ($70 billion) worth of government assets.[100] By mid-June, Standard and Poor's had down-graded Greek debt to CCC, making Greek public debt the lowest-rated in the world.[101] Yet the leading Euro Zone members continued to resist any suggestion that the debt might need to be restructured to provide fiscal relief to Greece.[102] Until the Fall 2011, EU leaders continued to apply pressure on Greek policy makers to accept a new package of economic austerity measures, in order to prevent a sover-

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94. Joe Kirwin, *EU Agreement Reached to Recapitalize Irish Banks, Spell Out Aid Conditions*, BNA INT'L BUS. & FIN. DAILY, Dec. 8, 2010, at D6.

95. Ljung, *supra* note 70; Joe Kirwin, *EU Considers 'Re-Profiling' Approach to Resolve Continuing Greek Debt Crisis*, BNA INT'L BUS. & FIN. DAILY, May 18, 2011, at D13. The term re-profiling, sometimes referred to as "rescheduling," involves the voluntary rescheduling of repayment due dates on sovereign bonds, by way of contractual modification. Kirwin, *EU Considers 'Re-Profiling' Approach to Resolve Continuing Greek Debt Crisis*, *supra*.

96. Ljung, *supra* note 70.

97. *Id.*

98. "Core" or "tier-one" capital consists of equity capital (fully paid ordinary common stock and non-cumulative perpetual preferred stock) and disclosed reserves of post-tax earnings. *See, e.g.*, *International Convergence of Capital Measurement and Capital Standards (Basle Capital Accord)*, 5 Fed. Banking L. Rep. (CCH) ¶ 47-105, at 51,125 (Nov. 6, 1991) (defining "Tier 1 capital").

99. Ljung, *supra* note 70.

100. Kirwin, *supra* note 95.

101. Thomas & Hauser, *supra* note 70.

102. Bengt Ljung, *Greece's Creditworthiness Receives Downgrade as EU Discusses Options*, BNA INT'L BUS. & FIN. DAILY, May 10, 2011, at D5.

eign debt default. The arrangement was expected to involve a "Brady bond" type of arrangement,[103] under which European banks with the largest exposures in Greek sovereign debt would agree to a write-down of as much as fifty to sixty percent of the bonds they hold as they were rolled over into new thirty-year bonds.[104]

A key change in the atmospherics of the negotiations among Euro Zone finance ministers came on June 17, 2011, when the German Chancellor dropped demands for a "quantifiable and creditable" loan concession on the part of private creditors as a condition of approval of any new bailout plan for Greece.[105] Instead, Chancellor Merkel expressed willingness to accept an approach under which private creditors would be required to agree to rollover bonds as they mature into new bonds at more concessionary rates.[106] Furthermore, on June 20, 2011, the Euro Zone finance ministers agreed that the new European Stability Mechanism (ESM), set to begin in 2013,[107] would not accord preferred creditor status on bailout funds relating to Greece, Ireland, or Portugal.[108] If this consensus holds, it would increase the likelihood that these countries would in the future be able to attract private investors if and when they returned to the bond markets.[109] At the same time, instead of releasing some $16 billion in bailout funding due in July in order to keep the Greek Government solvent, the Euro Zone finance ministers delivered an ultimatum that required approval of a new package of job and pay cuts before the funding would be made available.[110]

Greece yielded on June 30, 2011, to EU demands that it approve drastic new fiscal austerity measures, and German banks indicated that they

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103. So-called "Brady bonds" are an artifact of the 1980s sovereign debt crisis in Latin America, in which U.S. Treasury Secretary Nicolas Brady negotiated the roll-over of Latin American government bonds by institutional investors, into newly issued bonds with financing support and guarantees from public international financial institutions. For discussion of the elements of the Brady plan, see MICHAEL P. MALLOY, INTERNATIONAL BANKING: CASES, MATERIALS, AND PROBLEMS 263 (2d ed. 2005).

104. Bengt Ljung, *EU Chiefs Settle Bank Recap Issue, Pursue Greek Debt Fix, Boost for EU Bailout Fund*, BNA INT'L BUS. & FIN. DAILY, Oct. 27, 2011, *available at* http://www.bna.com.

105. Joe Kirwin, *Euro Zone Spies Daylight on Greek Deadlock As Germans Soften Private Creditor Demands*, BNA INT'L BUS. & FIN. DAILY, June 20, 2011, at D7.

106. *Id.*

107. *See* Joe Kirwin, *EU Leaders Resolve Euro Zone Doubts with New Pact, Including Bailout Mechanism*, BNA INT'L BUS. & FIN. DAILY, Mar. 28, 2011, at D4 (discussing ESM).

108. Joe Kirwin, *Euro Zone Makes Exception for Private Debt in $1 Trillion Bailout Facility to Begin 2013*, BNA INT'L BUS. & FIN. DAILY, June 21, 2011, at D6.

109. *Id.*

110. Joe Kirwin, *Euro Zone Gambles on Greek Government Backing Austerity Package of Pay, Job Cuts*, BNA INT'L BUS. & FIN. DAILY, June 21, 2011, at D7.

were ready to back a Greek debt rollover plan.[111] Euro Zone finance ministers are now expected to approve the next installment of rescue lending of approximately $16 billion to maintain Greek solvency for the next few months.[112]

The current crisis highlighted the limits and shortcomings of the supervisory structure of the EU.[113] The risk concentrations were not detected. Surveillance and supervision were not effective or timely.[114] Much of this was due to the difficulty of coordinating between national financial supervisors within the EU member states.[115] Coordination was especially difficult at the height of the crisis in fall 2008, as large transborder banks confronted challenges.[116]

Clearly, there is a need for effective supervisory authority at the EU level. Member states bailed out banks over the past two years in a wide variety of approaches, with little or no guidance or involvement at the EU level. In April 2010, Internal Markets Commissioner Michel Barnier called for the establishment of a "'coordinated resolution framework'" that would give the EU authorities a "tool box" of supervisory powers to prevent or intervene in bank crises in the future.[117] The tool box is expected to include more harmonized, preventive powers with respect to corporate governance standards, risk management requirements, and early intervention powers that would allow authorities to prohibit unsafe activities or to limit dividends.[118]

As of January 1, 2011, however, the European Systemic Risk Board (ESRB)—a macro-supervisor for the financial industry—and three sectoral supervisory authorities assumed responsibility for EU-wide supervision of the stability of the financial system as a whole, not individual banks and other financial firms.[119] The ESRB, headquartered in the European Central Bank (ECB) in Frankfurt, will be responsible for "early warnings when systemic risks are building up."[120] It is chaired by the ECB president and includes the "heads of EU central banks [as well as] national and European

111. Joe Kirwin, *Euro Zone Ministers Expected to Back Greek Aid, Consider New Bank Rollover Plan*, BNA INT'L BUS. & FIN. DAILY, July 1, 2011, at D4.

112. *Id.*

113. Bengt Ljung, *Barnier Hails New EU Authorities to Supervise Banks, Markets, Pensions*, BNA INT'L BUS. & FIN. DAILY, Jan. 4, 2011, *available at* http://www.bna.com (discussing supervisory conditions during crisis).

114. *Id.*

115. *Id.*

116. *Id.*

117. Joe Kirwin, *EC Outlines 'Tool Box' Plans for Crisis Prevention, Management*, BNA INT'L BUS. & FIN. DAILY, April 20, 2010, *available at* http://www.bna.com.

118. *Id.*

119. Ljung, *supra* note 113.

120. *Id.*

financial supervisors."[121] The three sectoral supervisors are the European Banking Authority (EBA) based in London, the European Securities and Markets Authority (ESMA) based in Paris, and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt.[122] While these new regulatory entities are intended to have broad supervisory authority, the ongoing financial crisis and its ad hoc treatment by EU and international institutions has distracted attention from these new structures. It remains to be seen whether they will in fact be able to provide efficiently and effectively the kind of early-warning, swift-response approach to systemic financial crisis that was so lacking in the current crisis.

Something more was required at the micro-level, however. In June 2010, the European Commission suggested in a green paper that stricter corporate governance and enhanced shareholder rights for financial service companies would be required to support the effectiveness of any new regulations that the EU might adopt to prevent future financial crises.[123] A year later, we are still searching for such rules.

A European meltdown was only averted in 2010 by establishing an *emergency* $1 trillion joint bailout fund together with the International Monetary Fund.[124] At this stage, the current debate needs to shift its focus from the public solvency issues that have dominated public attention so far, and concentrate on improving safety and soundness supervision throughout the EU. One element of this new approach would be to establish a *permanent* emergency contingency fund, like the U.S. Treasury's Exchange Stabilization Fund (ESF),[125] designed to act as a fall-back in the face of any future Euro Zone country sovereign debt problems. The European Financial Stabilization Mechanism (EFSF), initiated in May 2010 in response to the risk of a Euro meltdown, will expire in 2013.[126] The ESM, set to begin in 2013 with funding planned to be in excess of €675 billion (nearly $1 tril-

121. *Id.*

122. *Id.*

123. *Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*, COM(2010) 284 final (June 2, 2010), *available at* http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf.

124. Joe Kirwin, Andrea Schuessler & Diana I. Gregg, *EU Ministers, ECB, IMF Marshal Forces To Stabilize Euro With Trillion Dollar Plan*, BNA INT'L BUS. & FIN. DAILY, May 11, 2010, *available at* http://www.bna.com (discussing 2010 bailout measures).

125. 31 U.S.C. § 5302 (2006) (authorizing use of ESF for exchange transactions and other investment activities); *see also* 22 U.S.C. § 262r-3 (2006) (providing for reports on use of ESF in IMF stabilization programs); *see generally id.* §§ 286e-3, 286o-286p (2006) (authorizing use of ESF in connection with IMF transactions).

126. Joe Kirwin, *European Commission Proposes Bank Tax as Way to Finance Euro Zone Bailout Fund*, BNA INT'L BUS. & FIN. DAILY, Jan 18, 2011, *available at* http://www.bna.com.

lion),[127] would have the authority to buy primary market bonds of a Euro Zone country requiring its assistance, so long as the country commits to an austerity budget package.

However, funding the ESM may be problematic. In January 2011, the European Commission suggested that Euro Zone members impose a one-time 0.2 percent tax on Euro Zone bank assets, which should yield revenues of €45 billion (approximately $66 billion) to help finance the ESM.[128] This provoked intense criticism from European banking interests, and resistance from member states participating in negotiations to create the ESM.[129] As a result, final approval of the overall design of the ESM was not achieved until March 2011.[130]

This reluctance may suggest that, outside of traditional EU concerns and authority, EU policymakers still confront to some extent a system that thinks in national perspectives with only ad hoc consideration of regional supervisory concerns. As a result, a major crisis in the financial services market is almost inevitably viewed at first as an individual member state concern, with the attention of EU official typically limited to the effects of the rescue on European competition and subsidy policy.[131] With the capital markets still very much in play, this policy horizon must widen or the benefits of European single market policy may contract.

II. U.S. GOVERNMENT RESPONSE TO THE CRISIS

A. Dodd-Frank and the Crisis

While early attempts by the U.S. Government to respond to the crisis may have seemed half-hearted, the deepening crisis demanded action, and eventually the demand led to the enactment on July 21, 2010, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA),[132] the most significant structural response so far to the ongoing financial crisis precipitated by the failure of the subprime mortgage market. In many respects the

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127. Joe Kirwin, *EU Leaders Resolve Euro Zone Doubts with New Pact, Including Bailout Mechanism*, BNA INT'L BUS. & FIN. DAILY, Mar. 28, 2011, *available at* http://www.bna.com.

128. Kirwin, *supra* note 126.

129. Joe Kirwin, *Finance Ministers Make Little Progress Toward Revising Euro Zone Bailout Fund*, BNA INT'L BUS. & FIN. DAILY, Jan. 19, 2011, *available at* http://www.bna.com.

130. Kirwin, *supra* note 127.

131. *See, e.g.*, *EU Governments' Subsidies Nearly Triple in 2008 as Result of Economic Crisis*, BNA INT'L BUS. & FIN. DAILY, Dec. 8, 2009, *available at* http://www.bna.com (discussing EU policy interests in competition and subsidy effects).

132. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at scattered sections of 2, 5, 7, 11, 12, 15, 18, 20, 22, 26, 28, 31, 42, 44 U.S.C.) [hereinafter DFA].

new act, sprawling over hundreds of printed pages, is dense and imponderable,[133] but its basic theme is to mandate new supervision and controls over large and "systemically significant" financial institutions on the one hand, and to create genuine consumer protection mechanisms at the federal level on the other hand. Since administrative implementation of the DFA will likely stretch out over several years, it remains to be seen whether these two basic but diametrical goals can be maintained in balance with each other, and whether the Act is adequate to the task of effectively reforming the regulatory structure applicable to the financial services industry. The principal features of the Act are described below.

First, in a dramatic development, the DFA transferred the functions and responsibilities of the Office of Thrift Supervision to the Office of the Comptroller of the Currency and the FDIC,[134] except for authority over savings and loan holding companies and affiliate transactions, which was transferred to the Board of Governors of the Federal Reserve Board (Federal Reserve).[135] The transfer was effective July 21, 2011,[136] and the OTS and its director were to be abolished ninety days after that effective date.[137]

Second, the Act established a Financial Stability Oversight Council (FSOC), a committee of financial services regulators.[138] The FSOC is intended "to identify systemic risks, to promote market discipline, and to respond to emerging threats to the U.S. financial system."[139] For those nonbank financial companies identified by the FSOC as systemically significant,[140] the Act has expanded and enhanced the authority of the Federal Reserve to supervise nonbank financial companies.[141] This authority is in addition to its traditional authority over bank holding companies.[142] DFA also created FDIC authority to supervise resolution of financial crises—or "or-

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133. For tabular analysis of the DFA, see 1 MALLOY, *supra* note 2, figs. 1.37 & 1.38. For tabular analysis of regulatory implementation of the DFA, see *id.* fig. 1.39.

134. *See* DFA §§ 312(b)(2)(B), 314 (codified at 12 U.S.C. §§ 1, 4a, 11, 5412(b)(2)(B)) (OCC authority). Residual authority over state savings associations was transferred to the FDIC. *Id.* § 312(b)(2)(C) (codified at 12 U.S.C. § 5412(b)(2)(C)).

135. *Id.* § 312(b)(1), (b)(2)(A) (codified at 12 U.S.C. §§ 5412(b)(1), (2)(A)).

136. *Id.* § 311(a) (codified at 12 U.S.C. § 5411(a)). The effective date may be extended under certain specified circumstances. *Id.* § 311(b) (codified at 12 U.S.C. §5411(b)). Technical details of the transfer are handled by DFA §§ 302, 312(a)-(b), 317, 319, 322-327.

137. *Id.* § 313 (codified at 12 U.S.C. § 5413).

138. *Id.* § 111(a)-(h) (codified at 12 U.S.C. § 5321(a)-(h)). For discussion of the functions of the FSOC, see 1 MALLOY, *supra* note 2, § 1.03[H].

139. DFA § 112(a)(1) (codified at 12 U.S.C. § 5322(a)(1)).

140. *Id.* § 113 (codified at 12 U.S.C. § 3523).

141. *Id.* §§ 161-169 (codified at 12 U.S.C. §§ 5361–5369); *see also id.* § 170 (codified at 12 U.S.C. § 5370) (providing for safe harbor exemptions for certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by Fed).

142. *See* 12 U.S.C. §§ 1841-1852 (2011) (authorizing regulatory role of Federal Reserve over bank and financial holding companies).

derly liquidation"—with respect to any systemically significant financial company.[143] This is distinct from FDIC authority over insured depository institutions.[144]

Third, DFA established a Bureau of Consumer Financial Protection within the Federal Reserve to create and enforce effective consumer protection principles with respect to financial services.[145] Title X of the DFA also appears to repudiate the broad preemptive effect of *Watters* and its progeny.[146] Nevertheless, despite Title X, DFA does not represent a clean break with past preemption practices of the OCC and the OTS.[147] In certain respects, it substantially preserves federal preemption of state regulation of financial services, but with important exceptions in the consumer protection area.[148]

Fourth, DFA restricts, but does not eliminate, proprietary securities trading by banks.[149] For these purposes, *proprietary trading* is defined to mean

> engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the [Federal Reserve] in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in [§ 1851(b)(2)], determine.[150]

143. DFA §§ 201-214 (codified at 12 U.S.C. §§ 4403, 5381-5394; 18 U.S.C. §1032(1)).

144. *Id.* § 201(a)(8)(B) (codified at 12 U.S.C. § 5381(a)(8)(B)).

145. *Id.* §§ 1001-1067 (codified at 12 U.S.C. §§25b, 1465, 5481, 5491-5497, 5511-5519, 5531-5536, 5551-5587; 20 U.S.C. §9702(c)(1), (d)). For an excellent survey of the history and current state of consumer protection law and policy in the United States, see Mark E. Budnitz, *The Development of Consumer Protection Law, the Institutionalization of Consumerism, and Future Prospects and Perils*, 26 GA. ST. U. L. REV. 1147 (2010) (arguing that consumer protection principles are embedded in U.S. law and policy, both in terms of individual litigation and likely state and federal legislative policy).

146. *See, e.g.*, DFA § 1044 (codified at 12 U.S.C. § 25b(b)) (establishing narrow grounds for federal preemption of state consumer protection laws).

147. *See* 1 MALLOY, *supra* note 2, § 1.03[I][2] (discussing effect of federal preemption policy on state bank regulation).

148. *See* R. Christian Bruce, *Dodd-Frank Act's Language on Preemption Forces Some Quick Decisions, Lawyers Say*, BNA BANKING DAILY, July 23, 2010, at D12 (discussing implications for preemption).

149. DFA § 619 (codified at 12 U.S.C. § 1851).

150. 12 U.S.C. § 1851(h)(4) (2011).

In addition, DFA § 619 requires the FSOC to study and make recommendations on implementing this restriction on proprietary trading, known as the "Volcker Rule."[151]

Fifth, DFA imposes new mortgage lending standards.[152] These would include rules implementing appraisal independence standards mandated by DFA § 1472(a), which enacted the Truth in Lending Act (TILA) § 129E. TILA § 129E establishes new requirements for appraisal independence in consumer credit transactions secured by the consumer's principal dwelling.[153] This would ensure that real estate appraisals used to support creditors' underwriting decisions are based on an appraiser's independent professional judgment, free of influence or pressure that might be exerted by parties with an interest in the transaction.

Sixth, for all market participants, DFA imposes new standards with respect to securitization of pools of financial instruments.[154] Prior to the 2008 collapse of the mortgage market, securitization, the process in which interests in a pool of obligations or rights were marketed to investors as pro rata securities, was one of the critical processes for moving mortgage obligations into the capital markets as securities. This provision has the potential to eliminate the danger of rampant securitization that was characteristic of the subprime mortgage market at its height, but it remains to be seen whether it will create a safer regulatory environment for the capital markets.

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151. DFA § 619(b). The restriction is called the "Volcker Rule" for former Federal Reserve Chairman Paul Volcker, who first recommended the inclusion of a broader prohibition in the draft that eventually became the DFA. *See* Stephen Joyce, *SEC Official: Dodd-Frank, Volcker Rule Protect Investors, Help Financial Markets*, BNA BANKING DAILY, Mar. 9, 2011, at D20 (discussing Volcker Rule and current controversy concerning its regulatory implementation).

152. DFA §§ 1401-1484 (codified at 12 U.S.C. §§ 1701p-2, 1701x(a)(4), (c)(5)(A)(ii)(III)-(V), (e), (g)-(i), 1701x-1, 2603(c), 2604(a)-(d), 2605(e)-(f), (g), (k)-(m), 3310, 3332(a)(1), (5)-(6), (b), 3335, 3338(a)-(b), 3339, 3341(b), 3342, 3345(c), (e), 3346, 3347(a), (b)(2), 3348(a)(2), 3350(6), (8), (11), 3351(a)(1), (b), (d), (g)-(i), 3353-3355, 5219a-5219b, 5220b; 15 U.S.C. §§ 1602, 1604(h), 1607(a)(7), 1638(a)(16)-(19), (b)(4), (f), 1638a, 1639(e), (j)-(v), 1639a-1639h, 1640(a), (e), (k)-(l), 1691(e); 42 U.S.C. § 3533(g), 8108; repealing 15 U.S.C. § 1639(c)(2)); *see* Truth in Lending, 75 Fed. Reg. 66,554 (Oct. 28, 2010) (codified at 12 C.F.R. pt. 226, Supp. I; removing 12 C.F.R. § 226.36(b)) (promulgating interim rule implementing DFA § 1472).

153. DFA § 1472 (codified at 15 U.S.C. § 1639(e)).

154. *Id.* §§ 941-945 (codified at 15 U.S.C. §§ 77d(5), 77g(c)-(d), 78c(a)(4)(B)(vii)(I), 78c(a)(77), 78o(d), 78o-11); *see also id.* § 621(a) (codified at 15 U.S.C. § 77z-2a) (concerning conflicts of interest with respect to securitizations); *cf. id.* § 619(g)(2) (codified at 12 U.S.C. § 1851(g)(2)) (protecting otherwise authorized sale or securitization of loans by banking entity or systemically significant nonbank financial company from prohibitions on proprietary trading).

Seventh, DFA enhances the enforcement powers of the Securities and Exchange Commission (SEC).[155] It also allows for the SEC to maintain an additional $100 million of its revenues in a separate fund, which the SEC could use as necessary, with a full accounting to Congress.[156] Unfortunately, implementation of these new powers has been stalled by skepticism on the part of the new Congress.

Eighth, DFA requires hedge fund and private equity fund advisers to register with the SEC and will subject them to SEC inspection and examination.[157]A *hedge fund* can be defined as an investment fund open to a limited number of investors and requiring a relatively large initial minimum investment, committed to the fund for a relatively long period of time.[158] Typically, its investment strategies are aggressive, with leveraged and derivative trading intended "to increase the rate of return when the securities perform well."[159] A *private equity fund* can be understood as an investment fund specializing in investments not quoted on a public exchange.[160] Typically, it invests directly in existing private companies, or gains a controlling interest in a public company and takes it private. Investors in these funds are usually institutions or sophisticated, wealthy individuals who place relatively large amounts with the fund for a relatively long period of time.[161]

155. DFA §§ 912, 919, 921–929X (codified at 5 U.S.C. §§3101, 3114(a); 15 U.S.C. §§ 77h-1(g), 77o, 77s(e), 77t(d)(3)(A), 77v(a), 78d-5, 78g(c)(1)(A), 78i(d)-(j), 78j(a)(1), 78m, 78m(f), 78o(b)(6)(A), (c)(1)(A), (e)-(j), (n)-(o), 78o-4(c)(4), (8), 78o-5(c), 78p(a), 78q(f)(1)-(2), 78q-1(c)(4)(C), (g), 78s(h)(4), 78t(a), (e), 78u(a)(1), (d)(3)(C)(i), 78u-1, 78u-2(a), 78u-6, 78u-7, 78x, 78aa, 78cc(a), 78ddd(d)(1)(C), (h), 78eee(a)(3), 78fff-3(a)(1), (d)-(e), 78jjj(c)-(d), 80a-9(d)(1), 80a-30, 80a-35(a), 80a-41(e)(3)(A), 80a-43, 80a-48, 80b-3(f), (i)(1), 80b-4, 80b-5(a), (f), 80b-9(e)(3)(A), (f), 80b-10(d), 80b-14, 7201(9), 7215(c)(6), 7216, 7217(d)(3), 7246(a)-(b); 18 U.S.C. §§ 1514A(a), (b)(2), (e)); DFA §§ 912, 919, 921–929X (codified at scattered sections of 5, 15, 18 U.S.C.).

156. *Id.* § 991 (codified at 15 U.S.C. §§ 77f(b), 78d(i), 78m(e), 78n(g), 78ee(m), 78kk) (match funding).

157. *Id.* §§ 401-412, 419 (codified at 15 U.S.C. §§ 80b-2(a)(11), (29)-(30), 80b-3(b), (l)-(n), 80b-3a(a), 80b-4, 80b-10(c), 80b-11, 80b-18b). As a general rule, these registration requirements are effective as of July 21, 2011, except that an investment adviser may, in its discretion, register with the SEC under the Investment Advisers Act of 1940 during this one-year transition period, subject to rules to be promulgated by the SEC. 15 U.S.C. § 80b-2 (2011).

158. MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION 271 (3d ed. 2011).

159. *Id.* at 272.

160. *Id.*

161. The DFA treats these definitional issues less helpfully. *See* DFA § 619 (codified at 12 U.S.C. § 1851), which defines both terms as follows:

> The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.), but for [the Investment Company Act exemptive provisions in 15 U.S.C. § 80a-3(c)(1) or (c)(7)], or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the

Ninth, DFA provides for comprehensive regulation of swaps and security-based swaps by the Commodity Futures Trading Commission (CFTC) and the SEC[162] in consultation with the Federal Reserve.[163] The SEC and the CFTC have joint responsibility for swap products, to be allocated between the two agencies depending on whether the underlying product is a "security" or not.[164] Institutions deemed to be swap dealers—typically, large banks that act as market makers in swaps by creating and selling them[165]—as well

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> Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.

The exempting provisions referred to in the quoted excerpt actually provide a more informative description of these types of funds as follows:

> [N]one of the following persons is an investment company within the meaning of [the Investment Company Act]:
>
> (1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. . . .
>
> (7)(A) Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers [i.e., sophisticated investors], and which is not making and does not at that time propose to make a public offering of such securities. . . .
>
> (E) For purposes of determining compliance with this paragraph and paragraph (1), an issuer that is otherwise excepted under this paragraph and an issuer that is otherwise excepted under paragraph (1) shall not be treated by the Commission as being a single issuer for purposes of determining whether the outstanding securities of the issuer excepted under paragraph (1) are beneficially owned by not more than 100 persons or whether the outstanding securities of the issuer excepted under this paragraph are owned by persons that are not qualified purchasers. . . .

15 U.S.C. § 80a-3(c)(1), (c)(7) (2011); *see* Clemente Global Growth Fund, Inc. v. Pickens, 705 F. Supp. 958 (S.D.N.Y. 1989) (interpreting § 80a-3(c)(1)).

162. DFA §§ 711-716, 718 (codified at 7 U.S.C. §§ 6d(h), 24(c); 15 U.S.C. §§ 78o(c)(3)(C), 8301-8306).

163. *Id.* § 712(a)(8) (codified at 15 U.S.C. § 8302(a)(8)).

164. *Id.* § 717 (codified at 7 U.S.C. § 2(a)(1)(C), 7a-2(c)(1); 15 U.S.C. §§ 78c-1, 78s(b)(10)); *cf. id.* § 720 (codified at 15 U.S.C. § 8308) (memorandum of understanding to be negotiated between CFTC and Federal Energy Regulatory Commission). The SEC and the CFTC have already jointly issued proposed rules "further defining" key terms and regulating "mixed swaps." Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 51,429 (proposed Aug. 20, 2010) (to be codified at 17 C.F.R. pt. 1 (CFTC rules); pt. 240 (SEC rules)). Public comments were due September 20, 2010. *Id.*

165. At the same time, a "de minimis" exception from designation as a swap dealer is available to "an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers." DFA § 721(a)(49)(D) (codified at 7 U.S.C. § 1a(a)(49)(D)). This clause is important for regional banks and other smaller financial institutions such as savings associations and credit unions and will enable them to avoid the regulatory burdens likely to be associated with being identified as a swap dealer.

as "major swap participants" are required to register with either the SEC or CFTC, depending on the nature of their products.[166]

Despite the welcome imposition of disclosure requirements with respect to, and federal supervision over, derivatives and derivatives markets, there are still no clearly established jurisdictional lines between the SEC and the CFTC over derivatives. For example, the DFA provides that the SEC and the CFTC, in consultation with the Federal Reserve, must jointly "further define" certain key terms (specifically, "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant," and "security-based swap agreement"), and jointly prescribe regulations regarding "mixed swaps," as that term is used in DFA Title VII.[167] Hence, at the statutory level there remains fundamental uncertainty about the scope of the new derivatives approach.

Tenth, DFA imposes disclosure requirements on credit rating agencies, and requires their registration with and supervision by the SEC.[168] DFA also expands the availability of private rights of action against credit rating agencies. It eliminates an explicit exclusion of private rights of action arising out of 1934 Act,[169] requiring registration of nationally recognized statistical rating organizations.[170] It also includes credit rating agencies implicitly among the "persons liable" under the 1933 Act for having prepared or certified part of a registration statement by eliminating an SEC rule[171] that deemed credit ratings not to be a part of the registration statement "prepared or certified" by a person within the meaning of the private right of action under 1933 Act § 11.[172] Hence, credit ratings are now part of the "expertised" portions of a 1933 Act registration statement filed with the SEC, giving rise to an express private right of action against a credit rating agency for materially false or misleading ratings prepared by it and contained in such a statement.[173]

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166. *Id.* §§ 721-724 (codified at 7 U.S.C. §§ 1a, 1b, 2(a)(1), (c)(2)(A), (i)-(j), 6(c)(1), (6), 6d(f) 6m, 6q, 6s(l), 7-7a-1, 13-1(a), 16(h), 27; 11 U.S.C. § 761; 15 U.S.C. §§ 78f, 8321-8322).

167. *See id.* §§ 711-716, 718 (codified at 7 U.S.C. §§ 6d(h), 24(c); 15 U.S.C. §§ 78o(c)(3)(C), 8301-8306).

168. *See id.* §§ 931-939B, 939F (codified 12 U.S.C. §§ 24a, 1817(b)(1)(E)(i), 1831e, 4519; 15 U.S.C. §§ 78a(3)(a), 78c(a)(62), 78o-7(m), (u)-(v), 78o-8, 78u-4(b)(2), 80a-6(a)(5)(A)(iv)(I); 22 U.S.C. § 286hh(a)(6)).

169. 15 U.S.C. § 78o-7(m)(2) (2006) (foreclosing implication of private right of action resulting from registration of statistical rating agency).

170. DFA § 933(a) (codified at 15 U.S.C. § 78o-7(m)) (applying 1934 Act enforcement and penalty provisions to statements made by a credit rating agency).

171. 17 C.F.R. § 230.436(g) (2009) (nullified by DFA § 939G).

172. 15 U.S.C. § 77k (2006).

173. Pre-Dodd-Frank litigation attempts to impose liability on credit rating agencies that provided misleading favorable ratings for securitized subprime mortgage pools have

Eleventh, DFA requires companies registered pursuant to 1934 Act § 12[174] to permit their shareholders to have a nonbinding vote, at least once every three years,[175] on executive compensation.[176] DFA also requires disclosure by any person soliciting proxies in favor of a merger or other acquisition of any "golden parachute" compensation agreement or understanding in favor of departing executives in connection with the merger or acquisition.[177] These provisions of DFA do not appear to supersede substantive guidance previously issued by the regulators.[178]

B. The Crisis Continues for Small Business

Despite these and many other reform aspects of DFA, there are many missing features and potential shortcomings in the government response to the crisis. The absence of some of these features raises genuine concerns about the adequacy and likely effectiveness of DFA. The final shape of the Act reflects certain significant political compromises made by the Administration and/or the principal sponsors of the legislation, and it is not clear that the political atmosphere will improve in the near term. For example, the Act "does not address the operations of government-sponsored housing fi-

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generally been unsuccessful. *See, e.g.*, Pub. Emps.' Ret. Sys. of Miss. v. Merrill Lynch & Co., 714 F. Supp. 2d 475, 481-82 (S.D.N.Y. 2010) (dismissing 1933 Act § 11 action against credit rating agencies; holding agencies not "underwriters" for § 11 purposes); Teamsters Allied Benefit Funds v. McGraw, 09 CIV.140 (PGG), 2010 WL 882883, at *6-8 (S.D.N.Y. Mar. 11, 2010) (dismissing derivative suit by shareholders of parent company of credit rating agency for failure to state adequate claim under 1934 Act § 10(b)).

174. 15 U.S.C. § 78l.

175. The DFA allows for more frequent nonbinding votes, upon the approval of the shareholders in that regard. *See* DFA § 951 (codified at 15 U.S.C. § 78n-1(a)(2)) (permitting, at least once every six years, shareholder vote on frequency of compensation votes).

176. 15 U.S.C. § 78n-1(a)(1) (2011).

177. *Id.* § 78n-1(b)(1). For these purposes, the term "golden parachute" is characterized by the statute as

> any type of compensation (whether present, deferred, or contingent) that is based on or otherwise relates to the acquisition, merger, consolidation, sale, or other disposition of all or substantially all of the assets of the issuer and the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.

Id.

178. For example, in late June 2010, the OCC, the Fed, the FDIC, and the OTS adopted final guidance designed to ensure that "incentive compensation policies" at banking organizations did not encourage imprudent risk-taking, and that they were consistent with safety and soundness. Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36,395, 36,405-36,414 (June 25, 2010). The guidance was effective June 25, 2010. 75 Fed. Reg. at 36,396.

nance enterprises (GSEs) Fannie Mae and Freddie Mac."[179] In some respects, the insolvency of these two enterprises and the subsequent government takeover of both in September 2008 are two of the strike points that helped to unleash the meltdown of the capital markets.[180] It may reasonably be argued that their long-term disposition should have been treated in the regulatory reform legislation.[181] As it is, the two enterprises have already "required about $150 billion in Treasury funds" to continue operation.[182] Even a cursory review of the principal features of DFA reveals that, no matter how effective these provisions may be on their own terms, they are directed almost exclusively at macroeconomic, structural concerns, rather than the microeconomic, interstitial issues that are likely to have the most immediate impact on the small business sector. Many of the structural changes may well result in a stronger, more stable system of capital access, and this would eventually be of benefit to small business. However, the extended deadlines for implementation of many of these measures—and the growing political volatility surrounding financial services reform—make it likely that the small business sector is unlikely to see improvement in its economic conditions within a reasonable period of time.

Reform features that might offer indirect benefits to the small business sector are mired in transitional mode. The mortgage market remains, three years after the collapse of the subprimes, still largely under water, and the concomitant retail activity that normally flourishes around a vibrant real estate market is holding its breath. Prospective reforms in mortgage lending standards, credit rating practices, and safety and soundness supervision are still awaiting implementation.

DFA gave relatively little attention to *direct* efforts to improve conditions for the small business sector. There are nine DFA provisions that appear to consider explicitly the need for amelioration of the impact of reform measures on the small business sector. None of these provisions is particularly proactive or of appreciably broad effect. The administrative procedure for comment-gathering where a significant economic impact on a substantial number of small entities is expected has been amended. Prior to publication of an initial regulatory flexibility analysis that the CFPB, among other "covered agencies,"[183] is required to conduct, the Bureau must notify the Chief Counsel for Advocacy of the Small Business Administration and pro-

179. *See, e.g.*, Mike Ferullo et al., *Senate Sends Financial Regulatory Reform to White House for President's Signature*, BNA BANKING DAILY, July 16, 2010, at D12 (discussing situation of two enterprises).

180. *Id.*

181. *Id.*

182. *Id.*

183. On the meaning of the term "covered agency" for these purposes, see 5 U.S.C. § 609(d) (2011).

vide "information on the potential impacts of the proposed rule on small entities and the type of small entities that might be affected."[184] In the right hands, this notification could lead to significant input in the rulemaking deliberations of the CFPB, but it does not appreciably constrain the discretion of the agency to impose regulatory burdens on the small business sector.

By contrast, DFA does impose substantive limitations on the authority of the CFPB with respect to merchants, retailers, and other sellers of nonfinancial goods or services that regularly extend credit subject to a finance charge.[185] A seller is not subject to this authority if, pursuant to § 3 of the Small Business Act,[186] it "meets the relevant industry size threshold to be a small business concern."[187] The breadth of this exception is narrowed by the additional conditions that the seller must extend credit only for the sale of nonfinancial goods or services,[188] and must retain the credit on its own accounts.[189] As a result, this exception from the scope of CFPB authority is unlikely to free up a small business determined to expand and diversify its services.

Likewise, DFA provides an exemption from SEC registration for any investment adviser that acts solely as the adviser to a small business investment company (SBIC),[190] or to companies in the process of qualifying as SBICs.[191] Yet even here, the price of the exemption is an artificial limit to growth and diversification.

The DFA offers no relief to small business owners under the new minimum standards for residential mortgage loans. To the contrary, the act emphasizes that, in considering a loan application a creditor is permitted to take into account "the seasonality and irregularity" of any small business income of the applicant "in the underwriting of and scheduling of payments for such credit."[192]

On the other hand, DFA does mandate the request for and collection and reporting of loan application data with respect to the small business status of applicants.[193] The purpose of this mandate is to facilitate enforcement of fair lending laws, and to "enable communities, governmental enti-

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184. *Id.* § 609(b)(1).

185. 12 U.S.C. § 5517(a)(2)(B)(iii) (2010) (granting authority to CFPB).

186. 15 U.S.C. § 632.

187. 12 U.S.C. § 5517(a)(2)(D)(ii)(III).

188. *Id.* § 5517(a)(2)(D)(ii)(I). On the scope of the term credit for the sale of nonfinancial goods, see *id.* § 5517(a)(2)(A)(i).

189. *Id.* § 5517(a)(2)(D)(ii)(II). However, the credit may be sold or conveyed if the debt "is delinquent or otherwise in default." *Id.*

190. *See* 15 U.S.C. §§ 661-689q.

191. *Id.* § 80b-3(b)(7).

192. *Id.* § 1639c(a)(9).

193. *Id.* § 1691c-2(b).

ties, and creditors to identify business and community development needs and opportunities of . . . small businesses,"[194] among others. The data, analyzed and aggregated in accordance with the provision,[195] conceivably would be a useful tool for identifying "redlining" of small business loan applications by a financial institution. As a general rule, no loan underwriter, financial institution loan officer or employee, or affiliate is permitted access to this data.[196] This seems somewhat impractical, especially since the seasonality or irregularity of small business income can be considered by a creditor in deciding on the terms of mortgage loans.[197] Indeed, this provision itself recognizes that the financial institution might consider it important for the underwriter or others to have access to the information in making a determination on the application. The institution may do so, provided that it gives notice to the loan applicant, "along with notice that the financial institution may not discriminate on the basis of such information."[198] Obviously, this last notice might be somewhat misleading, since DFA itself allows the small business source of repayment income to be considered in determining whether income is seasonable or irregular.

On the somewhat controversial issue of interchange debit transaction fees,[199] DFA could actually give small businesses some relief, although it remains doubtful whether it will. DFA expressly limits any interchange transaction fee that any debit card issuer may receive or charge on an electronic debit transaction to what is "reasonable and proportional to the cost incurred by the issuer with respect to the transaction,"[200] and authorizes the Federal Reserve to promulgate rules implementing the provision and preventing circumvention or evasion. However, in promulgating these rules, the Federal Reserve was required to "consult, as appropriate, with . . . the Administrator of the Small Business Administration,"[201] among others. The provision gives no indication as to the parameters of this consultation, and the provision's explicit understanding of what constitutes a "small issuer" of debit cards—"any issuer that, together with its affiliates, has assets of less than $10,000,000,000"[202]—raises a question as to the congressional motiva-

194. *Id.* § 1691c-2(a).

195. *See id.* § 1691c-2(e)-(f) (concerning compilation and maintenance of data, submission to CFPB).

196. *Id.* § 1691c-2(d)(1).

197. *Id.* § 1639c(a)(9); *see supra* text accompanying note 192.

198. *Id.* § 1691c-2(d)(2).

199. *See, e.g.*, TCF Nat'l Bank v. Bernanke, 643 F.3d 1158, 1162 (8th Cir. 2011) (denying preliminary injunction in case challenging constitutionality of interchange debit transaction fee restrictions).

200. 15 U.S.C. § 1693o-2(a)(2) (2011).

201. *Id.* § 1693o-2(a)(4)(C).

202. *Id.* § 1693o-2(a)(6)(A).

tion in exempting small issuers. Apparently, "small" was never a more relative concept than it is now.

Only in the area of community development policy do we get any straightforward expression of the need for affirmative support of small business growth and development,[203] and then only as an annotation to a codified section of the Housing and Community Development Act.[204] We are told that out of fresh funds allocated for community development, the Secretary of Housing and Urban Development should be guided by, among others, the principle that "[a]n eligible entity receiving a grant . . . shall, *to the maximum extent feasible*, provide for the hiring of employees who reside in the vicinity . . . of projects funded under this section or contract with small businesses that are owned and operated by persons residing in the vicinity of such projects."[205] That lawyerly phrase "to the maximum extent feasible"[206] speaks volumes about the limits of DFA's concern with the viability of small businesses in the midst of the Great Recession.[207]

Small business lending by credit card banks is supposed to be encouraged by amendments to the Bank Holding Company Act,[208] but at most this may free up lending by credit card banks to small businesses from the as yet unquantified regulatory costs of BHCA regulation. One might question whether these assumed cost savings would adequately incentivize small business lending—assuming that it is actually a realistic incentive in light of the other restrictions on the exemption.[209]

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203. *See* DFA, Pub. L. No. 111-203, § 1497, 124 Stat. 1376, 2209 (codified at 42 U.S.C. § 5301).

204. *Id.*

205. *Id.* § 1497(a)(8) (codified at 42 U.S.C. § 5301) (emphasis added).

206. *Id.*

207. Thus, according to *Webster's New World College Dictionary* 519 (4th ed. 2000), "feasible" can be defined as "capable of being done or carried out; practicable; possible," but it carries a secondary—and more nuanced—meaning of "within reason; likely or probable."

208. *See* DFA § 628 (codified at 12 U.S.C. § 1841(c)(2)(F)(v)) (exempting from definition of bank, for purposes of BHCA, any institution making commercial loans only in the form of credit card loans "made to businesses that meet the criteria for a small business concern to be eligible for business loans under regulations established by the Small Business Administration under" 13 C.F.R. pt. 121, subject to other additional conditions).

209. *See, e.g.*, 12 U.S.C. § 1841(c)(2)(F)(i)-(iv) (2006), limiting availability of the credit card small business lending exemption to

> [a]n institution, including an institution that accepts collateral for extensions of credit by holding deposits under $100,000, and by other means which—
> (i) engages only in credit card operations;
> (ii) does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others;
> (iii) does not accept any savings or time deposit of less than $100,000; [and]
> (iv) maintains only one office that accepts deposits. . . .

These conditions are cumulative, and therefore limit the applicability of the credit card bank exception in § 1841(c)(2)(F)(v). *See supra* note 208 (describing exception).

Finally, DFA § 1421 mandated a GAO study and report to determine the effects of the Act "on the availability and affordability of credit for [among others] small businesses,"[210] a set of issues obviously not predetermined by the sponsors, and perhaps little more than a hope. In fact, given the elongated implementation process in relation to many of the Dodd-Frank mandates, and the complexity of provisions, the GAO has expressed considerable caution—if not outright pessimism—about the likelihood that a definitive study could be completed at this relatively early stage in DFA implementation. The GAO explained,

> Because regulations governing implementation of these provisions are still being developed, the criteria we assessed could change based on rulemakers' review of comments from the public on the proposed rules. . . . Partly for this reason, assessing the potential impact of the Dodd-Frank Act provisions is challenging at this time.[211]

III. ADDRESSING SMALL BUSINESS CONCERNS

The impact of the financial crisis and the ambivalent effects of the government response have created serious and continuing risks for the small business sector. This is a critical issue. As the Federal Reserve Bank of New York stated in October 2010,

> Small businesses are vital to supporting the economic recovery. Small firms employ nearly half of all Americans, account for about 60 percent of gross job creation, and historically have created more jobs than larger firms at the start of economic recoveries. Yet recent contractions in business borrowing may be limiting the capacity of small businesses to play this critical role. As policymakers and stakeholders pursue measures to support sustainable lending to creditworthy firms, questions arise about how much of the credit decline may be attributed to weaker demand for loans; how much reflects weakened applicant quality; and how much is due to restricted credit availability.[212]

Neglected in favor of "too big to fail" financial services institutions during the early improvised stages of the government response, the sector often seems lost in the details of the programmatic initiatives of DFA. Indeed, a July 2011 study by Celent, a financial institutions research and advisory firm, predicts an accelerating concentration of U.S. deposits among the largest banks and a corresponding rapid decline in community banks.[213] Yet a pervasive recovery from the crisis must include the revitalization of the

210. DFA § 1421(a).

211. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 68, at 4.

212. *Access to Credit: Poll Evidence from Small Businesses*, FACTS & TRENDS, Oct. 2010, at 1 (footnote omitted), *available at* http://www.newyorkfed.org/regional/2010_Facts_Trends_Vol_3_2.pdf.

213. BART NARTER, CELENT, IT TAKES MORE THAN A VILLAGE REDUX (2011), *available at* http://image.exct.net/lib/ff021672706400/d/1/morethanavillageredux.pdf.

small business sector if the recovery hopes to be deep-rooted. There are avenues available to reach this desired result, and many of them would involve existing supervisory and regulatory authority.

By way of conclusion and as an invitation to further reflection, I would suggest the following measures as promising the needed revitalization of the sector. First, the federal depository institutions regulators need to resolve to invoke the Community Reinvestment Act (CRA)[214] aggressively to encourage depository institutions to give greater focus to the credit needs of small businesses in the communities that they serve.

Second, the regulators have broad statutory enforcement and compliance powers,[215] virtually untouched by DFA,[216] to take enforcement action against unsafe and unsound banking practices and violations of laws, rules, and regulations. These powers, firmly committed to the broad discretion of the regulators in their application,[217] could be activated to address a wide range of questionable practices by depository institutions that impact small business customers.

Third, the regulators should give high priority to the timely and effective implementation of Dodd-Frank mandates such as those identified in the previous subsection of this Article.[218] In March 2011, Federal Reserve Chairman Ben S. Bernanke assured the national convention of the Independent Community Bankers of America (ICBA) that the needs of commu-

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214. 12 U.S.C. §§ 2901-2907 (2011). For analysis of the CRA, see 1 MALLOY, *supra* note 2, § 2.05; *see also* David Evan Cohen, Comment, *The Community Reinvestment Act—Asset or Liability?*, 75 MARQ. L. REV. 599 (1992); Michael E. Schrader, *Competition and Convenience: The Emerging Role of Community Reinvestment*, 67 IND. L.J. 331 (1992).

215. *See, e.g.*, 12 U.S.C. §§ 1786, 1818 (formal enforcement powers of National Credit Union Administration and banking regulators). For analysis of these powers, see Michael P. Malloy, *Nothing to Fear but FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 OHIO ST. L.J. 1117 (1989) (discussing the formal enforcement powers of the federal depository institutions regulators); Stephen K. Huber, *Enforcement Powers of the Federal Banking Agencies*, 7 ANN. REV. BANKING L. 123 (1988) (exhaustive discussion of range of state and federal criminal and formal and informal civil enforcement authorities).

216. *Cf.* DFA, Pub. L. No. 111-203, §§ 172(b), 362(3), 363(3), 367(7), 1090(1), 124 Stat. 1376, 1439, 1549-52, 1557, 2093-94 (2010) (codified at 12 U.S.C. §§ 1786(g)(7), 1818, 1818(t)).

217. *See, e.g.*, Groos Nat'l Bank v. Comptroller of the Currency, 573 F.2d 889, 896-97 (5th Cir. 1978) (extensions of credit by bank in violation of written agreement with OCC constituted unsafe and unsound practices); Wachtel v. Office of Thrift Supervision, 982 F.2d 581 (D.C. Cir. 1993) (order for restitution of failed bank's asset deficit requires showing of recklessness or unjust enrichment under § 1818(b)(6)(a)); Spiegel v. Ryan, 946 F.2d 1435 (9th Cir. 1991), *cert. denied*, 503 U.S. 970 (1992) (discussing § 1818(c)(1)); Greenberg v. Comptroller of the Currency, 938 F.2d 8 (2d Cir. 1991) (OCC suit against director after separation from service). *But see* Gulf Fed. Savs. & Loan Ass'n. v. Fed. Home Loan Bank Bd., 651 F.2d 259, 264 & n.4 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982) (limiting discretion).

218. *See supra* Section II.B.

nity banks would be factored into the Federal Reserve's DFA rulemaking and into new capital rules under the Basel III framework.[219] Yet little tangible progress has materialized since then. While the regulatory responsibilities imposed by DFA are certainly weighty, a proper sense of what mandates are critical, as well as *feasible*, should lead the regulators to take steps to ensure that the operations of depository institutions support a recovery of the small business sector, and with it a sustainable recovery for the general economy.

219. Stephen Siciliano, *Bernanke Assures Community Bankers on Dodd-Frank Act Rulemaking, Basel III*, BNA BANKING DAILY, Mar. 24, 2011, at D9 (reporting on Bernanke speech).