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Risks, Rules, and Institutions: A Process for Reforming Financial Regulation

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Risks, Rules, and Institutions: A Process for Reforming Financial Regulation

SAULE OMAROVA & ADAM FEIBELMAN*

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The world has changed dramatically since the Department of Treasury released its Blueprint for a Modernized Financial

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Regulatory Structure in March of 2008. It has changed in ways that make the topic of the Blueprint all the more important than it was a few short months ago. In the midst of a genuine once-in-a-lifetime global crisis in financial markets, questions about how to regulate and channel the provision of financial services within and between jurisdictions have become paramount. It now seems likely that individual countries and international institutions will reconsider the shape of regulation of capital markets in the short- or intermediate-terms; in fact, much reshaping has already occurred in the ad hoc responses that regulatory entities and firms have made in recent moments of acute peril. Such a time is rich with opportunities for improvement and fraught with potential for mistakes.

As policymakers and scholars have begun struggling with crisis containment and looking forward to the post-crisis environment, the Blueprint has drifted from center-stage. There are signs, however, that its focus on regulatory structure is still central to unfolding policy debates. To the extent that this is true, it is unfortunate. Institutional and regulatory structure can promote effective regulation, but it is unlikely to do so unless the goals and tools of a regulatory regime are carefully defined. In calmer periods, other writers have tried to deemphasize concerns about the allocation of regulatory functions. During the last round of debates over financial regulatory reforms of the late 1990s, for example, Michael Taylor and Richard Abrams noted that "institutional structure is a second order issue." In the current, highly-politicized climate, however, such a claim sounds discordant. As Brunnermeier, et al. have recently observed, "[t]here is a tendency, commonly observed amongst politicians, to review the structure of the regulatory sys-


tem before considering the potential instruments to achieve better regulatory control.3

The current economic crisis has arguably vindicated the view that policymakers are mistaken to focus initially on questions of regulatory structure. There is a reasonable case to be made that today's crisis is not solely, perhaps not even primarily, due to lack of coordination among regulators or a misallocation of turf and regulatory responsibility.4 It appears likely that a host of different regulatory actors either failed to perceive fundamental risks or refused to address them. This experience has underscored that two primary challenges in regulating capital markets are, first, to identify risks within these markets and, second, to identify mechanisms that can lessen or manage those risks. Questions about how to allocate these mechanisms within a regulatory structure should be answered in light of policymakers' conclusions regarding what to regulate and how to regulate it.

The recent crisis will provide a partial roadmap to a better understanding of the types of risks embedded in different financial activities. It should now be clearer to policymakers, for example, that consumer lending is fraught with risks—thus giving rise to regulatory concerns—that flow well beyond the interests of the initial parties to these transactions. These risks flow through the institutions that purchase and pool consumer obligations, institutions that purchase interests in these pooled assets, and others that buy and sell products that are derivative of these interests. Each of these subsequent transactions gives rise to distinct risks that implicate parties forward and backward in the chain of relationships. In the wake of the current crisis, it is also now clearer that institution-


4. The Congressional Oversight Panel has made this point forcefully. See MODERNIZING, supra note 3, at 46.
level (that is, micro-prudential) regulation can be in tension with systemic stability.  

It is important, however, for policymakers not to assume that the particular risks that gave rise to the current crisis will reemerge in the post-crisis context. It is equally important for policymakers not to ignore other fundamental risks inherent in capital markets that might not have been revealed in recent months. Identifying the full range of risks and potential market failures in domestic and international financial systems requires both a keen appreciation of economic theory and a comprehensive understanding of the actual practices of market actors. The latter can be anticipated to some extent, but imperfectly. It is simply impossible to know exactly how financial markets will look when they reemerge from the current crisis. If policymakers do not wait long enough to have some meaningful understanding of how private actors will respond to the crisis, they run the risk of designing a regulatory system that is weak where it should be strong and strong where it should be weak.

Assuming that policymakers have an accurate assessment of the nature of financial firms, products, and services going forward, they must then develop criteria for distinguishing risks that should be borne by private parties from those that justify regulatory intervention. This will inevitably require a balancing of various potential policy objectives, such as protecting consumers and investors, promoting an efficient allocation of financial resources, and ensuring systemic stability. This analysis should be based upon a realistic assessment of available regulatory tools, such as activity restrictions, capital adequacy requirements, reserve requirements, conditions on affiliate transactions, disclosure requirements, etc. It should also take into account the potential modes of interaction between the regulators and the regulated, as well as improvements in private risk-management strategies, both of which may vary across different segments of the re-emergent financial services sector.

Only after policymakers identify the risks inherent in the financial system and determine the scope of justifiable regulatory intervention should they attempt to devise or reform the institutional structure for addressing such risks. Identifying the nature of risks and determining realistic regulatory goals should help polici-
cymakers determine the optimal institutional structure for regulating the domestic markets for financial products. By focusing on questions of institutional structure, the Blueprint and other subsequent proposals put the proverbial cart before the horse. The Blueprint itself proposed a long-term structural solution to divide prudential regulation, market conduct regulation, and financial stability oversight among three different agencies, according to what the Treasury views as the key policy objectives in the financial services sector. This notion of "objectives-based" regulation is, at this point, neither sufficiently specific nor substantively justified. Other more recent proposals compound this problem, and still others are too hasty in proposing specific substantive policies. If policymakers focus initially and immediately on institutional structure or substantive regulations, they are likely to perpetuate essential misalignments between business realities and regulation; they will just reallocate this misalignment to different regulatory entities or regimes.

There are some potential drawbacks and practical challenges to the approach to regulatory reform described above. Delaying the process of reform until after financial markets begin reemerging may miss an opportunity to shape the re-emergent markets through regulation. Regulatory actions taken to curtail the current crisis may constrain the regulatory paths and options available to policymakers in the post-crisis context. The current crisis may provide a unique opportunity to make comprehensive reforms, and there may be insufficient political will to do so and to override powerful special interests once the crisis subsides. Finally, it may be unreasonable to believe that the kind of comprehensive approach to regulatory reform proposed herein is feasible even where there is political will to undertake it. Nonetheless, the benefits of a slower, more deliberate approach to regulatory reform may outweigh those of acting quickly in the midst of financial and economic crisis. Even if policymakers proceed to tackle financial regulatory reforms in the short-term, the concerns outlined below may help temper that process.

I. THE EMERGING LANDSCAPE OF REFORM PROPOSALS

Treasury released its *Blueprint* in March of 2008, just as the current economic crisis was beginning to unfold but well before the extent of the crisis was apparent. The *Blueprint* had been much anticipated; work on the project was begun in the wake of conference on "capital markets competitiveness," convened by Treasury the year before. As the *Blueprint*'s executive summary states, "Conference participants . . . noted that while functioning well, the U.S. regulatory structure is not optimal for promoting a competitive financial services sector leading the world and supporting continued economic innovation at home and abroad." Within a few short months of its release, however, events had largely overtaken the *Blueprint*. Whatever its merits, it quickly became an open question whether the *Blueprint* would survive intact as a plausible or compelling plan for future reform of the financial system. In any event, it is now no longer conventional wisdom that the U.S. regulatory structure is—or was, in recent years—functioning well.

It may therefore be tempting to disregard the *Blueprint* or to treat it as peripheral to current discussion and debate. For a variety of reasons, however, this would be a mistake. Many of the alternative proposals that have emerged in recent months appear to respond—directly or indirectly—to the proposals in the *Blueprint*. Furthermore, many of these proposals are not significantly different from the *Blueprint* in key respects. Perhaps most significantly, the *Blueprint* provides a particularly useful retrospective roadmap of the weaknesses of approaches to financial regulatory reform that have prevailed over the last decade or so. This Part summarizes the substance of the *Blueprint* and briefly discusses some of the proposals for reforming the U.S. financial regulatory system that have emerged since the *Blueprint* was published.

8. See *BLUEPRINT*, supra note 1, at 1.
9. For a detailed discussion of some of the key alternative proposals, see infra notes 25–86 and accompanying text.
A. The Blueprint

In addition to articulating a broad "conceptual model for an optimal regulatory framework," discussed below, the Blueprint sets forth a number of short-term and intermediate-term recommendations. These recommendations do not depend on the structural changes described below, but they would certainly not foreclose such structural reforms. The Blueprint's short-term recommendations include expanding the scope, mission, and composition of the Presidential Working Group on Financial Markets, creating a "mortgage origination commission" that would establish federal "minimum licensing qualification standards"; and enhancing the ability of the Federal Reserve to provide liquidity to financial firms (including non-depository institutions) to ensure market stability. Intermediate-term recommendations include "phasing out" of the federal thrift charter; rationalizing federal supervision of state-chartered banks; creating a charter for "systemically important payment and settlement systems," which would be regulated and supervised by the Federal Reserve; creating an optional federal insurance charter and an Office of National Insurance, which would regulate federal insurance companies; and merging the Securities and Exchange Commission ("SEC") with the Commodities Futures Trading Commission ("CFTC").

The conceptual model articulated in the Blueprint is much more forward-looking than the recommendations noted above. It envisions largely dismantling the current functional arrangement of regulation that allocates regulation and supervision of distinct financial industries to separate regulatory actors. By way of contrast, the Blueprint describes its conceptual model as "objectives-based," involving three primary objectives: market stability; pru-

10. See BLUEPRINT, supra note 1, at 2.
11. This working group is currently composed of the heads of Treasury, the Federal Reserve, the Securities and Exchange Commission and the Commodities Futures Trading Commission. Among other things, the Blueprint proposes that the Working Group include the heads of the Office of Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Commission.
12. See BLUEPRINT, supra note 1, at 5–8.
13. See id. at 8–13. Currently, the Federal Reserve regulates and supervises state-chartered banks that are members of the Federal Reserve System and the Federal Deposit Insurance Corporation regulates and supervises all other state-chartered banks.
dential” financial regulation; and regulation of “business conduct.” The Blueprint proposes allocating regulatory functions in light of these goals. Thus, it proposes that policymakers establish a market stability regulator, a prudential financial regulator, and a business conduct regulator.

Under this scheme, the Board of Governors of the Federal Reserve System (“Federal Reserve”) would serve as the newly designated market stability regulator. This would essentially extend the Federal Reserve’s current roles. It would have broad powers to supervise and collect information from financial firms, to take “corrective action” where market stability required doing so, and to serve as a lender of last resort to non-financial and well as financial firms.

The Blueprint envisions creating a prudential financial regulator by merging the functions of the Office of the Comptroller of the Currency (“OCC”) and the Office of Thrift Supervision (“OTS”) and other existing federal-level prudential regulatory entities. It would have responsibilities relating to financial firms subject to federal government guarantees, especially deposit insurance but including insurance guarantee funds as well. Among other things, the prudential regulator would charter “federal insured depository institutions” (as well as “federal insurance institutions,” which would enjoy federal guarantees under the new scheme), determine permissible activities for these institutions, and regulate their affiliate relationships.

A business conduct regulator would essentially take over responsibilities for consumer protection, both regulatory and supervisory. It would regulate conduct by the full range of financial institutions and would charter some financial firms not within the chartering authority of the prudential financial regulator. The Blueprint’s conceptual model also envisions the creation of a corporate finance regulator, which would take over the activities cur-

15. See id. at 146–51.
16. See id.
17. See id. at 157–70.
18. See id. at 165–70. It would not regulate government-sponsored entities such as Fannie Mae and Freddie Mac.
19. See id. at 170–78.
rently allocated to the SEC and, eventually, those currently allocated to the CFTC as well.\textsuperscript{20}

In sum, the Blueprint’s “conceptual model” is primarily a model of regulatory structure. The essence of this approach is to reallocate regulatory functions and then to rely on actors within the new framework to determine the substantive content of financial regulation within their domain. While this approach is cast in terms future reforms, it is perhaps more interesting to consider the Blueprint as one of the last official products of the prevailing pre-crisis regulatory paradigm. Debate and discussion of regulatory reform over the last couple of decades has been largely concerned with determining the appropriate vertical structure of the financial markets and with mapping the allocation of regulatory functions onto that structure. In particular, policymakers focused throughout this period on the viability of Glass-Steagall-era separation of banking and other financial services.\textsuperscript{21} Thus, most of the energy spent on financial regulatory reform during this period related to various proposals culminating in the Gramm-Leach-Bliley Act,\textsuperscript{22} which partially dismantled the Glass-Steagall regime and allocated regulatory authority over financial conglomerates between the Federal Reserve, Treasury, and other federal agencies.\textsuperscript{23} Much of

\textsuperscript{20} See id. at 21.

\textsuperscript{21} The Glass-Steagall Act is the name commonly used to refer to §§ 16, 20, 21, and 32 of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.). The Glass-Steagall Act essentially separated the ownership and management of depository institutions (commercial banks) and firms engaged in securities underwriting (investment banks). See id. For a critical analysis of the history and rationale of the Glass-Steagall Act, see, for example, George J. Benston, The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered (1990).


\textsuperscript{23} The Gramm-Leach-Bliley Act established a system of “functional regulation” of financial holding companies, under which the Federal Reserve acts as an “umbrella” regulator and supervisor of the entire conglomerate on a consolidated basis, the relevant bank regulatory agencies retain primary regulatory and supervisory responsibilities for commercial banking subsidiaries, the
the scholarship on financial regulation that was not related to these debates focused on another aspect of regulatory structure—especially the somewhat convoluted arrangement of state and federal financial regulatory actors.  

B. Subsequent Proposals and Models

Since the Blueprint was released, a fast-growing number of writers and organizations have published proposals for reforming domestic and international regulation of financial markets. Not surprisingly, many of these subsequent proposals have responded directly to the unfolding economic crisis and only indirectly to the Blueprint itself. And whereas the Blueprint is predicated on the assumption that regulation of the U.S. financial system functions relatively well, most subsequent proposals assume that the current regulatory framework in the United States is, as one report puts it, "a broken system." This section does not aim to provide a comprehensive review of these recent proposals. Such a project is not particularly useful for present purposes, and it would become obsolete almost immediately. Rather, this section briefly summarizes a few notable and prominent proposals to illustrate some defining aspects of the current debate and discussion about financial regulatory reform.

1. The Group of Thirty Report. One prominent example of the emerging literature on financial regulatory reform is the report prepared by a steering committee of the Group of Thirty ("G-30"), chaired by Paul Volcker, a former chairman of the Federal Reserve

SEC continues to exercise primary regulatory and supervisory authority over securities affiliates of such conglomerate, and state insurance regulators continue to oversee insurance underwriting entities within the structure. See 12 U.S.C. § 1844 (1999); see generally LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 258-69 (2004).


This report addresses financial regulation from an international perspective. As an initial matter, it is noteworthy that the report makes a point to emphasize that the public sector has a crucial role to play in regulating financial markets. This should be understood as reflecting deep skepticism with the idea that market discipline can provide adequate and effective regulation of financial markets. Optimism about the potential role of market discipline helped shape financial regulation around the globe over the past two decades. Not surprisingly, skepticism with this deregulatory impulse is a common aspect of most of the recent proposals for financial regulatory reform. None reject a role for market discipline altogether, but almost all embrace the idea that there is a need for meaningful substantive reform of the current framework for regulation of financial markets.

The recommendations of the G-30 report in turn reflect this general embrace of a robust governmental role in regulating financial markets. It recommends, among other things, imposing "the highest international standards" on "the largest and most complex banking organizations"; ensuring that non-bank financial institutions are subject to "some form of formal prudential regulation and supervision"; improving the infrastructure of the financial system (for example, clearing and payment systems); avoiding regulatory approaches "that may inadvertently reinforce . . . excessive exuberance or risk aversion"; promoting "well-balanced" executive compensation; improving the structure of regulatory agencies responsible for crisis response; ensuring a meaningful degree of

28. See The Group of Thirty, supra note 27, at 17.
coordination and consistency of regulatory approaches across the
globe, especially for institutions operating trans-nationally; im-
proving governance and risk management by financial institu-
tions.30

In light of these guiding principles, the G-30 report makes
four core recommendations. First, it proposes to eliminate "gaps
and weaknesses in the coverage of prudential regulation and su-
pervision."31 In practice, this would entail extending prudential
regulation and supervision to all "systematically significant finan-
cial institutions."32 Thus, for example, it would require limiting
ownership of government-insured depository institutions to regu-
lated entities and would likely extend prudential regulation to at
least some money market mutual funds and to at least some hedge
funds. The second core recommendation is to improve "the quality
and effectiveness" of prudential regulation and supervision.33 This
would entail creating a regulatory framework that affords "higher
levels of national and international policy coordination."34 In this
regard, the report specifically recommends that countries rational-
ize their financial regulatory structures and consider allocating
regulation of market stability to their central banks.

The third G-30 recommendation is to strengthen "standards
for governance, risk management, capital, and liquidity."35 In this
regard, the report focuses on the potential dangers of "pro-cyclical
effects" of regulation and recommends raising capital requirement
that dampen pro-cyclicality.36 The report also recommends that
policymakers adopt "fair value accounting" of financial assets,
which would not require strict "marking to market" of these as-
sets.37 Finally, the G-30 report recommends making financial mar-
kets "more transparent," aligning "risk and prudential incentives."38
Here the report focuses largely on the need to "restor[e] confidence

31. See id. at 21.
32. This category is defined in the report as a function of size, leverage,
"interconnectedness," and relationship to infrastructure.
33. See THE GROUP OF THIRTY, supra note 27, at 34–38.
34. See id. at 34.
35. See id. at 40–46.
36. See id. at 42–43.
37. See id. at 44–45.
38. See id. at 48–56.
in securitized credit markets." This would in turn involve pressing financial firms to improve credit underwriting standards; reforming credit-rating practices; improving, or imposing, regulation and supervision of over-the-counter markets and products like credit default swaps.

2. The Government Accountability Office Report. In January of 2009, the U.S. Government Accountability Office ("GAO") issued a report on financial regulatory reform. This report primarily addresses what it describes as "the fragmented and complex arrangement" of actors with regulatory functions affecting U.S. financial markets. It emphasizes that this framework has "gaps" where large financial entities do not fall within the jurisdiction of any existing regulatory actors. Similarly, the report observes that various regulatory actors have failed to respond to market developments in financial products.

According to the GAO, the existing allocation of regulatory functions constitutes one of the fundamental weaknesses of the current system of financial-sector regulation in the United States. As the report states, "recent events clearly have shown that the fragmented U.S. regulatory structure contributed to failures by the existing regulators to adequately protect consumers and ensure financial stability." It proposes that policymakers clarify the goals of financial regulation; provide comprehensive regulatory coverage of financial activities; improve the ability of financial regulators to address systemic factors, perhaps by designating a market stability regulator; build a greater degree of flexibility into the regulatory system, perhaps allowing regulators to wait to intervene in markets "until it becomes clear that a particular activity or market poses a significant risk"; minimize regulatory burdens on financial markets where possible; and improve consumer and investor protections.

3. The Congressional Oversight Panel Report. The Congressional Oversight Panel ("the Panel") was created by Congress in October of 2008 to oversee the U.S. government's efforts to contain and resolve the current crisis and to evaluate the existing

39. See id. at 48–49.
40. GAO-09-216, supra note 25.
41. Id. at 1.
42. Id. at 3.
43. Id. at 55.
44. Id. at 54.
framework of financial regulation.\textsuperscript{45} Among other things, Congress specifically charged the Panel to determine "whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system . . . and whether there are any gaps in existing consumer protections."\textsuperscript{46}

In January of 2009, the Panel issued a report identifying past and current weakness of the U.S. financial regulatory system and recommending a number of areas in need of reforms.\textsuperscript{47} It is particularly noteworthy that the Panel disagreed with those who suggest that the underlying problems with U.S. financial regulation stem primarily from the regulatory structure. As the Panel states:

Structural and organizational problems are certainly important . . . . But at root, the regulatory failure that gave rise to the current crisis was one of philosophy more than structure. In too many cases, regulators had the tools but failed to use them. And where tools were missing, regulators too often failed to ask for the necessary authority to develop what was needed.\textsuperscript{48}

In general, the Panel's report strongly criticizes the trend over recent decades to embrace deregulatory policies and the emergence of essentially unregulated market actors and activities. It identifies three primary problems with the existing framework: it fails to effectively manage risks, to require sufficient disclosure, and to ensure "fair-dealing."\textsuperscript{49} The Panel's report offers eight particular proposals for reform: "[i]dentify and regulate financial institutions that pose systemic risk"; "[l]imit excessive leverage in American financial institutions"; "[i]ncrease supervision of the shadow financial system"; "[c]reate a new system for federal and state regulation of mortgages and other consumer credit products"; "[c]reate executive pay structures that discourage excessive risk taking"; "[r]eform the credit rating system"; "[m]ake establishing a

\textsuperscript{45} See Congressional Oversight Panel, http://cop.senate.gov/about/ (last visited Apr. 11, 2009).
\textsuperscript{46} MODERNIZING, supra note 3, at 6–7.
\textsuperscript{47} Id.
\textsuperscript{48} Id. at 19.
\textsuperscript{49} Id. at 7.
global financial regulatory floor a U.S. diplomatic priority"; and "[p]lan for the next crisis."\(^{50}\)

4. **The Committee on Capital Markets Regulation Recommendations.** The Committee on Capital Markets Regulation ("Committee"), an independent group of industry leaders and academics, released a set of recommendations on financial regulatory reform in January of 2009.\(^{51}\) The Committee's recommendations focus almost exclusively on reforming the structure of financial regulation in the United States. It strongly advocates reducing the number of domestic financial regulatory entities and allocating existing functions to a small group of surviving entities. In particular, the Committee recommends that the United States should have only two or three independent financial regulators: the Federal Reserve; a U.S. "Financial Services Authority" ("USFSA"), modeled on the United Kingdom's recently-created Financial Services Authority ("UK FSA");\(^{52}\) and, perhaps, an "investor/consumer protection agency."\(^{53}\)

The Committee would allocate to the Federal Reserve responsibilities for setting monetary policy, providing liquidity to financial market as a lender of last resort, and establishing capital requirements for financial institutions.\(^{54}\) The USFSA "would regulate all aspects of the financial system," and would thus be respon-

\(^{50}\) Id.

\(^{51}\) COMMITTEE ON CAPITAL MARKETS REGULATION, RECOMMENDATIONS FOR REORGANIZING THE U.S. FINANCIAL REGULATORY STRUCTURE (2009), available at http://www.capmktsreg.org/pdfs/CCMR%20Recom

\(^{52}\) The UK FSA is a unified regulator with broad jurisdiction over the UK's financial services industry, which was established in 1997 by combining the functions and staff of nine different regulatory and self-regulatory bodies. For a detailed analysis of the UK FSA's creation, operation, and regulatory and supervisory philosophy, see, for example, Eilis Ferran, *Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 BROOK. J. INT'L L. 257 (2003); Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253 (2007); Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. 317 (2003).

\(^{53}\) COMMITTEE ON CAPITAL MARKETS REGULATION, supra note 51, at 5–6.

\(^{54}\) Id.
sible for functions currently conducted by the OCC, the OTS, the Federal Deposit Insurance Corporation ("FDIC"), the SEC, and the CFTC. The Committee further proposes that the Treasury coordinate the activities of these two (or three) entities. The Committee was apparently split on whether the Federal Reserve or the new USFSA would have responsibility for supervision of financial institutions. It proposes three options: giving this responsibility to the Federal Reserve; giving it to the USFSA; or giving most of this responsibility to the USFSA and having the Federal Reserve supervise "systemically important" financial institutions.

5. The "Geneva" Report. A group of economists participating in a conference co-sponsored by the International Center for Monetary and Banking Studies and the Centre for Economic Policy Research recently released a conference draft, *The Fundamental Principles of Financial Regulation*. These writers argue that the current framework of financial regulation has been overly concerned with regulating the activities of institutions (micro-prudential) and insufficiently concerned with regulating aspects of institutional behavior that can give rise to negative systemic externalities (macro-prudential). They observe various ways in which transactions or policies that promote the performance and solvency of individual institutions can themselves create systemic instability. "It is possible, indeed often likely, that attempts by individual institutions to remain solvent can push the system into collapse."

Significant for present purposes, these writers propose an approach to regulatory reform in addition to substantive goals and principles. "What is needed is, first, a restatement of the basic objectives of financial regulation and, then, an assessment of whether the current regulatory framework is well structured to attain such objectives, and, if not, to explore what can be done to restructure such regulation so that it does." Pursuant to this approach, they propose that regulators classify financial institutions

55. Id. at 6.
56. Id. at 6–7.
57. Id. at 7.
58. Id. at 8–9.
60. Id. at 6.
61. Id. at 13.
62. Id. at 1.
based on objective risk measures that capture the risk-spillovers from one institution to the next . . . .

The fault line of regulation should be primarily determined by the institution’s actions and asset-liability structure, while its legal identity as a bank, insurance company, SIV, etc. should only play a secondary role.  

They further propose three categories of institutions based on this classification—“individually systemic” institutions; institutions that are “systemic as part of a herd” (for example, hedge funds); “non-systemic large” institutions (for example, insurance companies and pension funds); and what they refer to as “tinies.” According to these writers, only the first two categories implicate macro-prudential concerns. They also argue that policymakers adopt counter-cyclical regulations, police for “maturity mismatches,” allow financial firms to adopt “mark to funding” accounting practices, and impose capital charges for liquidity risk. With respect to regulatory structure, they argue that policymakers should adopt a “twin peaks” approach with a combination of micro- and macro-prudential regulators.

6. Pedersen & Roubini. Lasse Pedersen and Nouriel Roubini, professors at New York University’s Stern School of Business, recently offered a proposal for financial regulation that appeared in the Financial Times. Their proposal is primarily designed to prevent financial crises, not to redesign financial regulation in general. In this regard, it is narrower in scope than the proposals and recommendations discussed above. It is properly included with these other proposals, however, especially because it addresses what most proposals consider a fundamental challenge of financial regulation. Pedersen and Roubini’s proposal is elegantly simple. It employs an existing measure of a bank’s likelih-
ood of contributing to financial crisis and then uses that measure to determine how much capital each bank should be required to hold. Banks would also be required to purchase insurance against the extent of systemic risk they pose. The beneficiary of this insurance would be whichever financial regulator is responsible for addressing and containing financial crisis. The government would participate in this scheme as a partial insurer. According to Pedersen and Roubini, the insurance scheme “would provide incentives for a bank to limit systemic risk (to lower its insurance premium), provide a market-based estimate of the risk (the cost of insurance), and reduce the fiscal costs and the moral hazard of government bail-outs (because the company does not get the insurance payoff).”

7. U.S. Official Sector. As this Article is going to print, the new Obama administration has made it clear that it considers reform of financial regulation a near- to intermediate-term priority. In February of 2009, President Obama gave a speech that he characterized as “a critical first step in developing [a] framework” for a new financial regulatory regime. In this speech, he charged his economic advisors to “develop recommendations for regulatory reform . . . to collaborate with [Congress] . . . so that they can start crafting legislation in the coming weeks and months.” He identified a set of “core principles”: heightened oversight of systemically significant institutions; strengthening the regulatory and financial

70. Id.
71. Id.
72. Id.
73. It also apparent that the U.S. Administration is experiencing pressure from the international community to make quick progress toward reforming the regulation of financial markets. In April of this year, the G-20 countries agreed to address their respective domestic financial regulations. See The Group of Twenty [G-20], The Global Plan for Recovery and Reform: the Communiqué from the London Summit (Apr. 2, 2009), available at http://www.londonsummit.gov.uk/resources/en/PDF/final-communique ("We each agree to ensure our domestic regulatory systems are strong."). The G-20 countries specifically agreed, among other things, to extend “regulation and oversight” to “systemically important hedge funds.” See id.
75. Id.
system so that particular financial institutions are not too big to fail; "openness, transparency, and plain language"; "strong and uniform supervision of financial products marketed to investors and consumers" not based "on abstract models created by the institutions themselves"; executive accountability; elimination of regulatory gaps; and the promotion of strong regulations internationally.  

Two weeks later, Ben Bernanke, Chairman of the Federal Reserve Board, gave a speech at the Council on Foreign Relations in which he discussed broad principles for financial regulatory reform. "[I]t is not too soon for policymakers to begin thinking about the reforms to the financial architecture, broadly conceived, that could help prevent a similar crisis from developing in the future." He identified four key aims of such reform: 1) address the problem that some financial firms have become too big to fail; 2) improve the financial infrastructure; 3) limit pro-cyclicality in regulation; and 4) consider creating a systemic risk regulator. To limit the chances that firms become too big to fail, Bernanke argued that regulators should adopt policies that improve risk management and monitoring, that consolidate supervision of big holding companies, and that improve the way non-bank financial firm failures are resolved. Bernanke also asserted that improving financial infrastructure requires new approaches to clearing and settling complex financial instruments and addressing weakness in the money-market funds.

Following President Obama and Bernanke’s statements, Timothy Geithner, Secretary of the Treasury, announced a set of proposals for reforming U.S. financial regulation in testimony before the U.S. House of Representatives’ Financial Services Committee. Geithner stated that addressing failures in the financial

76. Id.
78. Id.
79. Id.
80. Id.
regulatory system "will require comprehensive reform. Not modest repairs at the margin, but new rules of the game." In this spirit, Geithner outlined a number of proposals that were generally consistent with the previous statements by President Obama and Bernanke noted above. He articulated four general, and now familiar, areas of regulatory concern: "systemic risk, consumer and investor protection, eliminating gaps in our regulatory structure[,] and international coordination." Geithner's testimony focused, however, on proposals to address concerns over systemic risk, including the establishment of "a single entity with responsibility for systemic stability over the major institutions and critical payment and settlement systems and activities." He also proposed to address systemic risk by adopting "more conservative capital requirements," requiring large hedge funds to register with the SEC, and imposing regulations on the over-the-counter derivatives. Perhaps most controversially, Geithner proposed giving federal regulators the kind of authority to address and resolve failures of non-bank financial firms that they currently have to resolve insolvent banks.

C. General Themes

While there is a significant amount of variation in the numerous recent proposals for financial reform, and while most tend somewhat toward the broad and the abstract, there are three noteworthy general themes that emerge from the current discussion and debate on the topic. First, this discussion continues to place a strong emphasis on questions of regulatory structure—the framework of regulatory actors and the allocation of regulatory functions. Some proposals are particularly robust in this respect, like

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82. See Overhauling Financial Regulations, supra note 81.
83. Id.
84. Id. Notably, this articulation suggests that a new entity be created rather than, say, extending new responsibilities to the Federal Reserve.
85. Id.
86. Id.
that of the Committee on Capital Markets Regulation.\textsuperscript{87} Although other proposals do not focus as concretely on structural concerns, these concerns continue to be an important component of most proposals. Many commentators follow the \textit{Blueprint} in calling, for example, for creating or designating an entity that will take primary responsibility for market or systemic stability. Others appear to mean something similar, at least in part, by arguing for a greater focus on macro-prudential regulation. The need for macro-prudential regulation or for systemic risk-management, after all, suggests the need for a regulatory actor to serve this function.

Second, most of the recent literature on financial regulatory reform tends to respond to the determinants of the current crisis and regulatory reforms that will address these problems. Either explicitly or implicitly, most of these recent proposals reflect concerns about the regulation of hedge funds, derivatives, mortgage origination, and credit rating entities—actors and activities that comprise the contemporary list of culprits. They similarly focus on regulatory failures such as “gaps” in the regulatory framework, pro-cyclical aspects of existing regulation, weaknesses in capital requirements, and lax oversight of lending standards. In other words, it seems fair to characterize much of the current discussion of financial regulatory reform as having a distinctly retrospective gaze, even where proposals are cast in prospective terms.

Third, the recent body of literature on financial regulation tends to convey a sense that there is a pressing, if not immediate, need for comprehensive reform in this area. There is a political dimension to this sense of urgency. As the crisis deepens and extends, policymakers, especially elected officials, may feel strong pressures to take clear, immediate, and decisive actions to show that they are responsive to current conditions. This political factor may be heightened as a new federal administration takes office and wants to be seen to repudiate the actions or inaction of the previous regime. There is also a practical dimension to this sense of urgency, an assessment that comprehensive reforms are only possible in the midst, or in the immediate wake, of crisis and disruption. It is important to note, however, that not all commentators share this sense of urgency. As the authors of the Geneva Report write, “hasty responses can have unintended consequences, and can focus on

\textsuperscript{87}. \textit{See Committee on Capital Markets Regulation, supra} note 51.
issues that have the greatest public profile, as opposed to the most significant practical impact.\textsuperscript{88}

II. TOWARD AN APPROACH TO FINANCIAL REGULATORY REFORM

The prevailing themes of the current debate about financial regulation discussed above have the potential to distort any process for meaningful reform. Recent experience will inevitably influence any reform process, but policymakers should guard against a retrospective impulse. Approaching comprehensive reform of financial regulation with particular structural and substantive reforms already in mind may increase the chances that policymakers will make consequential mistakes at a crucial juncture. Furthermore, the sense of urgency over the need to make significant reforms in the near-term greatly increases the chance that policymakers will make such mistakes.

This Part proposes an approach to financial regulatory reform that aims to resist these tendencies of the current discussions on the subject. As explained below, any meaningful reform of financial regulation should proceed first from a comprehensive understanding of the domestic and international financial markets that will emerge from the current crisis. Many of the current proposals are based upon accumulated knowledge of financial firms and markets and build upon an extensive body of scholarship on financial regulation. But a comprehensive process of reform would ideally start with a critical, fine-grained empirical reexamination of developments in the financial sector.\textsuperscript{89} Furthermore, nearly all of the current knowledge and scholarship about financial markets is based on conditions leading up to the current crisis. It is entirely reasonable to expect that market actors will adjust their behavior in light of the recent crisis. A reformed framework of financial regulation should be designed with reference to the actual, on-going nature of the firms and the activities to be regulated. Finally, regulatory and supervisory functions should be allocated (or reallocated) in a way that will maximize the effectiveness of substantive rules identified as necessary or desirable in light of

\textsuperscript{88} Brunnermeier, et al., supra note 3, at 45.

\textsuperscript{89} See STEPHEN BREYER, REGULATION AND ITS REFORM 318–19 (1982) (noting that “empirical investigation [of the industry or program to be reformed] is necessary because existing studies, while academically satisfactory, often suffer from inadequate information” or are out-of-date).
trends and developments in the aftermath of the current financial crisis.

A. Developing a Regulatory Paradigm

Much of the current literature and discussion on financial regulation argues or assumes that there is a need to dramatically overhaul financial regulation in the United States and internationally. Largely missing from the current discussion, however, is any proposal for how policymakers should determine whether significant reforms are needed in the first place or how to proceed with reforms if they are needed. Ideally, the answers to questions of whether and how to proceed with reform should be determined by a coherent, deliberate approach. In other words, principles of the reform process should be identified before substantive principles of regulation are embraced.

In general, surprisingly few scholars or policymakers have attempted to articulate normative accounts of the process of regulatory change. Writing over twenty-five years ago, while still an academic, Stephen Breyer noted that "there is no widely accepted systematic account of the difficulties that accompany the effort to tackle problems through the use of regulation." Breyer's *Regulation and Its Reform* remains perhaps the best attempt to articulate a general approach or framework for the process of adopting and reforming regulation. In that book, he proposed the following approach: study in detail the activity to be regulated, identify policy objectives, examine potential methods for achieving those objectives, and then choose the preferable method.

90. Broadly speaking, most scholarship on regulation and administrative law has tended to focus instead on more substantive questions, including debates over deregulation and cost-benefit analysis. For a good summary of the vast literature on regulation, see Jeffrey L. Harrison, Thomas D. Morgan, & Paul R. Verkuil, *Regulation and Deregulation: Cases and Materials* (2d ed. 2004). It should be noted that the public choice literature does focus on the process of adopting and reforming regulation, attributing that process to factors of political economy, especially interest-group politics. See, e.g., James Buchanan & Gordon Tullock, *The Calculus of Consent* (1962); Daniel A. Farber & Philip P. Frickey, *Law and Public Choice* (1991); Barry M. Mitnick, *The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Forms* (1982).


92. See id.
In a similar vein, Michael Taylor, a financial analyst and former staff member at the International Monetary Fund ("IMF"), has described an approach to reforming financial regulation in particular. Taylor called for rethinking of what he referred to as the "traditional regulatory paradigm" in the financial services sector, which was deeply rooted in the business and legal realities of the 1930s. He argued for developing a new paradigm that would reflect the changes in the underlying structure of the modern financial industry. Taylor was primarily criticizing the Glass-Steagall regime of U.S. financial regulation and suggesting that this regulatory arrangement had been outstripped by developments in financial markets. His work was directed at a different debate over financial regulation than the current one, yet his description of an approach to financial regulatory redesign stands out as one of the most useful discussions on the topic in recent years.

Relying explicitly on Thomas Kuhn’s famous work on paradigms and paradigm change, Taylor defined a “regulatory paradigm” as a combination of three major elements: 1) broad public policy objectives set for the regulatory system; 2) institutional arrangements for administering the set of regulatory requirements flowing from the policy objectives; and 3) specific regulatory methods and techniques used by the agencies entrusted with the task of implementing the regulation. The first element in this definition, public policy objectives underlying a system of financial regulation, includes, among other things, “basic assumptions about the trade-off between efficiency and stability and the extent to which the government could or should seek to indemnify consumers against risk.” These policy decisions generally involve normative judgments and are informed by various theories regarding the nature of the regulated industry and the potential dangers of leaving it unregulated.

The second element in Taylor’s definition of a regulatory paradigm, the institutional arrangements, includes, for example,

94. Id. at 793.
95. See supra note 21 and accompanying text.
97. See Taylor, supra note 93, at 794.
98. See id.
“the manner in which regulation is organized, the basis on which agencies are structured, and the type and nature of the powers that are conferred on them.” Finally, the last element of Taylor’s notion of regulatory paradigm, the methods and techniques used by regulators to discharge their tasks, encompasses, among other issues, “the type and nature of the information that regulators gather from regulated firms, the standards they apply and the methods they use to ensure compliance with those standards, and matters like the kinds of knowledge and expertise regulatory personnel must possess.”

Focusing primarily on banking, Taylor used this framework to argue that the then-existing system of regulation was based on a set of assumptions about the structure and the operation of the financial services sector dating back to the Great Depression era. Taylor argued that this framework had failed to keep pace with the changes in the global financial market, especially in the period starting in the 1980s. This assessment was consistent with much of the criticism of financial regulation at the time, which helped lay the foundation for the significant reforms of the Gramm-Leach-Bliley Act of 1999. According to Taylor and others, the traditional regulatory paradigm, at least as it applied to the banking field, reflected the New Deal’s strong policy preference for preserving financial stability at the expense of promoting competition. Restrictions on bank activities, government guarantees, and deposit insurance were designed in large part to address risks to the financial system. This fundamental policy objective also shaped

99. Id.
100. Id.
101. Id. at 795.
102. Id. at 800.
104. Taylor, supra note 93, at 795.
the institutional structure of the financial services regulation and supervision conducted largely along sectoral lines and based on “clear segmentation of markets and products between debt, equity, and insurance contracts.” Finally, periodic assessment of banks’ capital adequacy, viewed as a standardized measurement of individual institutions’ prudential soundness, became the central technique of supervising banks under the traditional paradigm.

By the end of the twentieth century, the financial services industry had entered the period of a revolutionary change in the conduct of its business, which arguably eroded the foundations of this regulatory paradigm. Mainly as a result of technological innovation and deregulation in recent decades, the financial system had become more profitable, competitive, and volatile. However, the basic assumptions built into the regulatory framework remained unquestioned, and the full regulatory implications of the radical transformation in the risk profile of modern financial institutions were not sufficiently understood or even acknowledged.

Taylor’s call to arms was clear:

Only if we recognize that we are in the middle of a regulatory paradigm change can we begin to deal with what appears to be the crisis of regulation in the developed economies. This means to be prepared to think radical thoughts about the aims, scope, and techniques of regulation.

Today, twelve years after the publication of Michael Taylor’s essay, we have yet to rise to this challenge. In the wake of what is commonly understood to be the worst financial crisis since the Great Depression, it is now painfully apparent that policymak-

105. Id. at 795.
106. According to Taylor:
[T]he increased emphasis by banks on trading activities, the globalization of their activities, and their incorporation into diversified conglomerate group structures conducting a range of banking, securities, and insurance business, as well as the blurring of distinctions between debt, equity, and insurance contracts, all necessitate a rethinking of the traditional regulatory paradigm.

Id. at 798.
107. Id. at 800.
108. Id. at 797.
ers need to grasp fully the depth and breadth of paradigmatic changes in the financial industry to address the resulting weaknesses of the regulatory framework. Yet, doing so requires a comprehensive, holistic approach to the reform process, rather than a set of distinct structural or substantive "fixes" to the system.

B. The Approach

The frameworks set forth by Breyer and Taylor provide useful points of departure for developing an approach to, or process for, meaningful reform of financial regulation. Both suggest that a financial regulatory paradigm should be determined by the nature of the financial industries that it will regulate. Rules and regulations should be crafted to respond to the risks created by products, services, and activities. Regulatory structure should then be designed to implement the rules and regulations deemed to be desirable. While most contemporary commentators on financial regulation would likely agree with these points, they appear to overlook an important implication of this approach—that a change in the regulatory paradigm must be predicated on a comprehensive understanding of the prospective risks in the financial sector.

The process of redrawing the U.S. financial regulatory framework should be strategically sequenced. Effective regulatory modernization should start with an assessment of the actual arrangements of the financial sector and the behavior of market participants. Thus, current proposals regarding the regulation of specific products or market segments (such as credit default swaps, asset securitization, mortgage lending, and hedge funds) skip a crucial step of assessing system-wide dynamics affecting these market segments and the ongoing risks posed by particular financial products, especially as these dynamics and risks may evolve in the wake of the current crisis. If policymakers move directly to reform regulatory structure or substantive rules without a fine-grained assessment of the forces behind specific instances of market failure and of the post-crisis shifts in market practice, they risk adopting regulatory reforms that are either incomplete or tailored to obsolete circumstances. Emphasizing the particular determinants of the current crisis may cause policymakers to underestimate the likelihood that private market actors will adjust to the effects of the bursting of the latest asset bubble by redirecting the flow of capital, and risk, elsewhere.

An approach grounded primarily or exclusively in the recent experience is inherently reactive and retrospective in its focus
and ignores the likelihood that the post-crisis market will emerge in ways that create the potential for unfamiliar market failures and systemic risks.\textsuperscript{109} Thus, it is desirable that any process of designing a new financial regulatory regime or paradigm be delayed for as long as it takes the global financial system to stabilize and for the contours of re-emerging financial markets to begin to take shape. At the very least, it should be delayed as long as it takes to conduct a meaningful post-crisis inventory of financial markets.

It is worth noting that there are additional, perhaps independent, reasons for resisting the temptation to embark immediately upon significant structural or substantive reforms to the existing system of financial regulation. Chief among these is the fact that the United States is in a moment of financial and economic crisis and crisis-containment. In any context, hurried sweeping reforms may increase the chances of future regulatory failure. This danger may be elevated where the subject of regulation is still roiling in crisis. In recent months, a number of writers have explored the legal and regulatory implications of the current efforts to contain and, hopefully, resolve economic crisis.\textsuperscript{110} Much of this work has been focused on actual and potential responses to the current crisis and has evaluated the legal bases for these responses or approaches. Anna Gelpert has made an important contribution to this literature, arguing that crisis containment should be understood as a


distinct legal or regulatory enterprise.\textsuperscript{111} Using historical examples, she illustrates that containment involves a recurring set of policy choices.\textsuperscript{112} These choices include determining whether responses should be wholesale or ad hoc and distributing the ex post costs of containment.

For present purposes, the crucial point of Gelpen's work is this: crisis containment is categorically different from regulation or regulatory reform. As she writes:

> Containment measures are often conflated with financial regulation, crisis prevention and resolution. Unlike containment, these are long-term projects that share the goal of entrenching sound economic incentives, often embodied in positive rules. In contrast, containment is urgent and brief, defined by rule-breaking, claims of exception and the dearth of positive law. The paramount goal is 'to stop the bleeding'; the long view falls by the wayside.\textsuperscript{113}

Gelpen's work on containment does not explicitly aim to propose an appropriate sequence of, or timing for, containment, resolution and regulation. It is entirely possible, for example, that policy-makers could pursue containment and regulatory reforms concurrently; Gelpen's point is that these projects should be carefully distinguished. Her work provides a strong basis, however, for caution against attempting to conduct long-term regulatory policy-making or reform while engaging in crisis-containment. At the very least, doing so creates significant risk that containment and regulation will be confused with each other in ways that undermine both projects. This is especially troubling if containment policies are likely to be in tension with "peacetime" regulatory approaches.

\textsuperscript{111} Anna Gelpern, \textit{Financial Crisis Containment} (Working paper, 2009) (on file with the authors) (citations omitted).

\textsuperscript{112} For another insightful analysis and a taxonomy of crisis containment policies pursued by governments of different countries in recent years, see Charles W. Calomiris, Daniela Klingebiel & Luc Laeven, \textit{Financial Crisis Policies and Resolution Mechanisms: A Taxonomy from Cross-Country Experience}, \textit{in Systemic Financial Crises: Containment and Resolution} 25 (Patrick Honohan & Luc Laeven eds., 2005).

\textsuperscript{113} Gelpen, supra note 111 at 6.
This Article expands on Gelpern's work in arguing that crisis containment and regulatory reform should be separated not only conceptually but temporally as well. In other words, regulatory reform should, ideally, not be conducted at the same time as policymakers are attempting to contain a crisis. To some extent, this is due to factors that Gelpern describes—containment likely requires actions that are inconsistent with effective long-term or peacetime regulation.\(^1\) Containing a crisis will be difficult enough on its own. It may be even more difficult to take such containment actions that are in direct tension with a regulatory framework proposed for the post-crisis period.\(^1\) Furthermore, tackling containment and regulatory reform concurrently may increase the possibility that regulatory policymaking will be distorted by the politics of containment, especially if policymakers are concerned about the legal bases for their containment measures.

Imagine, for example, that policymakers suppose that a future regime should explicitly grant an agency authority to intervene in certain types of transactions (say, to void a contractual obligation). Proposing such a rule might be construed as an admission that the agency does not currently have the authority to take actions that may be important for containing the current crisis. Finally, there are other, perhaps more practical reasons to treat the projects of crisis-containment and regulatory reform as separate and sequential processes. Until a crisis is contained, it may simply not be possible to determine which firms will survive the crisis, what types of activities they will conduct, and what types of risks they will pose.

The unique significance of the current historic juncture magnifies all of these concerns. It would be a shame to waste this rare, and real, opportunity to transform the system of financial services regulation by diverting legislators' attention and energy toward partial, insufficient, or misguided solutions. Thus, a compre-

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114. Importantly, the immediate crisis containment measures frequently remain a part of the long-term policy responses and shape the post-crisis regulatory outcomes. *See* Calomiris, Klingebiel, & Laeven, *supra* note 112, at 28.

115. The proposal by Secretary Geithner to expand the resolution authority of federal regulators provides a helpful illustration of this possibility. Although this authority may be necessary to help resolve or contain the current financial crisis, it may not be a sound policy going forward. If not, skepticism about the long-term benefits of such policy may cause policymakers to deny it to regulators in the short-term.
hensive modernization of the U.S. system of financial sector regulation and supervision should take place after the current crisis recedes and should ideally proceed in three conceptually distinct steps: 1) an in-depth analysis of the current structure, business and risk profile of the U.S. financial services sector; 2) a reassessment of the broad policy objectives and substantive regulatory methods of achieving such objectives; and, finally, 3) a structural reform, or agency reorganization.

1. Step One: Taking Inventory

As discussed above, an effective program of regulatory reforms requires a clear and thorough understanding of the current state of affairs in the regulated industry. Therefore, it is crucial that any affirmative recommendations on reforming the substance or the institutional design of financial regulation be based on, and grow directly out of, an in-depth analysis of the fundamental trends in the business and structure of the financial services sector. In other words, the initial inquiry is "What and whom should we regulate?"

It may be possible to anticipate many of the conclusions of this inventory-taking exercise, and the recent proposals for financial regulatory reform go far in this direction. The first global financial crisis of the twenty-first century has made it abundantly clear that the business and risk profile of today's financial services industry has changed significantly since the 1930s, when the basic framework of the U.S. financial regulation was put in place. Various structural factors, including increasing globalization of financial markets, growth of large financial conglomerates with international operations, convergence of financial products and services traditionally offered by institutions separated by sectoral lines, and rising importance of institutional investors, have rendered many of the traditional regulatory boundaries among different categories of financial institutions such as commercial banks, thrifts, securities and insurance firms, etc., largely meaningless and inefficient.

116. See, e.g., BREYER, supra note 89, at 318–39 (advocating a "[d]etailed empirical investigation of the industry or program in question" as a crucial first step of regulatory reform).

Thus, the first step in the process of a comprehensive regulatory reform should focus on re-drawing the relevant boundaries within the modern financial services sector, that is, redefining the relevant segments of the industry and assessing the key risks inherent in each segment.

This initial step involves taking an inventory of the financial institutions and key market participants with the goal of developing a thorough, concrete, and up-to-date picture of the financial industry's composition and operation in the wake of the crisis. How many commercial banks, securities firms, insurance underwriters, mutual funds and other collective investment funds are there? What are their average size, geographic footprint, revenue and asset base, ownership structure, affiliations, regulatory status? Who are their customers and what types of services do these institutions provide to their customers? What types of financial products do these institutions deal, trade or invest in? Which of these services and products constitute significant or, conversely, insignificant sources of the financial institutions' revenues, and how is this changing over time? These are examples of questions that should be answered in the process of this inventory-taking.118

This inventory will enable policymakers not only to identify “systemically important institutions” but also to understand the real reasons that made them systemically important. Most of the recent regulatory reform proposals would distinguish between systemically important financial institutions and other institutions for regulatory purposes.119 Some of the proposals suggest broad criteria for defining which financial institutions are systemically important, individually or as part of a group.120 Even assuming that it is


119. See supra notes 23–25 and accompanying text.

120. See, e.g., THE GROUP OF THIRTY, supra note 27, at 19 (arguing that size, leverage, scale of interconnectedness, and role in infrastructure services are the four key characteristics of “systemically significant” financial institutions); Brunnermeier, et al., supra note 3, at 23–34 (suggesting to use the objective risk-spillover measure to determine the degree of systemic importance of finan-
possible to identify such criteria *ex ante*, actually sorting firms in or out of this category would presumably require a survey of the substantive scope of institutions’ ongoing business activities. Moreover, getting a clear up-to-date picture of all of the activities of the largest or potentially systemically important financial institutions and their affiliates would also help policymakers understand and gauge the true scale of potential risk to systemic stability associated with such institutions’ activities.

Despite its seemingly mundane nature, this is arguably the most important step in the process of redesigning the financial services sector regulation. Admittedly, this broad inventory-taking is likely to be the most time-consuming and labor-intensive phase in the reform process. It will require careful planning, organization and a truly cooperative long-term effort by the industry and the relevant policymakers, not an easy feat to achieve. Furthermore, from a political perspective, calling for an exhaustive study of a financial institutions). Some proposals simply call for the relevant regulatory agencies to identify systemically important institutions in their relative areas of the financial markets.

121. For instance, as the GAO points out:
Identifying which institutions and which of their products and services pose similar risks is not easy and involves a number of important considerations. Two institutions that look very similar may in fact pose very different risks to the financial system, and therefore may call for significantly different regulatory treatment. However, activities that are done by different types of financial institutions that pose similar risks to their institutions or the financial system should be regulated similarly to prevent competitive disadvantages between institutions.


122. For example, a large financial institution may hold a significant share of nationwide retail deposits and loan assets, play the key role in the financial infrastructure (such as, for example, the payments, clearing and settlement systems), conduct major dealing and market-making activities in global derivatives markets, run sizeable proprietary investment funds, and engage in active trading and dealing in physical commodities and energy. The sheer size of its balance sheet and infrastructural functions make this institution “systemically important,” which might deflect regulatory attention from its derivatives dealing or commodity trading businesses. Only a detailed survey of its business activities, ownership structure, and intra-company transactions can reveal the full array of potential systemic risks that an institution presents and, ultimately, inform the regulatory approach to mitigating such risks.
complex phenomenon, which has a veneer of a tedious and largely academic exercise, lacks the political payoff potential and the general appeal of putting forward a ready-made policy prescription or a legislative proposal.

Nevertheless, a thorough empirical examination of the structure and functioning of the financial industry is an indispensable first step in determining how to regulate it, especially in the wake of the current global crisis. The very process of a collective, cooperative inventory-taking can bring together all of the relevant constituencies—the financial institutions and other private market participants, federal and state regulators, legislators, consumer advocates, and academics—thereby creating a solid basis for future collaboration in the formulation and implementation of desirable reforms.  

2. Step Two: Assigning Priorities, Identifying Rules

Once policymakers have taken a comprehensive inventory of the post-crisis financial system, they would then need to perform two interconnected tasks: 1) articulate the broad policy objectives regarding the principal risks associated with the types of business conducted by each identified segment of the financial services sector, and 2) outline the key regulatory tools and methods available for achieving such objectives. Thus, the key inquiry at this stage in the process is “Why and how should we regulate?”

123. In some respects, the process envisioned by the drafters of the Uniform Commercial Code provides an early model of the kind of empirically based, collaborative lawmaking endeavor proposed here. See William Twining, Karl Llewellyn and the Realist Movement 278–92 (1973). It is important to note, however, that the Code’s drafter’s did not exactly follow the model often attributed to them. See Lisa Bernstein, The Questionable Empirical Basis of Article 2’s Incorporation Strategy: A Preliminary Study, 66 U. Chi. L. Rev. 710, 713 n. 13 (1999) (“[W]ith the exception of seeking (and then ignoring) the opinions of merchants in hearings on the Code . . . rigorous empirical research into what types of rules would actually be responsive to merchant concerns was never undertaken.”).

124. See, e.g., GAO-09-216, supra note 25, at 49–50 (emphasizing that reform of financial regulation should be based on detailed reassessment of the goals of regulation in that context).

125. In the area of bank regulation, for example, the most familiar of such regulatory methods include restrictions on commercial banks’ investments and activities, capital adequacy requirements, reserve requirements, limitations on
At this stage, the conceptual focus shifts primarily to defining the parameters within which various regulatory techniques guard against or limit specific risks and create the right incentives and disincentives for private market actors. In effect, this step in the reform process would involve an evaluation of the utility and effectiveness of the current, as well as potential, tools of financial regulation in achieving the newly defined public policy goals in the complex environment of today's financial markets. A detailed understanding of the business and risk profiles of modern financial institutions will allow policymakers to redefine and re-prioritize regulatory objectives and to align them more effectively with the risks embedded in financial market practices and activities.

Again, most of the policy objectives that are likely to be identified at this stage can be anticipated. As the recent reforms proposals suggest, the list of key policy objectives will likely include some or all of the following: protecting customers of financial institutions from overreaching and fraud, ensuring systemic stability, preserving the safety and soundness of financial institutions, containing conflicts of interest, and broadening access to and allocation of credit. This stage of the reform process should build upon and incorporate theoretical insights and policy proposals advanced by various commentators in recent years, including those discussed above, and should involve a full and comprehensive examination of those proposals. The reform process advocated in this Article would thus bring into a sharper focus the critically important debate that is occurring in the midst of the crisis containment and that is frequently overshadowed by the debate over institutional structure of regulatory oversight.

As discussed above, the emerging literature on financial regulatory reform includes proposals to ensure consistent regulation and supervision, on a consolidated basis, of all systemically important financial institutions, including currently unregulated hedge funds and other pools of private capital, and to revise international capital adequacy standards by raising the quantitative benchmarks for capitalization and correcting their harmful tenden-

transactions with affiliates, periodic reporting and public disclosure of financial information. See infra notes 136–38 and accompanying text.

126. See supra notes 7–88 and accompanying text (discussing some of the recent proposals for regulatory reform in the financial sector).

127. See, e.g., MODERNIZING, supra note 3, at 22–24; THE GROUP OF THIRTY, supra note 27, at 28–32; Brunnermeier, et al., supra note 3, at 23–27.
This literature also addresses such issues as establishing formal regulatory oversight of over-the-counter derivatives markets, increasing transparency of and enhancing disclosure requirements applying to complex financial instruments, tightening the rules governing executive compensation in the financial sector and operation of credit rating agencies, enhancing the system of consumer protection, and creating effective channels of international cooperation and coordination among financial regulators and supervisors. This body of literature should serve as a solid analytical basis for the systematic assessment of the regulatory goals and methods to be conducted at this second stage in the reform process. When grounded in the empirical analysis of the risks inherent in the operation of today’s financial services industry, these ideas will inform the process of designing the regulatory toolkit necessary to achieve the newly formulated and prioritized public policy goals.

As part of this dual-track exercise of articulating regulatory objectives and lining up regulatory techniques, policymakers will have to define and redefine key regulatory boundaries within the financial industry. Which types of business activities or market segments should be grouped together and be regulated under a common scheme? Conversely, which types of activities or market segments should be separated for regulatory purposes? And should such activities be conducted in separate entities subject to different regulatory regimes? These decisions are likely to be based, among other factors, on the types of risks embedded in the nature of the given business activities, the dynamics of the relevant

129. See, e.g., MODERNIZING, supra note 3, at 28–30; THE GROUP OF THIRTY, supra note 27, at 52–53.
130. See, e.g., THE GROUP OF THIRTY, supra note 27, at 55–56; Brunnermeier, et al., supra note 3, at 51.
131. See, e.g., MODERNIZING, supra note 3, at 37–40; THE GROUP OF THIRTY, supra note 27, at 40–41; Brunnermeier, et al., supra note 3, at 45–49.
132. See, e.g., MODERNIZING, supra note 3, at 40–45; THE GROUP OF THIRTY, supra note 27, at 50–51; Brunnermeier, et al., supra note 3, at 50.
133. See, e.g., MODERNIZING, supra note 3, at 30–37.
134. See, e.g., MODERNIZING, supra note 3, at 45–46; THE GROUP OF THIRTY, supra note 27, at 37–38.
market, and the role of various types of financial institutions within these markets.

Perhaps the most challenging aspect of this process will be the need to reexamine the existing regulatory framework in light of the conclusions policymakers reach about the desirable goals and scope of financial regulation. The current framework is based largely on boundaries determined by the legal status of regulated entities, and it may be necessary to identify alternative grounds for redrawing such boundaries. Thus, an important element of this exercise involves assessing the current arrangement of substantive rules and regulations governing financial markets in relation to newly compiled empirical industry data. The objective here is to map out the existing regulatory terrain with a critical view toward the key points of tension between the regulatory and supervisory principles and methods on the one hand and the changed risk profiles of financial institutions and markets on the other.

Prior academic studies and recent proposals for financial regulatory reform have identified a number of such regulatory points of tension in the existing framework, particularly in the banking sector. For example, the existing system of regulation and supervision of commercial banks in the United States is aimed at protecting the safety and soundness of the banking system. This aim is fundamentally tied to the need to minimize the risk of bank runs and other risks posed by the asset-liability mismatch inherent in the traditional deposit-taking-and-lending model of banking business. Consequently, many of the existing regulatory tools were designed to shape banks’ balance sheets by imposing capital

135. The existing system of vertical regulatory “silos” in the United States is sometimes characterized as “functionally-based” or product-based. More generally, though, in the United States’ highly fragmented system of financial regulation and supervision, the applicability of a specific regulatory regime depends on the type of charter, license, or authorization that is required for an entity to conduct certain business and offer certain regulated financial products and services. For example, the same function of lending is subject to regulation under different regimes when conducted by commercial banks, securities broker-dealers, or finance companies. See, e.g., THE GROUP OF THIRTY, supra note 27, at 34–35.

requirements and limitations on investments and activities. ¹³⁷ Other regulatory policies and institutions were created to help insulate banks from depositor runs by guaranteeing banks' obligations to their retail depositors and by providing access to temporary sources of liquidity. In recent decades, however, large United States banks have been actively diversifying away from the traditional model of spread-based business of deposit-taking and lending. Increasingly, banks have pursued activities tied to global capital markets, such as investment banking and dealing and trading in equity and commodity derivatives and structured products. ¹³⁸ These trends raise a serious question about the continuing ability of bank regulators and supervisors to monitor and minimize risks inherent in these new, more volatile, lines of banks' business. ¹³⁹

Similarly, the current system of regulation of U.S. securities firms and investment banks generally assumes that they act primarily as fee-earning agents for third parties participating in capital markets such as issuers of securities, investors, and so forth. Thus, the U.S. securities laws are designed to ensure the integrity of the capital markets and protect U.S. investors, particularly retail investors, from fraud and overreaching by securities broker-dealers, underwriters, investment advisors, and other types of professional intermediaries. ¹⁴⁰ Since the 1980s, however, investment banks and securities firms have been rapidly growing other lines of business, including lending and deposit-taking, securitization, prime brokerage, derivatives dealing and trading, and have become increasingly dependent on proprietary trading in a wide variety of

¹³⁷ GROUP OF THIRTY, supra note 27, at 34–35; see also KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION AND EFFECTS (2000).


¹³⁹ See generally GAO-08-32, supra note 117.

¹⁴⁰ For a detailed discussion of the U.S. system of securities regulation, see generally THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION (2009); LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION (2008).
financial assets. As a result, the risks these institutions carry on their books, as well as potential risks they themselves present for the financial system, are qualitatively different from the risks embedded in the traditional securities brokerage or underwriting business. The disclosure-based regulatory regime is arguably not geared toward addressing these new risks.

This much is known. However, these observations are simply meant to illustrate the types of regulatory points of tension policymakers should expect to discover in the course of mapping regulatory goals onto the post-crisis financial system. With the results of a thorough inventory-taking in hand, policy makers should be able to successfully identify the weak spots within the existing regulatory system and the critical mismatches between that system and risk profiles of modern financial markets.

To be clear, this Article does not advance any concrete hypotheses with respect to the optimal regulatory re-alignment in the financial services sector. To the contrary, it eschews a reform process based on such hypotheses. There may be several methods of drawing the regulatory and supervisory lines: by product or function, target customer base, size and complexity of operations, and so forth. It is essential to keep an open mind about the outcome of this inquiry. In the process of gathering, processing, and analyzing empirical information about today's financial industry, the outlines of potential new substantive approaches to regulation and supervision will inevitably begin to take shape. Once certain patterns and trends in the structure and dynamics of the financial markets become more visible, it will be easier to revisit (and per-


142. For general discussion of inadequacy of disclosure-based regulatory regime in the era of complex financial transactions, see Steven L. Schwarcz, Disclosure's Failure in the Subprime Mortgage Crisis, 2008 UTAH L. REV. 1109 (2008).

143. The data collected during this initial phase in the process of regulatory reform may suggest, for example, that the main segmentation line in today's financial services sector should be drawn along the horizontal axis (separating wholesale and retail financial markets) rather than the existing vertical one (separating different "product" lines).
haps retire) some of the old ideas on how to fix the regulatory system and to discover new ones.

Finally, it should be emphasized that, at this intermediate stage in the process of regulatory reform, the ultimate goal is broader than formulating policy priorities or outlining the contours of substantives rules governing the conduct of private market participants. It is equally important to identify the most effective and efficient modes of interaction between the regulators and the regulated, which may vary across different segments of the financial services sector. Thus, in effect, this step in the paradigm-building project should be aimed at developing a comprehensive and self-reflective regulatory philosophy. Recent literature on regulatory philosophy has largely focused on contrasting a more traditional concept of rigid top-down financial regulation with a more flexible approach to financial regulation as a cooperative state-industry enterprise. Much of this debate in the financial services context has revolved around the juxtaposition of so-called principles-based and rules-based regulation. Not surprisingly, proposals to insti-

144. There is a growing body of inter-disciplinary scholarship exploring the increasingly polycentric, negotiated, and collaborative nature of regulation in modern world. This “new governance” literature is a potentially rich source of new ideas and approaches to redefining the balance between public and private governance in the financial services sector. See, e.g., IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992); Scott Burris, Peter Drahos & Clifford Shearing, Nodal Governance as an Approach to Regulation, 30 AUSTL. J. LEG. PHIL. 30 (2005); Jody Freeman, Collaborative Governance in the Administrative State, 45 UCLA L. REV. 1 (1997); Orly Lobel, The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought, 89 MINN. L. REV. 342 (2004); Michael Moran, Understanding the Regulatory State, 32 BRIT. J. POL. SCI. 391 (2002).

stitute a "principles-based" regulatory system in the United States, drawing heavily on the experience of the United Kingdom's recent experiment with this approach, led many commentators to question the ideological basis and practical effectiveness of such an approach.

The approach advocated here would allow policymakers to move beyond a retrospective stance and place these crucial questions in a proper empirical context. There are real dangers to identifying an appropriate regulatory philosophy before embarking on a systematic quest to understand the emerging financial services landscape. A regulatory philosophy should, ideally, emerge gradually and organically from the analysis and synthesis of the industry data gathered at an initial stage and the assessment of the effectiveness and proper scope of substantive rules and regulatory techniques. Thus, for example, the right balance between top-down regulatory prescriptions and mandates, on the one hand, and bottom-up private industry self-regulation and self-monitoring, on the other, may differ across segments of the financial services sector. Finding such balance depends fundamentally on the dynamics and risk profiles of individual industry segments (as defined during the first stage of the reform process), as well as the policy objectives

more collaborative and iterative "new governance" regime in securities regulation).

146. It is worth noting that, on March 18, 2009, the Chairman of the UK FSA, Lord Adair Turner, published a report laying out his recommendations for a regulatory overhaul of the UK's financial regulation and supervision. See THE TURNER REVIEW, supra note 29. This report essentially envisions abandoning UK FSA's "light-touch" approach to regulation in favor of a more intrusive, and potentially more strictly rules-based, oversight. Id.

147. See, e.g., Lawrence A. Cunningham, A Prescription to Retire the Rhetoric of "Principles-Based Systems", in Corporate Law, Securities Regulation and Accounting, 60 VAND. L. REV. 1411 (2007) (arguing that any rhetoric juxtaposing "rules-based" and "principles-based" regulatory systems is, in fact, misleading and politically motivated); see also JULIA BLACK, RULES AND REGULATORS (1997) (suggesting combining different types of rules as one potential strategy for addressing certain inherent regulatory problems, including the issue of certainty and flexibility in regulation); John Braithwaite, Rules and Principles: A Theory of Legal Certainty, 27 AUSTL. J. LEG. PHIL. 47 (2002) (arguing that legal certainty and consistency of regulatory outcomes in complex regulatory domains are most effectively achieved through an appropriate mix of rules and principles, rather than through the use of principles alone).
and regulatory techniques designed to address the risks specific to each such segment.

3. Step Three: Designing the Architecture, Dividing Responsibilities

The final step in developing a new regulatory paradigm should be to design an institutional regulatory structure closely aligned with the underlying structure and profile of today’s financial services industry and explicitly geared toward achieving the key policy objectives identified earlier. Thus, “Who should regulate?” becomes the last inquiry in the proposed three-step process of reforming the financial regulatory paradigm.

Moving the institutional design of financial regulation to the last stage of the process of developing a new regulatory paradigm would help policymakers avoid recreating any existing misalignments between business realities and regulation. It would also help them focus initially on the substance of the much-needed legal and regulatory reform and perhaps help to dampen political battles over turf and influence. Most important, this approach explicitly acknowledges that an effective and efficient system of regulatory agencies cannot be “discovered” in the abstract before one determines the what, whom, why, and how of financial sector regulation. The ultimate shape of the institutional structure of financial regulation should thus emerge as a logical outcome of the first two steps in the process, described above.

At this final stage of the reform process, it will be useful to critically examine the various existing approaches to the structure of financial regulation and supervision. Generally, these include institutional/functional, integrated, and “twin-peaks” approaches. Under an institutional or functional approach, the jurisdictional lines of regulation are drawn primarily among different categories of market participants defined by their legal status (banks, broker-dealers, insurance underwriters, etc.) or among types of products (banking products, securities, insurance, etc.). This is essentially the structure currently existing in the United States. An integrated


149. See THE GROUP OF THIRTY, supra note 27, at 34.
regulatory structure envisions the concentration of regulatory and supervisory power in a single “super-regulator,” such as the UK FSA.\textsuperscript{150} Under a “twin-peak” approach, followed in Australia and advocated in the Blueprint, regulation and supervision responsibilities are divided between a prudential regulator occupied primarily with the safety and soundness of financial institutions and a market conduct regulator focusing mainly on market integrity and prevention of market abuses.\textsuperscript{151}

Another potential alternative that may be added to this list of structural options is a “three-peak” structure of financial sector regulation and supervision. In contrast to the Blueprint’s model, this proposal would divide agency powers and responsibilities not along vertical lines based on the subject-matter of regulation and supervision ("safety and soundness" and "business conduct") but along horizontal lines. Under this model, one agency would regulate and supervise the wide variety of retail financial service providers and markets. A separate, smaller and more nimble, agency would regulate and supervise the wholesale financial services providers and markets in complex financial instruments. These two agencies would pursue the same general policy objectives, including both safety and soundness of financial institutions and market conduct. In addition, they would likely utilize similar regulatory techniques, such as capital adequacy requirements, periodic reporting, and examinations. Yet, their specific policy priorities and philosophies may differ.

A third agency, a systemic regulator, would exercise across-the-board oversight aimed primarily at preventing system-wide disruptions and ensuring regulatory consistency and general market integrity across both segments of the financial system. In addition to providing an integrated framework for the operation of the two other key agencies, such a systemic regulator would be responsible, among other things, for regulating issuance of securities, operation of exchanges and trading platforms, rating agencies and public accounting firms, payments and clearance and settlement systems, as well as monitoring system-wide compliance with anti-money laundering laws and regulations. Under this scheme, the systemic regulator would be an entity separate from the central

\textsuperscript{150} See supra note 52 and accompanying text.

\textsuperscript{151} See Blueprint, supra note 1; GAO-05-61, supra note 149.
bank, whose primary functions would be to conduct monetary policy and to act as a lender of last resort.\textsuperscript{152}

There are many variations of each of these structural arrangements of financial sector regulation and supervision. It is not the purpose of this Article to propose a definitive structural solution. To the contrary, all models should be on the table and should be considered as potentially viable alternatives—no single structural proposal should be determined as an \textit{a priori} superior one. Once policymakers clearly understand the structure, operation, and risk profile of the financial services sector, define and prioritize policy objectives, and identify key clusters of regulatory techniques and methods, it should become significantly easier to assign regulatory and supervisory responsibilities and draw jurisdictional lines among regulatory agencies. The ideas and knowledge accumulated in the course of debating the structural reforms in recent years will be invaluable in informing and shaping this deliberative process. However, placing these discussions in the context of a thoughtfully sequenced reform process would prevent them from obscuring the more fundamental substantive issues involved in designing a new regulatory and supervisory regime that would reflect and respond to the actual risks inherent in the current business activities of financial services providers.

\textbf{C. Managing the Process}

The three-step approach to regulatory reform described above will require a sustained collective effort on the part of all constituencies with a stake in the financial services sector. As a practical matter, this may be extremely challenging. It will presumably require, for example, negotiating long-standing differences and entrenched rivalries among various existing regulatory entities. It will also require delicate balancing of a wide range of political and economic interests.

There are ways to organize a reform process to successfully navigate these challenges, however. It might be desirable, for example, to set up a fully independent panel appointed by and reporting directly to either Congress or the President and comprised of high-level representatives of all federal and state regulatory agen-

\textsuperscript{152} Although, in some sense, it might be more accurate to describe this approach as a "four-peak" structure, such description would obscure the fact that this model does not allocate any supervisory responsibilities to the central bank.
cies, financial institutions, consumer organizations, and prominent scholars. Another potential vehicle for conducting the reform process would be an interagency commission, established and overseen by the Department of the Treasury or directly by the President. An interagency commission could bring together the heads and other designated officials of the federal and state regulatory agencies (including the Department of the Treasury, the Federal Reserve, the OCC, the FDIC, the CFTC, the OTS, and so forth) and include industry and consumer representatives, and academic experts.

It may also be possible to organize a more decentralized and less formal process of financial regulatory reform that adheres to basic approach proposed in this Article. A decentralized process might allocate distinct components of the reform process (e.g., empirical investigation, formulating goals, and designing institutional structure) to some combination of research and policymaking entities. Such a process would require a broad framework and some institutional coordinator for reconciling and synthesizing the work of these various entities.

It is not the aim of this Article to advocate a particular plan for managing the process of reforming the regulation of financial markets. Rather, this section suggests some potential arrangements for managing that process. Whatever form it takes, however, the entity that manages or coordinates the process of regulatory reform will need to have sufficient autonomy and authority to do so, perhaps including the power to issue calls for public comment on specific issues, to hear testimony, and to request information it deems necessary. It would need to have authority to produce reports and recommendations on the long-term regulatory reforms in the financial sector and to draft legislative proposals based on its findings and conclusions. This entity should have permanent staff and the necessary resources to carry out its work in an effective and truly independent manner. Most importantly, this panel or commission will need the strong political support of Congress and the President. That political support will itself shape the expectations and political calculations of the various actors involved in the reform process and can thereby contribute to its ultimate success.

III. CONCERNS AND OBSTACLES

This Part notes a number of potential objections and practical challenges to the regulatory approach articulated above.
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Three of these important challenges are essentially variations on a single theme: the timing of reforms. There is an additional challenge that is not a function of timing: it may be unreasonable to believe that a comprehensive approach to regulatory reform is feasible even where there is political will. More modest reforms or tinkering with the existing paradigm may be the most feasible and least risky way to bring about beneficial changes in financial regulation.

A. Timing Issues

1. Letting the Cat Out of the Bag. It may be argued that delaying the process of strategic overhaul of financial regulation will essentially let the cat out of the bag, allowing post-crisis products, activities, and practices to become entrenched. If regulatory reform is based on an empirical assessment of re-emergent capital markets and a comprehensive evaluation of regulatory goals, this process will likely take a significant amount of time. It is hard to imagine that such a process could yield meaningful results in less than a year. There is reason to be concerned that, within this amount of time, post-crisis arrangements will become settled—firms will consolidate, they will invest in developing particular products and services, and they will begin marketing these services and products to other firms, consumers and investors. As a result, important private actors will become significantly committed to maintaining these new, perhaps fragile, arrangements. If so, crucial aspects of the post-crisis organization of capital markets may be impossible to unwind, even if policymakers determine subsequently that they should be curtailed or rearranged. Similarly, allowing financial markets to reorganize after the crisis may squander opportunities to shape the structure of re-emergent financial firms and markets.

2. The “Stickiness” of Crisis Containment. As noted above, it is important to remember that this is a moment of economic crisis and to distinguish regulatory reforms from government policies designed to contain and to resolve an acute crisis. That said, actions taken to contain and to resolve the current crisis may constrain the regulatory paths and options subsequently available to policymakers in the post-crisis context. This can happen by design if, for example, policymakers decide to adopt broad substantive or structural reforms in the midst of crisis. It can also happen inadvertently. To the extent that crisis containment measures are not expressly made temporary, or if they result in dramatic
reorganization among market relationships and participants, these measures can determine fundamental aspects of the re-emergent environment. Such measures can thus effectively preempt an approach that delays regulatory reform until after the crisis has been resolved.

3. The Iron is Hot. The current crisis, combined with a new energetic administration, may provide a unique opportunity to make comprehensive reforms, and there may be insufficient political will to do so and to override special interests once the crisis subsides. As noted above, some commentators have stressed that moments of crisis can be translated into moments of opportunity. In such moments, the public and political actors may have the will, or perceive a necessity, to make significant reforms that would otherwise be met with much greater skepticism or scrutiny. All of this suggests that policymakers should seize the historical opportunity and strike while the iron is hot, even if it means risking that the resulting reforms will be imperfect. To some extent, this suggestion contains its own response: why seize an opportunity to risk making consequential errors? On the other hand, there is an inescapable reality that moments of crisis do focus political will and that major reforms are exceedingly difficult to negotiate in “peacetime.” A process of reform that delays substantive or structural reforms until after crisis-resolution almost inevitably increases the political challenges to meaningful reform. It may be that, as a practical matter, policymakers face a choice between acting quickly and foregoing significant regulatory reforms.

B. Incremental vs. Comprehensive Reforms

Perhaps the most troubling objection to the process of reform described above is that efforts to change regulatory paradigms are rarely, if ever, fruitful. The few historical examples of successful large-scale regulatory overhauls have occurred after crises of such depth that overhaul was necessary. Consider, for example, the New Deal that followed the Great Depression or the creation of the par-value system of currency exchange rates after World War II. In such a context, policymakers do not really opt for comprehensive changes to regulation—it is thrust upon them. More purposeful efforts to undertake a comprehensive reform of a regulatory paradigm are much more likely to fail in “peacetime.” This is largely due to political factors. The political economy of regulatory reform may make it impossible to adopt the kind of fundamental and all-encompassing changes that policymakers
would prefer, assuming that they can reach consensus to begin with. Enacting a scheme into law may simply require too many compromises to private and public actors to allow the scheme to survive intact. Furthermore, any particular compromise or set of compromises may undermine crucial aspects of the scheme as designed.

Efforts to change a regulatory paradigm may also be doomed to fail if comprehensive regulatory reform is by its nature too complex for any set of individuals to design successfully. This is more likely to be true when the subject of regulation is itself complex, broad, and diffuse. It is hard to imagine anything more complex, broad, and diffuse than modern financial markets. If policymakers aim to address a number of significant substantive and structural changes as part of one process of reform, they may risk making numerous errors. If the effects of such errors compound, the ultimate consequence of these mistakes could be tremendous.

The possibility of such consequential failure may ultimately dissuade policymakers from embarking on a deliberate process to redesign the financial regulatory paradigm. It is worth noting, however, that this objection applies to many of the current proposals for financial regulatory reform, especially those that envision significant changes to the institutional structure of financial regulation. If it is true that comprehensive structural reforms are unlikely to succeed on their own terms, this may suggest that policymakers should eschew structural or significant substantive reforms in the short- and intermediate-terms. Instead, it may be preferable to make incremental adjustments to the existing framework to address the most salient regulatory concerns and give existing regulatory actors time to assess the need for future reforms.

It is important to note that the approach proposed here does not necessarily envision the adoption of a grand scheme of reform. It is, at most, a grand scheme for comprehensive assessment of financial markets and potential regulation. The ultimate agenda for substantive or structural reforms that it yields may or may not be dramatic, comprehensive or disruptive—that will depend on the data gathered and regulatory goals identified at the initial stages.

153. For an interesting and related discussion of "non-linear" and "adaptive" aspects of policymaking, see Donald T. Hornstein, Complexity Theory, Adaptation, and Administrative Law, 54 DUKE L.J. 913 (2005).
IV. CONCLUSION

Any of the objections noted above may, in fact, prove to be insurmountable. Taken together, they certainly do give some pause. Nonetheless, these concerns arguably frame the fundamental question: are the potential risks and challenges of taking a deliberately gradual and systematic approach to regulatory reform outweighed by the risks and challenges of taking potentially hasty actions in the midst of economic crisis? The answer to this question is hardly obvious, which means that there is at least a plausible case to be made for the process described in this Article and for delaying significant legislative action aimed at reforming financial sector regulation until that process has unfolded.

It is fair to say that reforming the regulation of the financial sector is currently one of the most hotly debated issues on the policymaking agenda. Proposals for such reform are proliferating, and the official sector appears committed to adopting at least some meaningful reforms in the near-term. Broadly speaking, this movement toward regulatory reform emphasizes the need for structural reforms, outlines specific rules and regulations targeting primarily the perceived causes of the current crisis, and is carried along by a strong sense of the moment. Rather than add to the body of institutional and substantive proposals, this Article articulates a strategic approach to regulatory reform as a process of designing and implementing a fundamental change in the paradigm of financial regulation. That process would begin with a comprehensive survey of emergent post-crisis financial markets. That inventory-taking would identify the key risks present in various market segments and would provide the basis for articulating the desirable substance and scope of financial regulation and comparing the optimal framework with the existing one. Finally, policymakers would employ the current and comprehensive data and analysis obtained in these first two steps to determine whether, and how, to reform the institutional structure of financial regulation. Ideally, such an approach would reduce the potential for unnecessary or unproductive regulatory reforms and help policymakers achieve the right balance between efficient regulation and crisis-prevention going forward.

It may be naïve to expect that policymakers, driven either by genuine commitment to serve public interest goals or by more narrow political calculations, will forego a rare chance to pursue regulatory reforms in the immediate wake of the current crisis.
Nevertheless, the proposal advanced in this Article has a significant pragmatic value. First and foremost, it offers a model approach to redesigning the regulation of financial services sector in a coherent and measured way. At the same time, even if this approach is not carried out in practice, there may be significant value in holding it out as a theoretical ideal. It may be, for example, that articulating an ideal process for financial regulatory reform will help frame important issues that may influence whatever reform process is actually undertaken. It may cause policymakers to try to limit the impact of crisis-containment measures and to reduce the chances that these measures will constrain future options for reform. It may also help influence policymakers to eschew an approach that begins with changes to regulatory structure and to focus more on what they perceive will be the significant risks embedded in post-crisis financial markets.