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Note

CRISIS COMPOUNDED BY CONSTRAINT: HOW REGULATORY INADEQUACIES IMPAIRED THE FED'S BAILOUT OF BEAR STEARNS

BRYAN J. ORTICELLI

This Note explores the failure of the investment bank Bear Stearns within the context of the greater financial crisis that began in the summer of 2007, largely as a result of the widespread collapse of the market for subprime mortgage-backed securities. Specifically, this Note discusses in detail the circumstances surrounding the fall of Bear Stearns, the unprecedented measures taken by the Federal Reserve to avoid a disorderly breakup of the firm, and the policy implications of the Fed's actions for the future of investment bank regulation. By devoting particular attention to the Fed's response to Bear Stearns's liquidity crisis, which peaked in March of 2008, this Note seeks to elaborate on the statutory provisions utilized by the Fed in the "unusual and exigent" situation presented by the Bear Stearns predicament. Moreover, drawing on criticisms voiced by members of both the public and private sectors regarding the inadequacies of the Fed's regulatory resources during the Bear Stearns crash, this Note considers potential reforms to federal supervision of investment banks in the future. With the hope of better understanding the government's role in the ongoing financial dilemma, this Note uses the Bear Stearns bailout as a template for increasing dialogue on the issue of the government's proper function during a free market catastrophe.

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CRISIS COMPOUNDED BY CONSTRAINT: HOW REGULATORY INADEQUACIES IMPAIRED THE FED'S BAILOUT OF BEAR STEARNS

BRYAN J. ORTICELLI*

As we continue to address current market stress, we must also examine the appropriate policy responses.[1]

In other words, the regulation that we have didn't work very well.[2]

I. INTRODUCTION

Long before American taxpayers became the proud owners of up to $700 billion in Wall Street's "toxic assets,"[3] Uncle Sam was already taking novel actions to rescue failing financial giants from their own balance sheets.[4] More specifically, in March 2008, nearly seven months prior to "one of the largest-ever government interventions in the nation's economy,"[5] the Federal Reserve ("Fed") exercised emergency lending authority to prevent an imminent failure of the investment bank, Bear Stearns.[6] In so doing, the Fed utilized a "Depression-era law"[7] in its role

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* Nova Southeastern University, Farquhar College of Arts & Sciences, B.S. 2007; University of Connecticut School of Law, J.D. Candidate 2010. I would like to express my sincere gratitude to Professor Patricia McCoy for her guidance and inspiration of this Note. This Note is dedicated to my parents for their unwavering support throughout my life. All errors contained herein are mine and mine alone.

[1] Henry M. Paulson, Fmr. Sec'y of the Treasury, Remarks to the National Press Club on Recommendations from the President's Working Group on Financial Markets (Mar. 13, 2008), *available at* http://www.ustreas.gov/press/releases/hp872.htm.

[2] Tyler Cowen, *Too Few Regulations? No, Just Ineffective Ones*, N.Y. TIMES, Sept. 14, 2008, at B7.

[3] *See* Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. § 115(a)(3) (2008) (authorizing the Treasury to incur up to $700 billion in purchase costs of troubled mortgage-backed securities and other assets).

[4] *See* Michael Crittenden & Marshall Eckblad, *Update: Fed Rescue of Bear Stearns Isn't Like Bailouts of Old*, DOW JONES NEWS SERV., Mar. 14, 2008 ("When the Fed announced . . . it had arranged short-term emergency financing for [Bear Stearns]—an unprecedented event, depending on whom you ask—it sent a signal to the world's investors that a failure at [Bear Stearns] could put markets around the world at risk."); *see also* David Fettig, *The History of a Powerful Paragraph*, REGION, June 2008, at 33, *available at* http://www.minneapolisfed.org/pubs/region/08-06/section13.pdf ("When describing the Federal Reserve's response to the Bear Stearns episode, observers have used words like 'extraordinary' and 'unprecedented.'").

[5] Greg Hitt & Deborah Solomon, *Historic Bailout Passes as Economy Slips Further*, WALL ST. J., Oct. 4, 2008, at A1.

[6] *See* Timothy F. Geithner, Fmr. President, Fed. Reserve Bank of N.Y., Testimony Before the U.S. Senate Comm. on Banking, Hous. & Urban Affairs (Apr. 3, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/gei080403.html (explaining the necessity of Fed intervention in the Bear Stearns financial crisis); Kate Kelly et al., *Fed Races to Rescue Bear Stearns in Bid to Steady Financial System—Storied Firm Sees Stock Plunge 47%; JP Morgan Steps In*,

as "lender of last resort"[8] to avert the economic catastrophe that a disorderly bankruptcy of Bear Stearns presented.[9] Fearful of the systemic risk posed by a sudden failure of an institution as large and interconnected as Bear Stearns, proponents of the bailout justified its imposition given the "unusual and exigent circumstances" involved.[10] Moreover, with no private sector solution readily apparent at the time, the Central Bank had few options to choose from to protect the nation's economy—a process Fed Chairman Ben Bernanke argued was "severely complicated by the lack of a clear statutory framework for dealing with such a situation."[11]

The arcane framework criticized by Chairman Bernanke consists of fragmented authority among a variety of agencies including, among others, the Fed, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC"), who all play a role in overseeing investment banks.[12] Not surprisingly, this consortium of

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WALL ST. J., Mar. 15, 2008, at A1 ("Credit turmoil spread to the heart of the U.S. financial system as Bear Stearns Cos., an 85-year-old institution that has survived the Depression and two world wars, sought and received emergency funding backed by the federal government."). For a more detailed discussion of the Fed's utilization of emergency lending authority during the Bear Stearns crisis, see *infra* Part III.A.–B. It should be noted at the outset that this Note's continuous reference to "Bear Stearns" is made with respect to the company as the nation's fifth-largest investment bank as it existed in March 2008. Benton Ives, *Fed Dips into Bag of Liquidity Tricks*, CQ WEEKLY, Mar. 17, 2008, at 684. Although The Bear Stearns Companies, Inc. included numerous subsidiary institutions and organizations, this Note is solely concerned with the operations of Bear Stearns as an investment bank. Investment banks (i.e., nonbanks), unlike their commercial depository counterparts, function primarily as financial intermediaries, and are subject to less regulatory oversight and standards than traditional banks. *See, e.g.*, Jose Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market* 10 (Fla. Int'l Univ. Legal Studies Research Paper No. 08-01, 2008), *available at* http://ssrn.com/abstract=1141955 ("Nonbank lenders need not comply with federal limits on how much the lender can leverage [or assume debt] itself." (citation omitted)).

[7] Greg Ip, *Bear on the Brink: Desperate Fed Dusts Off Remedy from the Depression to Save Bear—Opening the Discount Window for a Nonbank Requires Special Votes at Central Bank*, WALL ST. J., Mar. 15, 2008, at A9.

[8] David Fettig, *Lender of More than Last Resort*, REGION, Dec. 2002, at 15–19, 44–47, *available at* http://www.minneapolisfed.org/pubs/region/02-12/lender.pdf.

[9] *See* Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve, Remarks at the Federal Deposit Insurance Corporation's Forum on Mortgage Lending for Low and Moderate Income Households (July 8, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080708a.htm [hereinafter Bernanke, FDIC] ("[A]llowing Bear Stearns to fail so abruptly at a time when the financial markets were already under considerable stress would likely have had extremely adverse implications for the financial system and for the broader economy.").

[10] *See, e.g.*, Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve, Testimony Before the Joint Economics Committee (Apr. 2, 2008), *available at* http://federalreserve.gov/newsevents/testimony/bernanke20080402a.htm ("With financial conditions fragile, the sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in [critical] markets and could have severely shaken confidence."); *see also* Federal Reserve Act, 12 U.S.C. § 343 (2006).

[11] Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve, Remarks at the Federal Reserve Bank of Kansas City's Annual Economic Symposium (Aug. 22, 2008), *available at* http://federalreserve.gov/newsevents/speech/bernanke20080822a.htm [hereinafter Bernanke, Kansas City].

[12] *See Regulatory Checks and Balances*, CQ WEEKLY, Mar. 17, 2008, at 681, 681 ("A variety of federal agencies oversee the nation's financial institutions. In response to the sub-prime mortgage crisis, the President's Working Group on Financial Markets has proposed that many of those regulators step up their oversight, particularly in regards to trading in mortgage-backed securities.").

government entities can result in gray areas of regulation, where seemingly distinct oversight duties can overlap and lead to supervisory inconsistency, or worse.[13] For example, although Bear Stearns was primarily regulated by the SEC as a securities firm, the Commission (unlike the Fed) does not "have a checkbook to help inject money into an investment bank or market when it hits trouble."[14] Conversely, during the Bear Stearns emergency, the Fed lacked the extensive regulatory oversight of investment banks that the SEC's mandate provides[15]—oversight which may have preemptively thwarted the need for an eventual $29 billion bailout.[16]

Concerns such as these have prompted intense review by members of both the public and private sectors of existing financial regulation, particularly as coordinated and implemented by the Fed over investment banks.[17] With immense changes to government policy already occurring,[18]

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[13] *See* Kara Scannell, *The Bear Stearns Fallout: Crisis Highlights SEC's Limits—Agency's Lack of Tools to Stem Financial Woes May Rekindle Debate*, WALL ST. J., Mar. 18, 2008, at A19 ("These various [agencies] are all doing the same thing even if they're called different things. It doesn't allow for the effective measurement of risk, the effective development of national policy. It's just a patchwork quilt that needs to be revised." (quoting Harvey Pitt, former SEC Chairman)).

[14] *Id*.; *see also* Kara Scannell, *Credit Crisis: SEC Comes Under Criticism in Light of Bear Woes*, WALL ST. J., Mar. 27, 2008, at A6 (discussing the SEC's limitations in times of financial crisis).

[15] *See* Roger C. Altman, *How the Fed Can Fix the World*, N.Y. TIMES, Sept. 3, 2008, at A25 ("[S]uddenly, the Fed was standing behind both the larger [commercial] banks it regulates and the major investment banks it does not. This cannot continue."). Despite the SEC's broad ideological regulatory mission, its efforts in actively overseeing diverse financial operations, including those of hedge funds, have been the subject of ongoing scholarly criticism. *See* Thomas C. Pearson & Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 48–60 (2007) (evaluating historical limitations on the SEC's oversight of hedge funds).

[16] *See* Amit R. Paley & David Hilzenrath, *SEC Chief Defends His Restraint; Cox Rebuffs Criticism of Leadership During Crisis*, WASH. POST, Dec. 24, 2008, at A1 ("The March collapse of Bear Stearns illustrated an array of [SEC] shortcomings, according to a review by the SEC's inspector general. [The inspector general] concluded that [SEC] officials had been aware of 'numerous potential red flags' at Bear Stearns 'but did not take actions to limit these risk factors.'"); *see also* Kate Kelly, *The Fall of Bear Stearns: Bear Stearns Neared Collapse Twice in Frenzied Last Days—Paulson Pushed Low-Ball Bid, Relented*, WALL ST. J., May 29, 2008, at A1 ("To make [Bear's bailout] palatable to the Fed, J.P. Morgan assumed responsibility for the first $1 billion of any potential losses, reducing the government's exposure [in the bailout] to $29 billion.").

[17] *See, e.g.*, Stephen Morris & Hyun Song Shin, *Financial Regulation in a System Context*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2008, at 2, 2–13, *available at* http://www.brookings.edu/economics/bpea/~/media/Files/Programs/ES/BPEA/2008_fall_bpea_papers/2008_fall_bpea_morris_shin.pdf ("The most pressing policy question has been whether broker-dealers, [including investment banks] should fall under banking regulation overseen by the Federal Reserve, and if so how they should be regulated."); *see also* Elizabeth F. Browne, *The Tyranny of the Multitude Is a Multiplied Tyranny: Is the United States Financial Regulatory Structure Undermining U.S. Competitiveness?*, 2 BROOKINGS J. CORP. FIN. & COM. L. 369, 376–410 (2008) (criticizing the American financial regulatory structure as detrimental to global competition and providing empirical analysis of derogatory effects within various financial markets); Ashok Vir Bhatia, *New Landscape, New Challenges: Structural Change and Regulation in the U.S. Financial Sector* 17–19 (Int'l Monetary Fund, Working Paper No. 07/195, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1007943 (discussing emerging policy considerations in the changing U.S. financial markets).

questions remain as to the proper scope of the Fed's administrative authority[19]—especially now that the financial landscape has altered such that no major independent investment banks exist.[20] As the Bear Stearns incident suggests, effective government oversight directives can mean the difference between preventing a crisis and using billions of dollars of public funds to bail out private enterprises.[21] However, as former Treasury Secretary Henry Paulson has noted, regulation cannot "go so far as to . . . make our markets less efficient,"[22] or less competitive by stemming innovation.[23]

Using the Bear Stearns case as a template, this Note explores the criticisms regarding the regulatory structure of the American financial industry with the goal of increasing dialogue as to the proper role of government in the free market. By focusing on the unique circumstances precipitating government action in avoiding the collapse of Bear Stearns, this Note analyzes the legal tools relied on by the Fed to rescue Bear, and how these tools may have been inadequate for the task at hand. Finally, this Note draws on existing scholarly work to evaluate models of reform as the economy continues to evolve.

Part II chronologically traces the factual developments leading up to and including the Fed's bailout of Bear Stearns. Discussion centers on the early onset of the subprime mortgage crisis, initial effects of the crisis on Bear Stearns's ability to do business, and how Bear's exposure to exotic mortgage products eventually induced its demise. Part II also examines the near bankruptcy of Bear and the Fed's actions in forestalling this occurrence, including facilitating the acquisition of Bear Stearns by JPMorgan Chase ("JPMorgan").

Part III considers the legal authority (pursuant to the Federal Reserve Act) justifying the Fed's actions in providing emergency funding to Bear

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[18] *See* Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1 ("The S.E.C.'s oversight responsibilities will largely shift to the Federal Reserve, though the commission will continue to oversee the brokerage units of investment banks.").

[19] *See* Bernanke, Kansas City, *supra* note 11 ("Going forward, a critical question for regulators and supervisors is what their appropriate 'field of vision' should be.").

[20] *See* Jon Hilsenrath et al., *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J., Sept. 22, 2008, at A1 ("It had become increasingly clear to Fed officials . . . that the investment-banking model couldn't function in these markets.").

[21] *See* Bernanke, Kansas City, *supra* note 11 ("The regulation and supervisory oversight of financial institutions is another critical tool for limiting systemic risk. . . . A stronger [regulatory] infrastructure would help to reduce systemic risk.").

[22] Paulson, *supra* note 1.

[23] *See* Browne, *supra* note 17, at 376–410 (suggesting that disorganized government policy can negatively affect the United States' ability to compete for foreign investors in a variety of markets); John T. Lynch, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1423 (2008) ("An increasingly heavy regulatory burden and a complex, cumbersome regulatory structure with overlaps at the state and national levels is causing an increasing number of businesses to conduct more and more transactions outside the country." (citation omitted)).

Stearns and arranging JPMorgan's purchase of the company. Additionally, Part III assesses the creation and revision of lending facilities operated by the Fed following the Bear Stearns experience and how these facilities contribute to the growing supervisory authority of the Central Bank.

Part IV analyzes criticism as to both the Fed's apparently inadequate ability to effectively manage the Bear Stearns situation and concerns that have been voiced regarding the increasing omnipresence of government in the free market. To bolster the contextual perspective of these competing positions, comparisons will be drawn from diverse regulatory systems, including those operative in foreign arenas, particularly the United Kingdom.

Finally, Part V focuses on the principal issue of systemic risk in evaluating the future of investment bank regulation, and how current research on the topic may contribute to a new regulatory framework better equipped at protecting the American (and global) economy. Part V also reviews the state of the current financial markets in considering the need for added regulation, while reflecting on the causes and implications of the ongoing financial debacle.

II. THE TRAGEDY OF BEAR STEARNS

A. *The Opening Act: July 2007–February 2008*[24]

Prior to the summer of 2007, "the world experienced an unusual mix of financial conditions"[25] that resulted in a dramatic growth of a variety of consumer and financial markets, most notably the housing market and subprime mortgage loan industry.[26] Large investment banks sought to capitalize on the boom in the housing market by not only buying

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[24] This subpart is intended to provide necessary background leading up to the Fed's bailout of Bear Stearns in March 2008. As such, brief consideration is paid to the onset of the subprime mortgage crisis and the ensuing credit crisis within the financial markets, and how this phenomenon contributed to Bear Stearns' operational failure. However, full discussion of the causes and implications of the mortgage and credit crises is beyond the scope of this Note.

[25] Timothy F. Geithner, Fmr. President, Fed. Reserve Bank of N.Y., Remarks at the Council on Foreign Relations Corporate Conference 2008: The Current Financial Challenges: Policy and Regulatory Implications (Mar. 6, 2008), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/gei080306.html [hereinafter Geithner, Foreign Relations].

[26] *See* Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response*, 56 CLEV. ST. L. REV. 271, 282–300 (2008) (providing a detailed account of the growth and eventual collapse of the subprime mortgage market); s*ee also* A. Mechele Dickerson, *Consumer Over-Indebtedness: A U.S. Perspective*, 43 TEX. INT'L L.J. 135, 139–44 (2008) (describing the increase in mortgage lending and consumer debt assumption and noting how such factors contributed to the onset of the mortgage crisis); Paul Mizen, *The Credit Crunch of 2007–2008: A Discussion of the Background, Market Reactions, and Policy Responses*, FED. RESERVE BANK OF ST. LOUIS REV., Sept./Oct. 2008, at 531, 536, *available at* http://research.stlouisfed.org/publications/review/08/09/Mizen.pdf ("The market for subprime mortgages grew very fast.").

considerable stakes in subprime mortgage loans,[27] but also by "securitizing" and pooling these loans into structured assets that would be attractive to other investors based on anticipated return and risk exposure.[28] These assets, known primarily as subprime mortgage-backed securities ("MBS") and collateralized debt obligations ("CDOs"),[29] were particularly popular with two large hedge funds at Bear Stearns: the "High-Grade Structured Credit Strategies Fund" and the "High-Grade Structured Credit Strategies Enhanced Leverage Fund."[30]

Despite their initial appeal, subprime MBS and CDOs turned toxic when the housing bubble burst starting in late 2006 and early 2007, and extending into 2008.[31] Large losses from these investments quickly resulted in the evaporation of financing for private-label MBS,[32] causing loss of investor confidence and the subsequent failure of many subprime lenders.[33] As these problems continued to escalate in a vicious cycle

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[27] *See* Kenneth C. Johnston et al., *The Subprime Morass: Past, Present, and Future*, 12 N.C. BANKING INST. 125, 130 (2008) ("[N]ever before had those on Wall Street been invested so heavily in securities backed by subprime loans. . . . [T]hese investment vehicles became highly sought after by . . . investment banks."); Gretchen Morgenson, *Rescue Me: A Fed Bailout Crosses a Line*, N.Y. TIMES, Mar. 16, 2008, at B1 ("As of . . . Nov. 30, [2007,] Bear Stearns had on its books approximately $46 billion of mortgages [and] mortgaged-backed . . . securities.").

[28] *See* LUIGI SPAVENTA, CTR. FOR ECON. POL'Y RESEARCH, POLICY INSIGHT NO. 22, AVOIDING DISORDERLY DELEVERAGING 1 (2008), *available at* http://www.cepr.org/pubs/PolicyInsights/PolicyInsight22.pdf ("[B]anks would pool and securitize the [products] they originated to distribute them and transfer their risks to a myriad of investors.").

[29] *See* Johnston et al., *supra* note 27, at 128–29 (discussing CDOs and MBS as types of investments that derive their value from the repayment of loans by the initial home borrowers). To make these investments marketable, investment firms would splice original loans into "tranches" to reduce the risk of loss presented by a loan's default. *Id*. Thus, investors could largely choose the type of risk they were willing to accept based on the yield values of differing tranches. *See* Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 375–79 (2008) (detailing the distribution of CDOs and MBS through unique schematic processes).

[30] These funds held "60% of their net worth . . . in exotic securities." Matthew Goldstein & David Henry, *Bear Bets Wrong*, BUS. WK., Oct. 22, 2007, at 50; *see also* Kate Kelly et al., *Two Big Funds at Bear Stearns Face Shutdown—As Rescue Plan Falters amid Subprime Woes, Merrill Asserts Claims*, WALL ST. J., June 20, 2007, at A1 ("[T]he two Bear Stearns hedge funds held more than $20 billion of investments, mostly in complex securities made up of bonds backed by subprime mortgages . . . .").

[31] *See* Joe Nicer & Edmund L. Andrews, *Running a Step Behind as a Crisis Raged*, N.Y. TIMES, Oct. 23, 2008, at A1 ("The subprime mortgage debacle began emerging in the summer of 2007 . . . [b]ut the true depth and extent of the losses did not become clear until [early in 2008] . . . ."); John Tatom, *The U.S. Foreclosure Crisis: A Two-Pronged Assault on the U.S. Economy* 4–14 (Munich Personal Repel Archive, Paper No. 9787, 2008), *available at* http://mpra.ub.uni-muenchen.de/9787/1/MPRA_paper_9787.pdf (explaining how declines in the demand for housing and slowing in home appreciation contributed to losses in mortgaged related investments).

[32] *See* Ben S. Bernanke, Chairman of the Bd. of the Fed. Reserve, Testimony Before the Joint Econ. Comm. (Sept. 24, 2008), *available at* http://federalreserve.gov/newsevents/testimony/bernanke20080924a.htm ("[F]alling home prices and rising mortgage delinquencies have led to major losses at many financial institutions, losses only partially replaced by the raising of new capital.").

[33] *See* Frederic S. Mishkin, Governor of the Bd. of the Fed. Reserve, Speech to the Money Marketeers of New York University: Outlook and Risks for the U.S. Economy (Sept. 10, 2007), *available at* http://federalreserve.gov/newsevents/speech/mishkin20070910a.htm ("The rise in delinquencies in the subprime market has led to the collapse of some large subprime lenders and

throughout late 2007 and early 2008, consequences soon spread to Wall Street and Bear Stearns, which in the summer of 2007 attempted to save one of its hedge funds by injecting $1.6 billion into its reserves—ultimately to no avail as both funds eventually lost all value.[34]

"By various accounts, the funds' meltdown signaled the start of a collapse in the vital element of trust that must exist between a firm like Bear and its many customers."[35] This breakdown in trust would abruptly evolve into a contagion, attacking the heart of Bear Stearns's business operations and bringing the eighty-five-year-old institution to its knees.[36] For the fourth quarter of 2007, Bear reported a $2 billion write down in mortgage securities,[37] and posted its "first-ever quarterly loss" of $859 million.[38] Unfortunately for the company, such losses would be emblematic of Bear's remaining existence as a going concern. Throughout the rest of 2007 and into early 2008, Bear saw its stock value plummet, client trust evaporate, and cohesion among its leadership unwind.[39]

B. *The Perfect Storm: March 2008*

To understand how Bear Stearns ultimately collapsed, it is first important to explain Bear's financing structure. As an investment bank,[40] Bear relied on short-term (usually overnight) loans called repurchase agreements ("repos") to finance its daily activities and liquidity demands.[41]

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inflicted substantial losses on holders of subprime [MBS] and of some . . . CDOs. . . . These developments have contributed materially to the drop in demand for housing [in 2007].").

[34] *See* GARY SHORTER, CONG. RESEARCH SERV., BEAR STEARNS: CRISIS AND "RESCUE" FOR A MAJOR PROVIDER OF MORTGAGE-RELATED PRODUCTS 2, Mar. 19, 2008, *available at* http://assets.opencrs.com/rpts/RL34420_20080319.pdf (noting that soon after Bear's loans to these funds, "the funds lost all of their value and were allowed to wind down").

[35] *Id.*; *see also* Landon Thomas, Jr., *Run on Big Wall St. Bank Spurs U.S.-Backed Rescue*, N.Y. TIMES, Mar. 15, 2008, at A1 ("The demise of the hedge funds began a slow but persistent loss of market confidence in the bank . . . . Such erosion can be devastating for any investment bank, especially one like Bear Stearns . . . .").

[36] *See* SHORTER, *supra* note 34, at 2 (noting that the initial breakdown in trust among Bear's customers would lead to unprecedented moves by the company to survive).

[37] David Smith & Dominic Rushe, *The Banking Twister Heading Your Way*, SUNDAY TIMES (London), Mar. 16, 2008, at B4 ("A month [after Bear attempted to save one of its hedge funds,] the firm announced that the game was up for the funds, which had effectively lost all their value . . . .").

[38] SHORTER, *supra* note 34, at 2.

[39] *See* Kate Kelly, *The Fall of Bear Stearns: Lost Opportunities Haunt Final Days of Bear Stearns—Executives Bickered Over Raising Cash, Cutting Mortgages*, WALL ST. J., May 27, 2008, at A1 (documenting internal developments at Bear Stearns following the failure of its hedge funds in the summer of 2007 through January 2008).

[40] Unlike commercial banks, investment banks do not take deposits from traditional individual customers; rather, "[a]n investment bank's activities" consist of "(1) managing an investment portfolio . . . and (2) operating as a central market maker and counterparty" in financial markets. Dwight Jaffee & Mark Perlow, *Investment Banking Regulation After Bear Stearns*, ECONOMISTS' VOICE, Sept. 2008, at 1, 1–2.

[41] *See* Stephen A. Lumpkin, *Repurchase and Reverse Repurchase Agreements*, *in* INSTRUMENTS OF THE MONEY MARKETS 59, 60 (Timothy Q. Cook & Robert K. Laroche eds., 1993) ("[Repurchase] agreements usually are arranged with short terms to maturity—overnight or a few days."); Stephen G.

Repos are secured by collateral (including MBS) that the borrowing institution promises to buy back at a specified date and at a specified price, "which typically includes interest at an agreed upon rate."[42] In essence, because repos were vital to Bear's daily operations, they left Bear at the mercy of lender sentiment.[43] Thus, when the subprime mortgage crisis unfolded, lenders grew more fearful of entering into collateralized loans with Bear given the firm's large exposure to mortgage products.[44] Instead, lenders hoarded their liquidity, uncertain about the health of their own balance sheets and those of their counterparties.[45] "And it was the [eventual] refusal of Bear's repo lenders to extend overnight loans that confirmed that Bear had a liquidity crisis [in mid-March 2008]."[46]

However, the growing failure of Bear to secure its vital repos in March 2008 was not the only factor that led to the firm's "liquidity crisis."[47] While it may be said that Bear's repo problems kept it from pulling money in, Bear's exposure to a variety of deteriorating assets led to losses that eroded its already meager capital.[48]

For example, Bear, like other investment banks, initially appealed to investor concerns of security by selling a type of insurance product along

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Cecchetti, *Crisis and Responses: The Federal Reserve and the Financial Crisis of 2007–2008*, at 10 (Nat'l Bureau of Econ. Res., Working Paper No. 14134, 2008), *available at*, http://www.nber.org/papers/w14134.pdf ("Large financial institutions that hold various types of assets use repos to finance their short-term liquidity needs—and those needs have grown astronomically."). Amazingly, Bear Stearns borrowed "more than 30 times the value of its $11 billion equity base," amounting to a "leverage ratio of over 30 to 1." Thomas, *supra* note 35. To make matters more complicated, Bear used large amounts of this borrowed money to invest in the same CDOs it was selling to other investors. *See* Kelly et al., *supra* note 30 ("The problems can be exacerbated because many hedge funds invest in CDOs with the help of borrowed money. To buy a triple-A rated CDO note for $1,000, it is common for a hedge fund to put down only $100 of its own money . . . .").

[42] *See* Lumpkin, *supra* note 41, at 59, 62.

[43] *See* Gabilondo, *supra* note 6, at 19 ("It was lender sentiment [in the repo market] that [Bear's] managers considered when evaluating the severity of the firm's liquidity crisis." (internal citation omitted)).

[44] *See id.* ("Anxious about market conditions, these lenders preferred to hoard liquidity rather than to enter into collateralized loans."). This phenomenon was symptomatic of the larger financial crisis in which banks grew so fearful of lending to one another that access to available credit became very difficult to secure. *See* Cecchetti, *supra* note 41, at 12 ("[T]he overriding consideration in the refusal of banks to lend to one another must have become the concern over credit risk—that is, the risk that borrowers would fail to repay.").

[45] *See* Randall S. Kroszner, Governor of the Bd. of the Fed. Reserve, Remarks at the Risk Management Association Annual Risk Management Conference: Strategic Risk Management in an Interconnected World (Oct. 20, 2008), *available at* http://federalreserve.gov/newsevents/speech/kroszner20081020a.htm ("Uncertainty about the value of assets and other exposures, as well as uncertainty about the ability of institutions to sustain continued access to funding, has caused financial institutions to operate with great caution and hoard funds.").

[46] Gabilondo, *supra* note 6, at 19.

[47] Donald L. Kohn, Vice Chairman of the Bd. of the Fed. Reserve, Speech at the Federal Reserve Bank of New York and Columbia Business School Conference on the Role of Money Markets (May 29, 2008), *available at* http://federalreserve.gov/newsevents/speech/kohn20080529a.htm.

[48] *See* Geithner, *supra* note 6 ("The rumors of Bear's failing financial health caused its balance of unencumbered liquidity . . . to decline sharply . . . .").

with the MBS and CDOs Bear promoted.[49] Known as credit default swaps ("CDS"), these insurance contracts were marketed to investors as an effective way to hedge risks associated with the default of underlying mortgage loans.[50] Essentially, CDS enabled investors in CDOs or MBS to protect themselves in the event the underlying investment defaulted, by paying a periodic fee in exchange for the promised contingency payment.[51] Furthermore, even those investors who had not bought mortgaged-related products could purchase CDS as a type of side bet that loans would default and the investor would be paid the value of the CDS coverage.[52] CDS created systemic risk because the same investment banks that were selling these contracts were also buying them from other financial guarantors to secure the CDS they had sold.[53] Because the CDS market was largely unregulated,[54] the aggregate amounts of these contracts skyrocketed to an estimated total amount of $60 *trillion*,[55] with Bear Stearns alone holding roughly "$14.2 trillion of notional value in derivative contracts [including CDS] outstanding with thousands of counterparties."[56]

Ultimately, as mortgage loans defaulted in vast numbers, Bear's CDS liability was triggered. But there was one problem: "there was no money

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[49] *See* SHORTER, *supra* note 34, at 4.

[50] *See 60 Minutes: A Look at Wall Street's Shadow Market* (CBS television broadcast Oct. 5, 2008), *available at* http://www.cbsnews.com/stories/2008/10/05/60minutes/main4502454.shtml ("A [CDS] was available [to investors], marketed to them as a risk-saving device for buying a risky financial instrument." (quoting Michael Greenberger, Prof. of Law, Univ. of Maryland)); *see also* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2007) ("[A] credit default swap is a private contract in which private parties bet on a debt issuer's bankruptcy, default, or restructuring."). As credit derivatives, CDS derive their value from an underlying "price, rate, index, or financial instrument," such as a MBS or CDO. David Mangle, *Credit Derivatives: An Overview*, ECON. REV., Fourth Quarter 2007, at 1, *available at* http://www.frbatlanta.org/filelegacydocs/erq407_mengle.pdf.

[51] *See* Franklin Allen & Douglas Gale, *Systemic Risk and Regulation* 4–5 (Wharton Fin. Inst. Ctr., Working Paper No. 95-24, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=787797 (describing CDS arrangements).

[52] *See* Partnoy & Skeel, *supra* note 50, at 1022 ("Like other derivatives, credit default swaps can be used not only for hedging, but also for speculation or arbitrage."); *60 Minutes: Financial Weapons of Mass Destruction* (CBS Television broadcast Oct. 26, 2008), *available at* http://www.cbsnews.com/stories/2008/10/26/60minutes/main4546199.shtml?tag=currentVideoInfo;segmentUtilities ("[CDS] were essentially private insurance contracts that paid off if the investment went bad. But you didn't have to actually own the investment to collect on the insurance.").

[53] *See* Geithner, Foreign Relations, *supra* note 25 ("[O]n the assets they retained, these same institutions purchased insurance from financial guarantors and other firms that were exposed to the same risks.").

[54] *See 60 Minutes*, *supra* note 50 (discussing how CDS regulation had been lacking since 2000). Following the stock market crash of 1907, state laws across the country made betting arrangements (such as those embodied by CDS) a felony. *Id.* However, the Commodity Futures Modernization Act of 2000 effectively removed the restrictions placed on these transactions. *Id.*; *see also* Commodity Futures Modernization Act of 2000, 7 U.S.C. § 27f(c) (2006) (preempting state regulation of CDS transactions whose initial manifestation occurred in gambling houses known as "bucket shops").

[55] Jon Hilsenrath et al., *Worst Crisis Since '30s, with No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1.

[56] Cecchetti, *supra* note 41, at 17. This figure is not totally comprised of CDS, as the firm also held other types of derivative products, including futures and options. *Id.*

behind the commitments."[57] The same institutions that had sold CDS were not legally required to set aside the necessary cash to cover "their potential losses."[58] Together with the defection of its hedge fund customers who could easily withdraw their large deposits,[59] the CDS losses suffered by Bear helped set the stage for a classic run on the (investment) bank.[60] Amid growing market anxiety, key counterparties began canceling their investment and brokerage accounts with Bear,[61] with "[s]ome [investors] pulling their cash . . . for fear it could get locked up if there was a bankruptcy."[62] As clients withdrew their business, Bear watched as its credit dissolved, and it was only a matter of time before Bear's problems became a public concern.[63]

C. *The Time of Reckoning*

Bear's access to and drain of liquidity continued to develop in early 2008. On March 10, "rumors began to circulate in the market that there were significant liquidity problems at Bear Stearns itself."[64] These rumors were then exacerbated by attempts to quell them, as Bear executives and Moody's Investors Service ("Moody's") both issued statements aimed at reassuring investors that Bear was in good health, emphasizing the firm's large cash holdings of approximately $18 billion.[65] Nonetheless, such actions could not stop the intensifying "exit by counterparties" Bear was

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[57] *60 Minutes*, *supra* note 50. More precisely, CDS are traded as over-the-counter ("OTC") derivatives without strict regulatory oversight, and as such "contracts can be traded—or swapped—from investor to investor without anyone overseeing the trades to ensure the buyer has the resources to cover the losses if the security defaults." Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, http://www.time.com/time/business/article/0,8599,1723152,00.html.

[58] *60 Minutes*, *supra* note 50.

[59] *See* Morris & Shin, *supra* note 17, at 15.

[60] *See* Bernanke, Kansas City, *supra* note 11 ("The collapse of Bear Stearns was triggered by a run of its creditors and customers, analogous to the run of depositors on a commercial bank.").

[61] *See* Kate Kelly, *SEC Will Scour Bear Trading Data—Documents Reveal Who Was Exiting Deals in Final Days*, WALL ST. J., May 28, 2008, at A1 (describing how several important investment institutions sought to cancel their business connections with Bear in anticipation of the firm's collapse). The exit by counterparties actually increased market stress, as these parties struggled to find substitute transaction avenues. *See* Serena Ng, *Crisis on Wall Street: Credit-Default Market Freezes as Risk Grows*, WALL ST. J., Sept. 19, 2008, at C3 (discussing how this phenomenon negatively affected greater market confidence).

[62] Kelly et al., *supra* note 6.

[63] *See* Kate Kelly et al., *In Dealing with Bear Stearns, Wall Street Plays Guardedly*, WALL ST. J., Mar. 13, 2008, at C1 ("Bear's fundamental issue isn't liquidity or capital as much as the erosion of its business model as a result of the credit crunch.").

[64] JPMorgan Chase & Co., Definitive Proxy Statement (Form DEFM14A), at 27, (Apr. 28, 2008), *available at* http://files.shareholder.com/downloads/ONE/692396293x0xS1193125-08-92860/777001/filing.pdf.

[65] *See id.* ("Moody's clarified that . . . Bear Stearns' . . . current ratings outlook was stable [and] . . . Bear Stearns issued a press release denying the market rumors regarding its liquidity position."); Ruddy Boyd & Doris Burke, *The Last Days of Bear Stearns*, FORTUNE, Apr. 14, 2008, at 86.

experiencing.[66] And "a number of U.S.-based fixed-income and stock traders that had been actively involved with Bear . . . had reportedly decided by March 10 to halt such involvement."[67]

On Tuesday, March 11, investors continued to grow anxious over the rumors, and ING Group NV, "a major asset-management company," stopped doing trades with Bear[68]—it was clear that "[c]redit was drying up."[69] Again, in an effort to calm market fears, Bear Stearns executives decided that President and CEO Alan Schwartz should address the public live from a media conference in West Palm Beach, Florida.[70] Mr. Schwartz did so the next morning, appearing on CNBC and stating that "we don't see any pressure on our liquidity, let alone a liquidity crisis."[71] Meanwhile, "prime-brokerage clients continued to pull their money" from Bear,[72] "causing senior management . . . to become concerned that if these circumstances accelerated Bear Stearns's liquidity could be negatively affected."[73] When Mr. Schwartz arrived back in New York late Wednesday, March 12, he assembled "senior executives to discuss how to save the firm."[74] But, his efforts would prove fruitless.

By Thursday, March 13, "market speculation had swelled" regarding Bear's access to credit and "[a]round 4:30 p.m., Mr. Schwartz was convinced that Bear was facing a desperate situation."[75] Confronted with the ongoing demands of clients and lenders to withdraw their money from Bear, the firm had seen its liquidity reserves depleted to nearly $2 billion, a loss of approximately $15 billion in four days.[76] Frantic to find a solution, Mr. Schwartz contacted Jamie Dimon, CEO of JPMorgan Chase, in a bid to negotiate a deal with the company, which had a long transactional history with Bear Stearns.[77] Mr. Dimon agreed to help, dispatching senior

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[66] *See* Kelly et al., *supra* note 6 (explaining the swift departure of customers that had previously been willing to trade with Bear).

[67] SHORTER, *supra* note 34, at 3.

[68] *Id.*

[69] Boyd & Burke, *supra* note 65.

[70] *See* Kelly et al., *supra* note 6.

[71] Interview by David Faber with Alan Schwartz, President & CEO, Bear Stearns, on *CNBC: First on CNBC* (CNBC television broadcast Mar. 12, 2008), *available at* http://video.nytimes.com/video/2008/03/14/business/1194817092072/bear-chief-firm-was-on-solid-ground.html.

[72] Kate Kelly, *The Fall of Bear Stearns: Fear, Rumors Touched Off Fatal Run on Bear Stearns*, WALL ST. J., May, 28, 2008, at A1.

[73] JPMorgan Chase & Co., *supra* note 64, at 27.

[74] Kelly, *supra* note 72.

[75] William Sluis et al., *Bailout of Wall Street Firm Shocks Markets; Federal Reserve Forced to Save Company Squeezed by Mortgage Securities*, CHI. TRIB., Mar. 15, 2008, at C1.

[76] *See* Robin Sidel et al., *The Week that Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J., Mar. 18, 2008, at A1 ("By [Thursday], Bear Stearns's cash position had dwindled to just $2 billion.").

[77] *See* Kelly, *supra* note 72 (describing how Schwartz contacted Dimon during his birthday party and related to Dimon "[l]et's do something"); *see also* Mizen, *supra* note 26, at 549 (noting that JPMorgan Chase served effectively as Bear Stearns's "banker").

JPMorgan traders to Bear to review the firm's financial position.[78] Upon review, "[Dimon's] group appeared stunned,"[79] and it became apparent later in the evening that Bear would not be able to secure unassisted private financing from JPMorgan or any another institution.[80] Bear's directors approved an emergency bankruptcy filing, and the firm's corporate counsel, Cadwalader, Wickersham & Taft LLP, began drafting necessary documentation.[81] Representatives from the SEC and the New York Fed, which had been closely monitoring the situation, participated in a conference call with members of the Board of Governors of the Fed and the Treasury Department to discuss the implications of a Bear bankruptcy.[82] Chaotic discussions continued throughout the evening and into the early morning, but no clear resolution was in sight.[83]

At 5 a.m. on Friday, March 14, Timothy Geithner (then-President and CEO of the New York Fed) convened a conference call "with top government officials" to rule on the fate of Bear Stearns.[84] Recognizing Bear's highly complex interrelationships with thousands of counterparties, and fearing that a failure of Bear could touch off a domino effect among other institutions in similar market positions,[85] "the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase."[86]

Because Bear Stearns was an investment bank, it could not use its collateral to gain a direct loan from the Fed's "discount window,"[87] necessitating the utilization of emergency lending authority.[88] Although technically the Fed did not lend directly to Bear, by providing the funds to JPMorgan to then re-issue to the firm, the Fed itself assumed the risk of the

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[78] *See* Kelly, *supra* note 72; *see also* JPMorgan, *supra* note 64, at 28 ("Representatives of JPMorgan Chase and officials from the U.S. Treasury Department, the New York Fed and the Board of Governors of the Federal Reserve System engaged in discussions regarding how to resolve the liquidity deterioration at Bear Stearns.").

[79] Kelly, *supra* note 72.

[80] *See* JPMorgan, *supra* note 64, at 28.

[81] Kelly, *supra* note 72.

[82] *See* Geithner, *supra* note 6.

[83] *See* Sidel et al., *supra* note 76 ("'It was a traumatic experience,' says one person who participated. Sleep deprivation set in, with some of the hundreds of attorneys and bankers sleeping only a few hours . . . .").

[84] Kelly, *supra* note 72.

[85] For example, "Bear risked defaulting on extensive 'repo' loans . . . . If that happened, other securities dealers would see access to repo loans become more restrictive[,]" not to mention the fear that would be set off in the CDS markets. Kelly et al., *supra* note 6.

[86] Ben S. Bernanke, Chairman of the Bd. of the Fed. Reserve, Testimony Before the U.S. Senate Comm. on Banking, Hous. & Urban Affairs (Apr. 3, 2008), *available at* http://federalreserve.gov/newsevents/testimony/bernanke20080403a.htm.

[87] For purposes of this Note, the discount window is best understood as a lending mechanism which helps the central bank "ensure the basic stability of the payment system . . . by supplying liquidity during times of systemic stress." The Federal Reserve Discount Window, http://www.frbdiscountwindow.org/discountwindowbook.cfm?hdrID=14&dtlID=43#introduction (last visited Nov. 16, 2009).

[88] *See* Cecchetti, *supra* note 41, at 17.

loan.[89] "By any measure, this action was extraordinary," as the New York Fed provided Bear with approximately $12.9 billion, a move not seen since the Great Depression.[90] The twenty-eight day government guarantee was greeted with "high-fives" and cheers among Bear executives, who believed that the term of the loan would allow them enough time to find a private buyer for their firm.[91] To the contrary, news of the loan was not nearly as welcomed by Bear's counterparties, or the market as a whole, as Friday saw Bear's common stock close down forty-seven percent, and the major ratings agencies (Standard & Poor's, Moody's, and Fitch) drastically downgraded Bear's long- and short-term credit ratings.[92] Based on these developments, then-Secretary Paulson realized the loan was not a viable solution and contacted Mr. Schwartz that same evening,[93] informing the CEO that the Fed-backed liquidity "would not be available on Monday morning."[94] Suddenly, twenty-eight days became two, as Paulson told Schwartz "[he] need[ed] to have a deal by Sunday night."[95] With most of Bear's customers and clients abandoning ship, there seemed to be only one likely suitor: JPMorgan.

D. *Shotgun Marriage Made in Heaven*

Saturday morning, March 15, Mr. Schwartz together with senior management of Bear Stearns met with their counterparts at JPMorgan and J.C. Flowers & Co. ("JCFlowers") to discuss the potential for mergers or acquisitions.[96] Throughout the day and into the evening, Bear's leadership attempted to negotiate a realistic proposal that could be finalized by late Sunday evening before the open of Asian and European markets.[97] At the same time, Bear's legal team again began to analyze potential bankruptcy and/or liquidation scenarios, mindful of the limited protections available to the firm under the United States Bankruptcy Code, as well as the approaching Sunday deadline.[98]

Negotiations continued into early Sunday morning, March 16. However, it soon became apparent that a purely private sector solution would not be possible. JPMorgan reported that "it would need some level of financial support from the New York Fed" to undertake a Bear Stearns

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[89] *See* Kelly et al., *supra* note 6.
[90] Cecchetti, *supra* note 41, at 17.
[91] *See* Sluis et al., *supra* note 75.
[92] JPMorgan, *supra* note 64, at 28.
[93] *See* Kelly, *supra* note 16.
[94] JPMorgan, *supra* note 64, at 29.
[95] Kelly, *supra* note 16.
[96] JPMorgan, *supra* note 64, at 29.
[97] *See* Kelly, *supra* note 16 (providing detailed documentation of the negotiations as they unfolded on March 15).
[98] *See id*. (noting that Bear's status as a broker would present serious limitations and risks in any type of bankruptcy filing).

acquisition, and JCFlowers was having difficulty finding institutions to finance any type of transaction with Bear Stearns.[99] As such, officials from the New York Fed were advised of the situation and "indicated that [they] would be willing to consider the possibility of an arrangement that would result in the New York Fed assuming some of the risk associated with" a JPMorgan takeover.[100] Initially, the Fed agreed to provide $30 billion of "non-recourse funding"[101] to JPMorgan secured by collateral consisting mainly of risky MBS and other assets that Bear owned.[102] This liquidity infusion would enable JPMorgan to acquire Bear and immediately guarantee its outstanding debts to remaining counterparties and customers—a vital factor in returning trust to the shaken global markets.[103]

Armed with this taxpayer-based guarantee, JPMorgan approached Bear's board of directors with a finalized stock merger agreement in which Bear's common stock would be exchanged for JPMorgan common stock for $2 per share (the "original offer").[104] As a company that had a per-share value of approximately $171 in January 2007,[105] the original offer did not sit well with Bear's board, which voiced its disagreement and worried that acceptance would constitute a breach of their fiduciary duty to stockholders.[106] Nevertheless, the fear of imminent bankruptcy coupled with the fact that no other solution was feasible (and increased pressure from the government) led to an endorsement by Bear's board of the original offer, with the transaction announced in a joint press release Sunday evening.[107]

Before the original offer could be presented to Bear's shareholders for

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[99] JPMorgan, *supra* note 64, at 30.

[100] *Id.* at 31.

[101] A non-recourse loan is one in which the Fed would not be able to raise a legal claim against JPMorgan in the event the loan was not repaid and the Fed lost money. *See* MARC LABONTE, CONG. RES. SERV., FINANCIAL TURMOIL: FEDERAL RESERVE POLICY RESPONSES 7 (2008), *available at* http://assets.opencrs.com/rpts/RL34427_20080407.pdf.

[102] *See* JPMorgan, *supra* note 64, at 31.

[103] *See id.* ("[B]ased on the New York Fed's willingness to provide the $30 billion special funding facility, JPMorgan Chase thought that it would be able to work towards negotiating a stock-for-stock merger with Bear Stearns . . . with the need to guaranty certain obligations . . . effective immediately.").

[104] *Id.*

[105] *See* Madlen Read & Joe Bel Bruno, *Bear Stearns Shareholders OK Buyout by JPMorgan*, USA TODAY, May 29, 2008, http://www.usatoday.com/money/economy/2008-05-29-3197519795_x.htm.

[106] *See* JPMorgan, *supra* note 64, at 31–32 ("Bear Stearns registered its objections to [the original offer and] . . . [r]epresentatives of Bear Stearns' legal advisors reviewed the fiduciary duties of the board of directors, including the duties of directors if a company is insolvent or approaching insolvency."). Following the eventual endorsement of the merger, numerous "class action lawsuits [were] filed against Bear Stearns, its board of directors and certain of Bear Stearns' present and former executive officers" alleging, inter alia, breach of fiduciary duty. *Id.* at 48–49.

[107] *See id.* at 33 ("[T]he Bear Stearns board of directors unanimously approved the agreement . . . . Later that evening, JPMorgan Chase and Bear Stearns issued a joint press release announcing the transaction."); *see also* Holman W. Jenkins, Jr., *The Short, Happy Death of Bear*, WALL ST. J., Mar. 26, 2008, at A14 ("[The Fed] had plenty of legitimate clout, which it apparently used to virtually dictate the original $2 share price.").

approval, "perceived deficiencies" and market reaction concerning the merger's closure would necessitate amendments.[108] With the immediate concern of bankruptcy pacified, Bear Stearns and JPMorgan executives met throughout the week of March 17 to discuss merger revisions that would be more acceptable to Bear's shareholders and market speculation.[109] By week's end, no revised agreement had been reached, and for a third time Bear's legal team met to discuss the possibility that the firm would have to file for bankruptcy on Monday, March 24.[110] Anxiety increased among Bear's creditors that the merger would fall through given the low offer proposed, with tense negotiations occurring back and forth between Bear's and JPMorgan's legal offices.[111] "At one point, J.P. Morgan threatened to pull financing . . . [and Bear's] directors talked briefly about suing J.P. Morgan[,] . . . [b]ut they quickly realized their position was untenable."[112] Finally, by Monday, March 24, the parties reached a provisional agreement to amend the original offer.[113] Most importantly, the new merger agreement appealed to investors and market confidence by increasing the stock transfer rate from $2 to $10, and obligated JPMorgan to assume the first $1 billion in losses as deducted from the $30 billion guarantee to be provided by the New York Fed.[114]

For many, a crisis had been averted, but at what cost?[115] By pledging $29 billion of hard-earned taxpayer money through its discount window to an investment bank foiled by bad decisions,[116] the Fed's actions set a

[108] *See* JPMorgan, *supra* note 64, at 33 (describing how market reactions to the original offer prompted JPMorgan and Bear executives to enter into revised transaction negotiations).

[109] *Id.*

[110] *See id.* at 34 ("[I]f the New York Fed and JPMorgan Chase were unwilling to maintain their funding of Bear Stearns . . . [Bear] would not be able to open for business on Monday . . . .").

[111] *See id.* ("[R]epresentatives of Bear Stearns contacted JPMorgan Chase's counsel . . . to notify JPMorgan Chase that its proposal, as presently formulated, was not acceptable to the Bear Stearns board . . . .").

[112] Kelly, *supra* note 16.

[113] *See* JPMorgan, *supra* note 64, at 34–35.

[114] *See id.* at 35–36 (outlining the terms of the new merger agreement). "This means that if the value of the assets [accepted by the Fed] turn out to be less than $29 billion, the [Fed] would suffer a loss." Cecchetti, *supra* note 41, at 18. Since the time the Fed accepted these assets as collateral for the loan to October of 2008, taxpayers lost approximately $2.2 billion dollars, based on the ongoing deterioration of mortgage values. Editorial, *The Fed Takes a Writedown*, WALL ST. J., Oct. 28, 2008, at A16.

[115] Given the ongoing corrosion of key markets, the total loss that will be suffered by taxpayers as a result of the Bear Stearns bailout remains to be seen. "[I]n October, six months after taking on $29 billion from investment bank Bear Stearns' loan portfolio, the Fed decided to write down $2 billion of the holdings." Jon Hilsenrath, *Bernanke's Fed, Echoing FDR, Pursues Ideas and Action*, WALL ST. J., Dec. 15, 2008, at A2.

[116] *See* Jenkins, *supra* note 107 ("Opening up its loan window to investment banks, and through them to their hedge fund clients, [the Fed] has alleviated the fear of fire sales of mortgage assets."). For an interesting historical account of the creation and use of the Fed's discount window, see Anna J. Schwartz, *The Misuse of the Fed's Discount Window* (Apr. 9, 1992), *in* FED. RESERVE BANK OF ST. LOUIS REV., Sept./Oct. 1992, at 60–63, *available at* http://research.stlouisfed.org/publications/review/92/09/Misuse_Sep_Oct1992.pdf.

precedent that risky investors who were "too big to fail" would be saved from their own self-perpetuated demise.[117] Soon after the bailout, critics denigrated the Fed's actions as uncharacteristic of a capitalist society,[118] while others used the event as a catalyst to launch attacks against the broader financial regulatory system.[119] Now that the Fed is willing to use its resources to save private investment firms whose bankruptcy could harm the entire economy, what new types of regulation should such businesses be subject to? "As the Bear Stearns episode illustrates, some of the modern-day financial institutions that are too big to fail are not depository institutions that fall under the strict regulatory umbrella that accompanies membership in the Federal Reserve System."[120] The remainder of this Note analyzes the legal authority available to the Fed during the Bear Stearns collapse, why this authority has been criticized as deficient, and how scholarly review of twenty-first century financial threats may lead to the revision and modification of twentieth-century financial regulation.

III. AN "UNUSUAL AND EXIGENT" LENDER OF LAST RESORT

A. *Too Big to Fail*

"Legally, the Fed can extend virtually unlimited support to our financial system,"[121] and since the 1930s the Fed has had the authority to issue direct loans to private businesses through its discount window.[122] Nonetheless, before the Bear Stearns predicament, the Fed traditionally reserved discount window loans for those institutions that were subject to the Fed's strict supervisory protocol, namely, heavily regulated depository

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[117] Crittenden & Eckblad, *supra* note 4; *see also* LABONTE, *supra* note 101, at 12 ("Institutions that are too big to fail are ones that are deemed to be big enough that their failure could create *systemic risk*, the risk that the financial system as a whole would cease to function smoothly."). The problem of encouraging risky behavior by bailing out failing institutions is commonly referred to as "moral hazard." *See id.* at 11.

[118] *See, e.g.*, Gary S. Becker, *We're Not Headed for a Depression*, WALL ST. J., Oct. 7, 2008, at A27 ("The 'too big to fail' approach to banks and other companies should be abandoned as new long-term financial policies are developed. Such an approach is inconsistent with a free-market economy.").

[119] *See, e.g.*, Bernanke, Kansas City, *supra* note 11 (criticizing the regulatory framework of the American financial system as inefficient for being ambiguous in its legal mandates); *see also* William Neikirk et al., *Call Grows for Tough Financial Regulation; Candidates, Congress Consider Intervening in Banking, Markets*, CHI. TRIB., Mar. 28, 2008, at C1 ("Political fervor is growing for a broad re-regulation of America's financial markets after a major credit crunch pummeled Wall Street and Main Street, sent the economy sinking and threatened a market meltdown.").

[120] LABONTE, *supra* note 101, at 12.

[121] Altman, *supra* note 15.

[122] *See* LABONTE, *supra* note 101, at 3–4 (discussing the use of the Fed's discount window in the past). The statutory authority for the Fed's discount window lending is provided for in section 10(b) of the Federal Reserve Act, which provides that "[a]ny Federal Reserve bank . . . may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve bank." Federal Reserve Act, 12 U.S.C. § 347b(a) (2006).

institutions.[123] In essence, "[i]n exchange for putting up with regulation from the Fed and requirements over how much capital they can hold, [commercial] banks have access to the 'discount window,' at which they can borrow emergency cash in exchange for sound collateral."[124] However, despite its seemingly limitless potential to rescue ailing businesses, the discount window has long been a secondary tool of the Fed in altering market operations,[125] and even those firms which could access the Fed's window in the past have rarely done so for a couple of reasons. First, from the government's perspective, the Fed has likely been hesitant to issue loans because each time it does so a precedent is established that compounds moral hazard, or the tendency of market participants to engage in risky behavior irrespective of the consequences given the potential for a public rescue.[126] Second, when a private enterprise looks to the Fed's discount window for a loan, it usually means the government is the last resort for the company, which in turn demonstrates weakness to the greater market.[127] Thus, as a corollary of both government and private reluctance, rarely would one see the full extent of the Fed's lending power in action.[128]

But, what happens when one business's failure threatens the larger economy the Fed is obligated to protect, as Bear Stearns's bankruptcy did? Similarly, how can the Fed respond to a systemic threat from an institution not subject to its "regulatory regime?" The answer to these questions lies in a little known provision of the Federal Reserve Act. In such circumstances, the Fed can call on emergency lending authority to protect the larger financial system, and in doing so provide liquidity to *any*

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[123] *See* Greg Ip et al., *Stronger Steps: Fed Offers Banks Loans to Ease Credit Crisis*, WALL ST. J., Aug. 18, 2007, at A1 ("[T]he discount window's reach in the current crisis is limited by the fact that only [commercial] banks can use it, and they aren't the ones facing the greatest stains. Rather the strains are being felt by nonbanks . . . .").

[124] Neil Irwin, *Fed Leaders Ponder an Expanded Mission; Wall Street Bailout Could Forever Alter Role of Central Bank*, WASH. POST, Mar. 28, 2008, at A01.

[125] *See* LABONTE, *supra* note 101, at 4 ("The Fed's main policy tool shifted from the discount window to open market operations several decades ago.").

[126] *See* Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve, Speech at the Federal Reserve Bank of Atlanta Financial Markets Conference: Liquidity Provision by the Federal Reserve (May 13, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080513.htm [hereinafter Bernanke, Atlanta I]. Chairman Bernanke stated:

> A central bank that is too quick to act as liquidity provider of last resort risks inducing moral hazard; specifically, if market participants come to believe that the Federal Reserve or other central banks will take such measures whenever financial stress develops, financial institutions and their creditors would have less incentive to pursue suitable strategies for managing liquidity risk and more incentive to take such risks.

Id.; *see also* Cassandra Jones Havard, *"Goin' Round in Circles" . . . and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, 86 NEB. L. REV. 737, 752–54 (2008) (explaining moral hazard in the context of the mortgage crisis).

[127] *See* Ip et al., *supra* note 123 ("[The discount window] is little used because it generally carries a stigma, since it is seen as a struggling bank's last resort.").

[128] *Cf.* Nelson D. Schwartz, *A History of Public Aid During Crises*, N.Y. TIMES, Sept. 7, 2008, at A27 (noting government's past intervention in the private market during periods of financial crisis).

institution, not just those within its regulatory reach.[129] It is this emergency authority that gives credence to the Fed's characterization as "lender of last resort."[130] And it is precisely this use of the Fed's emergency authority to rescue Bear Stearns that has incited reconsideration of the Fed's regulation of investment banks—the argument being that if firms can get public money, they should be subject to heightened public oversight by the agency lending that money.[131]

The specific legal provision authorizing emergency lending to private enterprises is section 13(3) of the Federal Reserve Act.[132] That section provides in pertinent part:

> 3. Discounts for Individuals, Partnerships, and Corporations.
>
> In *unusual and exigent circumstances*, the Federal Reserve Board, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, . . . to discount for *any* individual, partnership or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise *secured to the satisfaction of the Federal Reserve bank*.[133]

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[129] *See* LABONTE, *supra* note 101, at 1 ("Lending to non-members requires emergency statutory authority that has not been used in more than 70 years." (citation omitted)).

[130] *Id.* at 2; *see also* Frederic S. Mishkin, Gov. of the Bd. of the Fed. Reserve, Speech at the Caesarea Forum of the Israel Democracy Institute: Global Financial Turmoil and the World Economy (July 2, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/mishkin20080702a.htm ("[I]t is critical that the Federal Reserve acts as lender of last resort when financial stability is threatened . . . .").

[131] *See, e.g.*, Donald L. Kohn, Vice Chairman of the Bd. of the Fed. Reserve, Speech at the Federal Reserve Bank of Richmond's Credit Market Symposium (Apr. 17, 2008), *available at* http://federalreserve.gov/newsevents/speech/kohn20080417a.htm ("[I]n my view greater regulatory attention will need to be devoted to the liquidity risk-management policies and practices of major investment banks.").

[132] Federal Reserve Act, 12 U.S.C. § 343 (2006).

[133] *Id.* § 343 (emphasis added). Interestingly, in Bear's case, "[t]he required number of five members of the Board of Governors was not present on the day in question. One of them was out of town and ratified the vote when he returned, but the first loan was already in motion." Walker F. Todd, *The Bear Stearns Rescue and Emergency Credit for Investment Banks*, AIER, Aug. 11, 2008, http://www.aier.org/research/commentaries/445-the-bear-stearns-rescue-and-emergency-credit-for-invesmtn-banks. The legal authority allowing for votes of less than five members of the Board of Governors is provided for by section 11(r)(2)(A)(ii)(I)–(IV) of the Federal Reserve Act, which mandates:

> A. Any action that the Board is otherwise authorized to take under Section 13(3) may be taken upon the unanimous vote of all available members then in office, if:
>
> > I. unusual and exigent circumstances exist and the borrower is unable to secure adequate credit accommodations from other sources;
> >
> > II. action on the matter is necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the financial system of the United States;
> >
> > III. despite the use of all means available (including all available telephonic, telegraphic, and other electronic means), the other members of the Board

Originally enacted in 1932, the law was an outgrowth of the bank failures of the early twentieth century and has been used in different contexts over its seventy-seven-year history, albeit never in the same manner as in the Bear Stearns case.[134] Aside from the requirement that five governors vote to approve a loan under section 13(3), the provision has few limitations in terms of the amount that can be lent, or the means by which the Fed can do so. The condition that collateral be offered "to the satisfaction of the Federal Reserve bank," is contingent upon a plethora of extrinsic considerations (including systemic risk) that at times may seem inconsistent.[135] For example, some have criticized the Fed for accepting the collateral pledged by Bear Stearns or American International Group ("AIG") under section 13(3),[136] while Lehman Bros. ("Lehman") was allowed to go into bankruptcy.[137] Also, discount window lending is usually secured through collateral possessing a good credit rating, which was certainly not the case in the loans made to Bear Stearns.[138]

> have not been able to be contacted on the matter; and
>
> IV. action on the matter is required before the number of Board members otherwise required to vote on the matter can be contacted through any available means (including all available telephonic, telegraphic, and other electronic means) . . . .

Federal Reserve Act, 12 U.S.C. § 248(r) (2006); *see also* Minutes of the Board of Governors of the Federal Reserve System 2–3 (Mar. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/other20080627a1.pdf (documenting the Board's vote with regard to factors specified by section 11(r)(2)(A)(ii)).

[134] *See* Fettig, *supra* note 8, at 15–19, 44–47 (describing the historical evolution of section 13(3)); Fettig, *supra* note 4, at 34 (providing a concise timeline of the development of section 13(3) from 1932 to present).

[135] 12 U.S.C. § 343 (2006).

[136] *See* Press Release, Fed. Reserve (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm ("The Federal Reserve Board . . . authorized the Federal Reserve bank of New York to lend up to $85 billion to [AIG] under section 13(3) of the Federal Reserve Act.").

[137] *See* Adam Shell et al., *No White Knight Emerges to Rescue Lehman Bros.*, USA TODAY, Sept. 15, 2008, at 1B ("The failure to get a Lehman deal was due largely to the federal government's refusal to provide interested buyers such as Barclays with the kind of support that JPMorgan Chase received when it bought troubled investment bank Bear Stearns in March."); *Sale Possible as Lehman Sits on Brink*, CHI. TRIB., Sept. 11, 2008, at C1 ("Compounding anxiety is that Lehman, unlike smaller rival Bear Stearns, might not be able to count on a lifeline from the government.").

[138] Technically, Federal Reserve Banks may only provide advances and discounts to individual institutions when such extensions of credit are "secured to the satisfaction of the Federal Reserve bank." Federal Reserve Act, 12 U.S.C. §§ 343, 347b(a) (2006). For purposes of discount window lending, the collateral being pledged by borrowers must "meet regulatory standards for sound asset quality," meaning that assets held by solvent, yet illiquid institutions, will generally be adequate to meet the satisfaction standard of the Federal Reserve Act. Federal Reserve Discount Window, Frequently Asked Questions, http://www.frbdiscountwindow.org/cfaq.cfm?hdrID=14&dtlID=89 (last visited Nov. 16, 2009). However, although MBS and SMBS are nominally acceptable as discount window collateral, it is hard to see how the toxicity of Bear's MBS assets would satisfy Federal Bank officials, especially when one considers the state of Bear's financial health during the Fed rescue. *See* Federal Reserve Discount Window General Information, http://www.frbdiscountwindow.org/discountwindowbook.cfm?hdrID=14&dtlID=43#introduction (last visited Nov. 16, 2009) (noting that "[t]he financial condition of an institution may be considered" when evaluating whether, and to what

Nonetheless, section 13(3) was used three times by the Fed in March 2008, initially as a means of preventing Bear Stearns's imminent default and arranging the JPMorgan acquisition, and subsequently to create a new lending facility specifically for the large institutions the Fed conducts daily transactions with.[139]

Interestingly, it is this last use that demonstrates the Fed's challenges in responding to emergency situations of a systemic nature. For if the only means by which the Fed can save institutions—by issuing direct loans—is the same mechanism scorned by the market as a sign of weakness, troubled institutions may hesitate to use the discount window during a financial crisis.[140] Thus, to counteract the stigma associated with the discount window, the Fed created new lending mechanisms—including the Term Auction Facility, the Term Securities Lending Facility, and the Primary Dealer Credit Facility—in anticipation of the need for heightened borrowing, which has since reached astronomical levels.[141] Given this deficiency, "Fed officials believe[] the [current economic] problems require[] more than what a central bank was designed to do—provide emergency loans to *healthy institutions* in tumultuous times."[142] And yet, stretching the Fed's loan capacity was not the only uncharacteristic action taken by the Fed in the Bear Stearns case—an even more controversial move was the manner in which the Fed brokered the JPMorgan takeover.

B. *Sweetening the Deal*[143]

As previously noted, when the Fed issued the $29 billion loan pursuant to section 13(3) of the Federal Reserve Act to arrange for JPMorgan's acquisition of Bear Stearns, the funds were first filtered to JPMorgan then

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extent, a Federal Reserve bank will issue extensions of credit through the discount window). Of course, this issue adds to the controversial nature of the Bear Stearns bailout.

[139] *See* Bernanke, Atlanta I, *supra* note 126 (detailing use of the Fed's emergency lending authority in each circumstance).

[140] *See* LABONTE, *supra* note 101, at 4–5 ("Ironically, this means that although the Fed encourages discount window borrowing so that banks can avoid liquidity problems, banks are hesitant to turn to the Fed because of fears that doing so would spark a crisis of confidence.").

[141] *See* Cecchetti, *supra* note 41, at 19–20 (noting that as of May 2008, the Fed had nearly $180 billion worth of loans as compared to a total of $190 million only nine months earlier). There is some indication that borrowing and lending from the Fed by both commercial and investment banks has decreased early in 2009—this could be the result of investor pressures seeking bank independence without government support. *See* Prabha Natarajan & Brian Blackstone, *Mortgage-Bond Purchases Start Strong—Fed's Various Efforts to Bolster Markets Are Ballooning Its Balance Sheet*, WALL ST. J., Jan. 9, 2009, at C3 ("Borrowing through the Fed's discount window by commercial banks . . . fell about $10 billion [in the first week of January, while] [l]ending through the Fed's [PDCF] . . . fell [$3 billion] . . . .").

[142] Jon Hilsenrath et al., *Crisis Mode: Paulson, Bernanke Strained for Consensus in Bailout*, WALL ST. J., Nov. 10, 2008, at A1 (emphasis added).

[143] This section focuses primarily on the Fed's use of emergency lending authority and other legal tools to arrange the eventual takeover of Bear Stearns by JPMorgan. As such, the discussion focuses on the legal authority involved in the merger, not other contexts.

used to secure Bear's debts and take over Bear's operations.[144] Aside from exercising emergency authority to distribute the loan in the first place, the Fed also had to exempt JPMorgan from another provision of the Federal Reserve Act, which is designed to prohibit the very type of transaction the Bear Stearns deal involved.[145] The provision in question is section 23A of the Federal Reserve Act, which provides:

> Restrictions on Transactions with Affiliates
>
> 1. A member bank and its subsidiaries may engage in a covered transaction with an affiliate only if:
>
>   A. in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and
>
>   B. in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank.[146]

Section 23A is designed to limit the extent of covered transactions, including loans, extensions of credit, or the purchase of securities, which member banks,[147] such as JPMorgan, enter into with affiliate institutions—in this case a wholly-owned subsidiary formed solely for the purpose of acquiring Bear Stearns.[148] Additionally, section 23A "limit[s] the ability of

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[144] *See supra* Part II.D. JPMorgan actually formed a wholly-owned subsidiary "solely for the purpose of consummating the merger." JPMorgan, *supra* note 64, at 25.

[145] *See* 12 U.S.C. § 371c(a)(1)A–B (2006); Letter from Robert deV. Frierson, Deputy Sec'y of the Bd. of the Fed. Reserve, to Kathryn V. McCulloch, Senior V.P. & Assoc. Gen. Counsel of JPMorgan Chase & Co. (July 1, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/federalreserveact/2008/20080701/20080701.pdf (authorizing exemptions from provisions of the Federal Reserve to allow JPMorgan to finalize the acquisition of Bear Stearns); Letter from Robert de V. Frierson, Deputy Sec'y of the Bd. of the Fed. Reserve, to Kathleen A. Juhase, Senior V.P. & Assoc. Gen. Counsel of JPMorgan Chase & Co. (Aug. 20, 2008), *available at* http://www.federalreserve.gov/BOARDDOCS/LegalInt/FederalReserveAct/2007/20070820c/20070820c.pdf (approving initial exemptions from the Federal Reserve Act authorizing JPMorgan to finance Bear's daily operations).

[146] 12 U.S.C. § 371c(a)(1)A–B. Near identical restrictions apply pursuant to the Federal Reserve Board's Regulation W, as codified in 12 C.F.R. § 223.11 (2009) and 12 C.F.R. § 223.12 (2009), which limit the aggregate amounts of transactions between member banks and single or multiple affiliates.

[147] The term "member bank" refers to depository firms which are members of the Federal Reserve System. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,560 (Dec. 12, 2002).

[148] Under section 23A, "covered transactions," include "loan[s] or extension[s] of credit to . . . affiliate[s] . . . [and the] purchase of assets . . . from [affiliates]." 12 U.S.C. § 371c(b)(7)(A)(C). An "affiliate" includes "any company that controls the member bank and any other company that is controlled by the company that controls the member bank." *Id.* § 371c(b)(1)(A). When JPMorgan acquired Bear Stearns, it formed a wholly-owned subsidiary "solely for the purpose of consummating

a member bank to transfer its Federal subsidy to affiliates," precluding non-member banks from accessing the Fed's safety net.[149] The intention of the law "is to prevent problems at the affiliate from endangering the [member] bank's depositors."[150] Exemptions from these restrictions can only be granted by the Federal Reserve Board when found to be in the "public interest and consistent with the purposes of" section 23A.[151]

As section 23A limits the "aggregate amount of covered transactions" that a member bank and an affiliate may engage in, the statute presented an impediment for Fed officials seeking to arrange the JPMorgan purchase of Bear in late March 2008. Specifically, the statute would expressly prohibit JPMorgan (as a member bank) from taking over Bear, because the $29 billion "extension of credit" that the arrangement involved was a "covered transaction" exceeding "20 per centum of the capital stock and surplus" of JPMorgan.[152] Thus, if the purchase of Bear was to be consummated as planned, the transaction would be illegal and void under the Federal Reserve Act.[153] This dilemma necessitated the utilization of an authorized exemption from the Federal Reserve Board to ensure that Bear's bankruptcy could be avoided in a legitimate manner.[154]

When JPMorgan first agreed to acquire Bear Stearns on March 16, 2008, the Fed granted a temporary (eighteen-month) 23A exemption so that JPMorgan would be able to "finance the operations of Bear Stearns" and guarantee its outstanding debts.[155] This initial exemption allowed JPMorgan to enter into transactions with Bear Stearns and its customers in aggregate amounts of up to fifty percent of JPMorgan's "capital stock and surplus for the second quarter of 2008 (approximately $58 billion)."[156] Subsequently, three months after the initial temporary exemption was granted, on July 1, 2008, the Federal Reserve Board again suspended the application of section 23A, allowing JPMorgan to complete the purchase

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the merger," which would trigger the application of section 23A of the Federal Reserve Act. JPMorgan, *supra* note 64, at 25.

[149] Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,560; *see also* PATRICIA A. MCCOY, BANKING LAW MANUAL, FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES § 6.05 (2d ed. 2002) (explaining the scope and purposes of sections 23A and 23B of the Federal Reserve Act).

[150] Brian Blackstone, *Fed Agrees to Ease Some Rules for J.P. Morgan*, WALL ST. J., Apr. 5, 2008, at A2.

[151] 12 U.S.C. § 371c(f)(2). The purposes of section 23A have been declared by the Board as being two-fold: "(i) to protect against a deposit institution suffering losses in transactions with affiliates and (ii) to limit the ability of a deposit institution to transfer to its affiliates the subsidy arising from the institution's access to the Federal safety net." Letter from Robert deV. Frierson to Kathryn McCulloch, *supra* note 145, at 3 (citation omitted).

[152] 12 U.S.C. § 371c(a)(1)(B).

[153] *Id.*

[154] *See* Letter from Robert deV. Frierson to Kathleen Juhase, *supra* note 145, at 1–5 (granting and explaining the exemption from section 23A and setting conditions on the authorized transaction).

[155] Letter from Robert deV. Frierson to Kathryn McCulloch, *supra* note 145, at 6.

[156] *Id.*

of Bear Stearns's assets for "approximately $44 billion."[157] In doing so, the Fed reduced the original March 16 aggregate ceiling to $5 billion, and declared the initial exemption void as of October 1, 2008.[158]

In both instances, the Fed justified its actions in granting 23A exemptions based on past practices,[159] and in allowing JPMorgan to complete the purchase of Bear Stearns, the Fed argued that the terms of the acquisition were substantially similar to those that would exist for "comparable transactions with unaffiliated companies," as otherwise required by federal law.[160] While these rationales may be valid, it remains unsettling that the Fed suspended enforcement of section 23A to permit the very type of transaction the law was enacted to prohibit.[161] Most importantly, concerns surround the potential losses JPMorgan (and in turn its depositors) were exposed to during the Bear Stearns transactions, a primary issue that the enactors of section 23A meant to protect against.[162] "In effect, [these] 23A exemption[s] signaled the Federal Reserve's willingness to allow troubled investment banks to shift their bad assets to insured commercial banks and thereby expose the Deposit Insurance Fund and U.S. taxpayers to a heightened risk of loss."[163] Additionally, by forwarding a federal subsidy through a member bank to Bear Stearns (a non-member institution) the Fed endorsed a collateralized transaction inconsistent with the underlying policy of "safe and sound banking practices,"[164] and specifically restricted by the Federal Reserve Act.[165]

The highly controversial nature of the Fed's manipulation of its legal authority in these circumstances has led to internal disputes among

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[157] *Id.* at 3.

[158] *Id.* at 6.

[159] *See id*. at 3 ("The Board routinely has approved exemptions . . . for one-time asset transfers that are part of a corporate reorganization and that are structured to ensure the quality of the transferred assets. The Board also has routinely approved exemptions . . . to facilitate the integration of recently merged companies." (internal citations omitted)).

[160] *See id.* at 5 ("Section 23B [of the Federal Reserve Act] requires that the [JPMorgan acquisition] be on terms that are substantially the same, or at least as favorable to [JPMorgan], as those prevailing at the time for comparable transactions with unaffiliated companies." (citation omitted)).

> Restrictions On Transactions with Affiliates.
>
> 1. A member bank and its subsidiaries may engage in any of the transactions described in paragraph (2) only—
>
>   A. on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies . . . .

12 U.S.C. § 371c-1(a)(1)(A) (2006).

[161] *See* Transaction Between Members Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,560–62 (Dec. 12, 2002).

[162] *See id.* at 76,560 ("Sections 23A and 23B of the Federal Reserve Act are important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates.").

[163] MCCOY, *supra* note 149.

[164] *See* 12 U.S.C. § 371c(a)(4).

[165] *See id.* § 371c(c)(3).

government officials as to the extent of the Central Bank's power to manage financial crises.[166] Ideologically, the Fed's conduct during the Bear Stearns bailout signals a policy shift at the Central Bank that embraces government intervention in preventing the failure of private firms, a strategy unlike the traditional models which allowed for market correction, limited government involvement, and ultimately private failures and bankruptcies. In turn, by becoming more involved in preventing the failure of private firms, the Fed has inherently increased the scope of its marketplace oversight—a result accomplished indirectly through the creation of new facilities and mechanisms implemented to protect ailing institutions. These new facilities, coupled with the modification of existing tools, have become the foundation for a new Central Bank that is progressively intervening more deeply into the market, yet limited by legal authority devised for the twentieth century.

C. *The Offspring of Emergency*

Early indications of the Fed's expanding presence in the financial markets can be traced back to the week leading up to the bailout of Bear Stearns. Mindful of the stigma attached to discount window borrowing, the Fed sought to stimulate lending in mid-March 2008 by relying on a supplementary loan tool initially developed in December 2007, known as the Term Auction Facility ("TAF").[167] Unlike the typical overnight lending done through the discount window, the TAF provides loans with longer maturity terms (such as twenty-eight days),[168] and "[t]he TAF allows the Fed to determine the amount of reserves it wishes to lend out, based on market conditions."[169] TAF loans can be collateralized using the same types of assets accepted at the discount window (including MBS),[170] but the amounts offered through the TAF "have greatly exceeded discount window lending."[171]

For example, on March 7, 2008, the Fed announced it would increase the amounts outstanding in the TAF to $100 billion, and declared that the two auctions to be held in that month would be extended to $50 billion,

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[166] *See* Hilsenrath et al., *supra* note 142 (detailing frequent disagreements between former Treasury Secretary Paulson and Fed Chairman Bernanke over proper scope of Fed authority to respond to systemic threats to the economy).

[167] *See* Charles T. Carlstrom & Sarah Wakefield, *The Funds Rate, Liquidity, and the Term Auction Facility*, ECON. TRENDS, Dec. 2007, at 5, 6, *available at* http://www.clevelandfed.org/research/trends/2007/1207/ET_dec07.pdf ("One of the major changes for the Federal Reserve [in December 2007] . . . was the institution of a 'term auction facility' (TAF) to supplement regular discount window borrowing.").

[168] LABONTE, *supra* note 101, at 5.

[169] *Id.*

[170] *See id.* ("Like discount window lending, TAF loans must be fully collateralized with the same qualifying collateral [accepted at the discount window].").

[171] *Id.*

$20 billion more than previously offered in February 2008.[172] Additionally, the Fed assumes the risk associated with a decline in the value of the collateral posted by private institutions in return for TAF loans, and questions have arisen as to whether this once temporary program will become permanent following reevaluation, albeit with reduced auction amounts.[173] Because the funds distributed by the Fed through the TAF reflect market needs and anticipated demand for assistance, the TAF is a more controlled platform for lending as compared to the traditional discount window.[174] In the fourth quarter of 2008, TAF lending and term limits had been extended to as much as $150 billion and eighty-five days respectively[175]—figures representative of the popularity (or necessity) of the TAF during the current financial crisis.

Aside from the growing role of the TAF, "[o]n March 11, 2008, the Fed set up a more expansive securities lending program for the primary dealers called the Term Securities Lending Facility" (the "TSLF").[176] The TSLF allows the Fed to promote financial market operations by providing easy access to liquidity for those institutions the Fed regularly conducts transactions with and whose financial size and strength are directly related to the health of the financial system—the primary dealers.[177] Lending through the TSLF can be in amounts of up to $200 billion in Treasury securities, for terms of twenty-eight days, and collateralized through a wide range of assets, including illiquid MBS.[178] Initially, MBS collateral had to be AAA-rated; however, the Fed eventually broadened the types of eligible collateral to include "all investment-grade debt securities," and changed TSLF auctions from biweekly to weekly in September 2008.[179] The TSLF allows the largest financial institutions to regularly swap their unmarketable assets for easily marketable Treasury securities, which "is

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[172] *See* Press Release, Fed. Reserve (Mar. 7, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080307a.htm.

[173] *See* LABONTE, *supra* note 101, at 5.

[174] *See id*. ("Discount window lending is initiated at the behest of the requesting institution—the Fed has no control over how many requests for loans it receives.").

[175] Press Release, Fed. Reserve (Oct. 6, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081006b.htm.

[176] LABONTE, *supra* note 101, at 6.

[177] *See id.* at 6 (explaining TSLF operations and providing technical definition of primary dealers); Press Release, Fed. Reserve (Sept. 14, 2008), *available at* http://federalreserve.gov/newsevents/press/monetary/20080914a.htm (explaining how the TSLF stimulates flow of liquidity between largest financial institutions). For a discussion of the role of primary dealers, see Marco Arnone & George Iden, *Primary Dealers in Government Securities: Policy Issues and Selected Countries' Experience* 3–10 (IMF Working Paper No. 03/45, 2003), *available at* http://www.imf.org/external/pubs/ft/wp/2003/wp0345.pdf.

[178] *See* Franklin Allen & Elena Carletti, The Role of Liquidity in Financial Crisis 6 (Sept. 4, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1268367. Treasury securities include Treasury notes, bonds, and bills, backed by the Federal Government and, as such, are very safe investments. U.S. Secs. & Exch. Comm'n, Treasury Securities, http://www.sec.gov/answers/treasuries.htm (last visited Nov. 16, 2009).

[179] Press Release, Sept. 14, 2008, *supra* note 177.

intended to promote liquidity in the financing markets for Treasury and other collateral" and improve the overall performance of financial markets.[180]

Finally, following JPMorgan's announced acquisition of Bear Stearns on March 16, 2008, the Fed launched yet another new lending tool designated the Primary Dealer Credit Facility ("PDCF"), which was designed to improve access to discount window-type loans to primary dealers.[181] The PDCF was created pursuant to the emergency lending provisions of section 13(3) of the Federal Reserve Act, and "provides primary dealers with a liquidity backstop similar to the discount window for deposit institutions in generally sound financial condition."[182] Because many primary dealers, such as Bear Stearns, could not previously pledge their collateral for direct discount window loans from the Fed, the PDCF seems to have been the result of Fed frustration in attempting to work within its legal authority in loaning funds to non-member institutions. As with the TSLF, the PDCF initially required investment-grade securities as collateral for overnight or short-term loans; however, the Fed has subsequently broadened the acceptable PDCF collateral to include assets exchanged in repo markets.[183] From its inception, the PDCF seems to have contributed to growing lending confidence among primary dealers and their counterparties, yet the very fact that the PDCF has been extended into 2009 suggests that market conditions remain abnormal.[184]

The Fed's use of the TAF, TSLF, PDCF, and other facilities[185] raises

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[180] LABONTE, *supra* note 101, at 6 (citation omitted).

[181] *See* Fed. Reserve Bank of N.Y., Primary Dealer Credit Facility, http://www.newyorkfed.org/markets/pdcf.html (last visited Nov. 16, 2009) ("The . . . (PDCF) is an overnight loan facility that will provide funding to primary dealers in exchange for a specified range of eligible collateral that is intended to foster the functioning of financial markets more generally.").

[182] Bernanke, Atlanta I, *supra* note 126.

[183] *See* Press Release, Sept. 14, 2008, *supra* note 177 ("The collateral eligible to be pledged at the Primary Dealer Credit Facility (PDCF) has been broadened to closely match the types of collateral that can be pledged in the tri-party repo systems of the two major clearing banks.").

[184] *See* Bernanke, Atlanta I, *supra* note 126 (discussing improvement in confidence among primary dealers and their counterparties and noting that despite improvement in confidence, financial markets "are still far from normal"); Press Release, Fed. Reserve (July 30, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080730a.htm (announcing the Fed's extension of the PDCF until January 30, 2009).

[185] The Fed has developed numerous facilities, other than the ones previously described, in an ongoing effort to stimulate liquidity transfers in financial markets and promote confidence between counterparties. For example, in October 2008, the Fed created the Commercial Paper Funding Facility ("CPFF"), which provides a "liquidity backstop" to domestic providers of commercial paper by allowing the Fed to purchase "three-month unsecured and asset-backed commercial paper directly from eligible issuers." Press Release, Fed. Reserve (Oct. 7, 2008), *available at* http://federalreserve.gov/newsevents/press/monetary/20081007c.htm. Likewise, in late November 2008, the Fed instituted the Term Asset-Backed Securities Loan Facility ("TALF"), which allows the New York Fed to "lend up to $200 billion on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans." Press Release, Fed. Reserve (Nov. 25, 2008), *available at* http://www.federalreserve.gov/monetarypolicy/20081125a.htm. The TALF is designed to

important questions about the expanding intervention of the federal government in our free market economy, as well as the threat to economic independence and innovation that the Fed's growing presence poses. Similarly, skepticism as to the tools utilized by the Fed to combat ailing market operations emphasizes the concern that the Fed's policy responses may indirectly promote moral hazard.[186] These issues have incited a consensus that regulatory reform is overdue and will be a major undertaking of the Obama administration and the 111th Congress.[187]

IV. INADEQUACIES IMPAIRING INTERVENTION

A. *The Call for Regulatory Reform*[188]

Four months after Bear Stearns was saved from bankruptcy, Fed Chairman Ben Bernanke testified before the House Committee on Financial Services to "discuss financial regulation and financial stability."[189] Using Bear Stearns as an example, Bernanke suggested that the current regulatory framework for the financial system was inadequately structured to respond to and remedy problems posed by contemporary investment banks and products.[190] In particular, Bernanke explained that limited oversight of investment banking practices and sophisticated investment vehicles had contributed to the creation of a financial system more advanced than the laws that governed it.[191] As in Bear Stearns's case, private institutions (and the market as a whole) had evolved to the extent that a single firm's failure could bring the entire system to its

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make it "easier for consumers to borrow money," thus easing lending markets and stimulating growth. Deborah Solomon, *New Facility Targets Consumer Lending*, WALL ST. J., Nov. 25, 2008, at C1.

[186] *See* Ben S. Bernanke, Chairman of the Bd. of the Fed. Reserve, Speech at the Greater Austin Chamber of Commerce: Federal Reserve Policies in the Financial Crisis (Dec. 1, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm [hereinafter Bernanke, Austin] ("[I]ntervening to prevent the failure of a financial firm is counterproductive, because it leads to erosion of market discipline and creates moral hazard.").

[187] *See id.* ("In the longer term, the development of a statutory framework for resolving systemically critical nonbank financial institutions in ways that do not destabilize the financial system as a whole must be another key priority.").

[188] This section discusses the impetus for reform of the regulatory structure of the financial system within the narrow realm of the investment banking industry and the expanding role of the Federal Reserve as a central administrator. Therefore, consideration of broader regulatory reform that may be appropriate in other contexts (such as the mortgage industry) is beyond the scope of this Note.

[189] Ben S. Bernanke, Chairman of the Bd. of the Fed. Reserve, Testimony Before the House Comm. on Fin. Servs. (July 10, 2008), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20080710a.htm [hereinafter Bernanke, Fin. Servs.].

[190] *See id*. ("[I]n light of the Bear Stearns episode, Congress may wish to consider whether new tools are needed for ensuring an orderly liquidation of a systemically important securities firm that is on the verge of bankruptcy, together with a more formal process for deciding when to use those tools.").

[191] *See id.* ("Congress should consider granting the Federal Reserve explicit oversight authority for systemically important payment and settlement systems.").

knees.[192] Known as "systemic risk,"[193] the occurrence of this phenomenon necessarily prompts the intervention of the federal government.[194] However, the nature of that intervention has come under intense scrutiny in the wake of Bear Stearns.[195] Specifically, the scope of the Fed's authority as lender of last resort during systemic crisis remains obscure in the context of nonbank institutions that traditionally were not subject to Fed oversight.[196] "The decision to treat Bear Stearns as if it were a commercial bank appears to have marked a permanent shift in the governance of financial services firms."[197] Likewise, as Professor Steven Schwarcz of Duke University School of Law has noted, de facto bailouts of systemically important institutions facing bankruptcy focus merely on "symptoms of the disease . . . not on the disease's underlying cause."[198] Thus, the Fed's capacity to respond to financial distress appears constrained by both the lack of a robust supervisory mandate and a limited number of tools available to protect the nation's economy.[199] For example, although the Fed can issue emergency loans to nonbank financial institutions, "such loans must be backed by collateral sufficient to provide reasonable assurance that they will be repaid; if such collateral is not available, the Fed cannot lend."[200] And while the Fed "serves as the umbrella supervisor of all bank holding companies," nonbank institutions are generally supervised by other agencies that lack the resources and legal authority of the Fed.[201]

Discrepancies between the Central Bank's status as "umbrella

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[192] *See id*. ("[T]he stability of the broader financial system requires key payment and settlement systems to operate smoothly under stress to effectively manage counterparty risk.").

[193] *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198 (2008) ("A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect."); *see also* Olivier De Bandt & Philipp Hartmann, *Systemic Risk: A Survey* 10–11 (Eur. Cent. Bank, Working Paper No. 35, 2000), *available at* http://www.ecb.int/pub/pdf/scpwps/ecbwp035.pdf. Systemic risk as a focus of regulation is discussed *infra* Part V.A.

[194] *See* Mishkin, *supra* note 130 (explaining the necessity of the central bank as lender of last resort during systemic financial crises).

[195] *See* Bernanke, Kansas City, *supra* note 11 ("[I]n the rare circumstances in which the impending or actual failure of an institution imposes substantial systemic risks, the standard procedures for resolving institutions may be inadequate.").

[196] *See* Bernanke, Fin. Servs., *supra* note 189 ("[U]nder current arrangements, the SEC's oversight of the holding companies of the major investment banks is based on a voluntary agreement between the SEC and those firms.").

[197] David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 740 (2008) (reviewing Curtis J. Milhaupt & Katharina Pistor, LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD (2008)).

[198] Steven L. Schwarcz, *Markets, Systemic Risk, and the Subprime Mortgage Crisis*, 61 SMU L. REV. 209, 214 (2008).

[199] *See, e.g.*, Bernanke, FDIC, *supra* note 9.

[200] Bernanke, Austin, *supra* note 186.

[201] Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Allied Social Science Association Annual Meeting (Jan. 5, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070105a.htm.

supervisor" and its restricted oversight of investment and securities firms is largely the result of the Gramm-Leach-Bliley Act of 1999 (the "GLBA").[202] In passing the GLBA, "Congress was cognizant of the fact that functional regulation for securities [subsidiaries of depository institutions], when combined with the traditional oversight powers of the [Fed], had the potential to create added regulatory burdens for bank and financial holding companies."[203] Therefore, the GLBA directed the Fed "to limit the focus and scope of [its] examinations" into nonbank institutions (i.e., investment banks) subject to alternative regulatory schemes, and "forego examinations [of these firms] in lieu of reviewing examination reports by the [SEC]."[204] Unfortunately, this division of responsibility severely curtails the Fed's ability to anticipate systemic risks posed by investment banks and financial institutions, especially when the SEC does not live up to its obligations. As Professor Patricia McCoy of the University of Connecticut School of Law explains, "[the GLBA] essentially envisions systemic risk as risk that is confined to one sector (for example, the banking sector as opposed to the securities sector). As financial services become more intricate and interdependent, however, that assumption [along with the efficacy of patchwork regulation] must be questioned."[205] Indeed, Bear's primary regulator, the SEC, "played almost no role" in Bear's rescue, suggesting that the Fed's principal regulation of commercial banks may be obsolete and too narrow-minded given today's reality.[206]

The regulatory deficiencies that seem to impair the Fed's ability to effectively respond to systemic threats are even more pronounced considering the fact that "the Fed is the only agency that has the power to serve as a liquidity provider of last resort, a power that has proved critical in financial crises throughout history."[207] Because the Fed has come to assume the risk associated with loans to previously unregulated institutions, officials contend that increased supervision of such firms by the Fed is only reasonable and in keeping with the Fed's obligation to

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[202] Gramm-Leach-Bliley Act, 15 U.S.C. §§ 6801–6809, 6821–6827 (1999).

[203] PATRICIA A. MCCOY, BANKING LAW MANUAL, BANK AND THRIFT SUPERVISION § 2.04(1)(a)(ii) (2009).

[204] *Id*.

[205] *Id*.

[206] *See* Skeel, *supra* note 197, at 735–36; *see also* Kristen French, *Wall Street Turf Wars: SEC Versus Fed*, July 24, 2008, http://registeredrep.com/regulatory/sec_versus_fed_0724/index.html ("There has been some speculation that the Federal Reserve would begin to regulate investment banks much in the same way that it regulates commercial banks today, requiring them to compute capital requirements and maintain liquidity levels on a consolidated basis, and discouraging certain kinds of financial risk-taking.").

[207] Bernanke, FDIC, *supra* note 9.

promote overall financial stability.[208] Of course, "[w]ith the Fed bearing apex responsibility for U.S. financial stability, it is reasonable to ask whether it enjoys sufficiently broad oversight authorities."[209] Given its "macroeconomic objectives" of "maximum sustainable employment and price stability,"[210] Fed leaders have stressed the importance of enhanced oversight authority as a necessity for accomplishing its directives.[211] Ideally, providing the Fed with greater supervisory powers would limit the need to issue emergency loans in the future, as the Central Bank could use policy initiatives to deter investment operations that lead to systemic risk. In this way, the financial system as a whole, and the American taxpayer, would be better protected from future instances of market disruption caused by irresponsible trade practices. If the Fed were better able to anticipate failures among individual firms or markets, it would be less likely that gaps in the regulatory structure would afflict the broader economy.[212]

These issues have led some officials to argue that a unified system of financial regulation under the direction of the Fed would make the most sense in light of the oversight failures of the past year.[213] In fact, the heterogeneous makeup of the existing regulatory system has been criticized as unduly redundant, inefficient, and archaic, and a liability to the security of the future financial industry.[214] Even before the onset of the current crisis, empirical evidence suggested that those countries that had a

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[208] *See* Irwin, *supra* note 124 ("[Former] Treasury Secretary Henry M. Paulson Jr. said that if investment banks are given permanent access to the Fed's emergency funds, they should have the same kind of supervision that the Fed requires for conventional banks.").

[209] Vir Bhatia, *supra* note 17, at 17 (emphasis omitted).

[210] Kevin Warsh, Governor of the Bd. of the Fed. Reserve, Remarks at the New York State Economics Association's 60th Annual Conference: Financial Stability and the Federal Reserve (Oct. 5, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/warsh20071005a.htm.

[211] *See* Bernanke, FDIC, *supra* note 9 ("[H]olding the Fed more formally accountable for promoting financial stability makes sense only if the institution's powers are consistent with its responsibilities."); Donald L. Kohn, Vice Chairman, Fed. Reserve, Speech at the Exchequer Club Luncheon (Feb. 21, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/kohn20070221a.htm ("The Federal Reserve's activities as a bank supervisor provide us with important and sometimes critical information . . . . Thus, I want to take this opportunity to emphasize and reinforce the case for central bank involvement in bank supervision.").

[212] *See* Browne, *supra* note 17, at 385–87 (discussing how gaps in the regulatory structure of the financial industry impair the nation's global competitiveness).

[213] *See* Scannell, *supra* note 13 ("'What makes more sense [than the current approach] is to have a unified system of financial-services regulation.'" (quoting Harvey Pitt, former SEC Chairman)).

[214] *See* Norman D. Slonaker, *The Department of the Treasury Blueprint for a Modernized Financial Structure*, 1708 PRAC. L. INST. 955, 958 (2008).

> The current regulatory system of separate agencies across functional lines (banking, insurance, securities and futures) has resulted in:
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> i. No single regulator with all the information and authority to monitor systemic risk and coordinate action throughout the financial system
> ii. Jurisdictional disputes among the agencies
> iii. Regulatory redundancies
> iv. Inefficiency and loss of U.S. competitive advantage

Id.

unified supervisory and monetary program enjoyed fewer bank failures in the 1980s and 1990s than countries that separated such responsibilities among different agencies.[215] Together with other statutory reforms designed to streamline government oversight of nonbank institutions and complex securities,[216] proponents of enhanced Fed supervision within the financial services industry argue that the Central Bank is the most economic platform from which to shape the future regulatory structure.[217]

Currently, Fed officials are attempting to clarify the Central Bank's existing supervisory protocol in an effort to increase awareness as to the Fed's oversight abilities.[218] It remains to be seen whether the results of this internal review will reinforce arguments for the revision of financial regulation. Needless to say, as the market continues to adjust to the barren landscape of the post-housing bubble, commentators have observed that the lack of a clear regulatory structure is hindering economic recovery.[219] Still, others doubt whether increased regulation is the answer to recurring economic crises, and even public officials have warned that rushing to regulation is imprudent.[220]

B. *Private Skepticism*

Amidst the seemingly ubiquitous appeals for tougher regulation,

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[215] *See* Joseph G. Haubrich, *Combining Bank Supervision and Monetary Policy*, FED. RESERVE BANK OF CLEVELAND, Nov. 1996, http://www.clevelandfed.org/Research/Commentary/1996/1196.htm.

[216] For example, the Treasury Department has suggested that the SEC and CFTC merge to afford consolidated oversight and regulation of the securities and futures markets. *See* DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 11 (2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf. Additionally, Chairman Bernanke has suggested that a new regulatory regime be developed specifically for nonbank institutions. *See* Bernanke, Kansas City, *supra* note 11 ("A statutory resolution regime for nonbanks, besides reducing uncertainty, would also limit moral hazard by allowing the government to resolve failing firms in a way that is orderly but also wipes out equity holders and haircuts some creditors, analogous to what happens when a commercial bank fails.").

[217] *See* DEP'T OF THE TREASURY, *supra* note 216, at 146–56 (detailing how the Fed's current responsibilities and authority complement the expanded protocol suggested by the Treasury Department).

[218] *See* David L. Kohn, Vice Chairman, Fed. Reserve, Testimony Before the U.S. Senate Comm. on Banking, Hous. & Urban Affairs (June 5, 2008), *available at* http://federalreserve.gov/newsevents/testimony/kohn20080605a.htm ("The Federal Reserve is nearing completion of enhancements to its supervisory guidance to clarify [its] role as consolidated supervisor of bank and financial holding companies . . . . The updated guidance is primarily intended to provide greater clarification to [its] own examination staff.").

[219] *See* Tyler Cowen, *Was an Old Bailout a Bad Precedent?*, N.Y. TIMES, Dec. 28, 2008, at BU5 ("Regulatory uncertainty is stifling the ability of financial markets to engineer at least a partial recovery.").

[220] *See* Ben S. Bernanke, Chairman, Fed. Reserve, Speech at New York University Law School: Financial Regulation and the Invisible Hand (Apr. 11, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070411a.htm ("[T]he benefits of regulation come with direct and indirect costs. Direct costs include those arising from compliance with a thicket of complicated rules . . . . Indirect costs include reductions in innovation or competition that can result from overly restrictive regulations.").

skeptics have voiced their dissent in an attempt to explain why this most recent economic catastrophe should cause lawmakers to pause before instituting a mass overhaul of the existing regulatory structure.

Critics of such a legislative renovation, both in the United States and abroad, argue that more regulation may simply be ineffective in preventing future crises given the incredibly complex nature of today's financial markets.[221] For example, Professor Tyler Cowen of George Mason University has explained that "regulators will never be in a position to accurately evaluate . . . many of the most important market transactions."[222] Because of the intricate web of international finance, which involves highly sophisticated players and trillions of dollars, government regulators lack the resources to use reform as a means to prevent disaster.[223] Instead, "the real issue is setting strong regulatory priorities to prevent outright fraud and to encourage market transparency, given that government scrutiny will never be universal or even close to it."[224] Similarly, using government to restrain un-regulated financial sectors after they have wreaked havoc on the system may not be the best guide for controlling future threats.[225] As some commentators have pointed out, the debate over the future of regulation has arisen in the smog of disaster, and a complete reconsideration of traditional models of reform may be necessary.[226]

Additionally, the possibility that reform will create a slippery slope of government abuses and outright favoritism has made headlines in the United Kingdom, where revised banking policies have been criticized as allowing the public sector to "cherry-pick assets and transfer them to a private sector buyer."[227] Interestingly, the United Kingdom delegates the responsibility of bank and financial services supervision to a single agency, the Financial Services Authority ("FSA").[228] As a central hub of financial oversight, the FSA draws on expansive regulatory powers to influence and observe market operations, and functions independently of the Bank of

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[221] *See* Cowen, *supra* note 2, at BU7 ("[I]t's not obvious that the less regulated financial sector performed any worse than the highly regulated housing and bank mortgage lending sectors, including, of course, the government-sponsored mortgaged agencies.").

[222] *Id.*

[223] *See id.*

[224] *Id.*

[225] *See id.*

[226] *See* Adrian Blundell-Wignall & Paul Atkinson, *The Sub-Prime Crisis: Causal Distortions and Regulatory Reform*, *in* LESSONS FROM THE FINANCIAL TURMOIL OF 2007 AND 2008 55, 66 (Paul Bloxham & Christopher Kent eds., 2008), *available at* http://www.rba.gov.au/PublicationsAndResearch/Conferences/2008/Blundell-Wignall_Atkinson.pdf ("There needs to be some new thinking about reform of the regulatory and policy-making paradigms for the longer run.").

[227] Philip Aldrick, *Banking Reforms Will Jeopardise Financial Industry, Say Lawyers*, DAILY TELEGRAPH (London), Sept. 4, 2008, at 3 (quoting Bob Penn, Regulatory Partner, Allen & Overy).

[228] *See* About the FSA, http://www.fsa.gov.uk/Pages/About/What/index.shtml (last visited Nov. 16, 2009) (providing links to details on the scope, objectives, and structure of the FSA).

England.[229] This separation of central banking and banking supervision is emphasized by critics who reject the expanding role of the Fed as a financial administrator over nonbanks.[230] Those who endorse the United Kingdom's regulatory approach contend that increased independence of financial regulators allows flexibility in governance, which in turn promotes efficient use of resources and generally more effective policies.[231] By adopting a "principles-based" methodology of supervision that encourages voluntary compliance by private institutions, the FSA has been commended for promoting market discipline.[232] Furthermore, by removing supervisory responsibilities from the purview of a central bank, and thereby reducing its oversight authority, some scholars have argued that the risk that a conflict of interest would impede the Fed's ability to impose monetary restraint out of concern for banks is largely reduced if not eliminated, by the FSA paradigm.[233] With countries such as Korea, Japan, India, and South Africa moving toward systems that mirror those of the United Kingdom,[234] questions will soon arise as to how the United States should proceed and what the future role of the Fed should be.

Finally, even public officials have cautioned that added regulation cannot threaten the ability of market participants to develop innovative business models or investment products.[235] Although the existing framework does not seem to promote American competitiveness in key global markets,[236] any new regulatory system for the financial industry should not be "counterproductive" by encouraging parties to conduct their

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[229] *Id.*

[230] *See* C.A.E. Goodhart, *The Organisational Structure of Banking Supervision* 8–23 (Fin. Stability Inst. Occasional Papers No. 1, 2000), *available at* http://www.bis.org/fsi/fsipapers01.pdf (addressing arguments that have been made for the continued separation between central banks and banking supervision).

[231] *See* Harvey L. Pitt, *Bringing Financial Services Regulation into the Twenty-First Century*, 25 YALE J. ON REG. 315, 321–23 (discussing the benefits of the FSA model of supervision as contrasted with that of the SEC); *see also* Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Federal Reserve Bank of Atlanta's Financial Markets Conference: Regulation and Financial Innovation (May 15, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm [hereinafter Bernanke, Atlanta II] (describing the FSA's "[p]rinciples-based" supervisory approach as concentrating government resources and attention to those "firms, markets, or instruments in proportion to the perceived risks to the FSA's regulatory objectives").

[232] *See* Pitt, *supra* note 231, at 321–23 (describing how the FSA's approach is more efficient than traditional models employed by American organizations); John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L.J. 381, 383–87 (2008) (discussing the mechanics of "principles-based" regulation as adopted by the FSA and some American organizations, and the praise and criticism "principles-based" regulation has garnered).

[233] *See* Goodhart, *supra* note 230, at 20–23 (discussing how separating supervision from central banking works to reduce the occurrence of conflicts of interest with regard to the creation of monetary policy).

[234] *See id.* at 6–7.

[235] *See* Kohn, *supra* note 211 (advising that regulations which attempt to anticipate and control all possible systemic threats may unduly restrict market growth).

[236] *See* Browne, *supra* note 17, at 393–410 (discussing how U.S. firms are losing influence in various markets as a result of current regulatory deficiencies).

business overseas.[237] With the major U.S. investment banks now all subsidiaries of bank holding companies, some argue that the Fed no longer needs enhanced supervisory powers over nonbanks to successfully monitor market threats. However, as discussed in Part V, existing oversight restrictions continue to limit the Fed's capacity to adopt a prophylactic risk management policy.[238] Obviously, striking the right balance between laissez-faire and new financial regulation is a complicated issue that remains a key focus of those at the Fed and on Capitol Hill. Therefore, the remainder of this Note draws on existing scholarly work devoted to the challenge of improving banking and financial system oversight with the goal of increasing dialogue as to the proper role of the Fed in such future regulatory schemes.

V. GOING FORWARD: THE FUTURE OF INVESTMENT BANK REGULATION

A. *An Attempt at Reconciliation*

It goes without saying that the goal of regulators in implementing any new framework of investment banking and financial system oversight should be to focus on the most important threats to economic stability facing our country. While some may argue that those threats range from unbridled greed to government incompetence, the key concern of lawmakers should be the contemporary nature of systemic risk.[239] As the current crisis illustrates, systemic risk has developed into a cross-sector cancer, capable of emerging within the securities realm and spreading to the banking and credit sectors. This development stresses the jurisdictional boundaries of federal agencies, reducing the capacity of the Fed or similar regulators to respond to systemic risks in accordance with existing legal authority.[240] Because "[f]ederal banking agencies are specifically barred from examining registered investment company subsidiaries," the Fed must rely on inconsistent piecemeal examinations of these firms, which themselves are subject to "stringent restrictions."[241] For example, as the

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[237] *See* Neikirk et al., *supra* note 119, at C1 ("Those who oppose too many new federal regulations on Wall Street investment banking firms fear such a move could be highly counterproductive and drive more financial transactions overseas to London, Hong Kong, or other spots.").

[238] *See* MCCOY, *supra* note 203, § 12.04(1) (describing how the existing scheme of banking regulation is duplicative and inefficient).

[239] *See* Robert W. Hahn & Peter Passell, *The Rush to Reregulate*, AEI ON THE ISSUES, Aug. 20, 2008, http://www.aei.org/issue/28495 ("The most easily justifiable rationale for [government] intervention is the potential for damage to those not directly involved—for example, people who lose their savings in bank runs when credit markets freeze.").

[240] MCCOY, *supra* note 203, § 12.04(1)(a)(ii); *see also* Schwarcz, *supra* note 193, at 198–204 (discussing how systemic risks faced by individual institutions and markets should not be considered in isolation when defining systemic risk as a focus of regulation).

[241] MCCOY, *supra* note 203, § 12.04(1)(a)(ii).

GLBA mandates, the Fed may only examine "functionally regulated subsidiaries" (including investment banks) in three instances: (1) where the Fed has "reasonable cause to believe" the activities of the subsidiary "pose a material risk to an affiliated depository institution[;]" (2) where the Fed "reasonably determines" an examination is needed to assess the propriety of the internal monitoring and control systems of the subsidiary; and (3) where the Fed has "reasonable cause to believe" a subsidiary is in violation of federal law within its jurisdiction.[242] These provisions effectively preclude the Fed from undertaking routine examinations of investment banks, thereby increasing the potential for risks to go unnoticed. Additionally, the GLBA specifically prohibits federal banking agencies from inspecting or examining any "registered investment company that is not a bank holding company or a savings and loan company."[243] And, although "the FDIC has full authority to examine any affiliate of a depository institution[,]" it can only do so when "*necessary* to disclose fully the relationship between the two companies and the effect of that relationship on the depository institution's condition."[244]

Loopholes such as these inhibit the effective management of risks within the investment banking and financial sectors, impairing the Fed's ability to protect the commercial banking industry. Given the potential for systemic threats to devastate various markets and the real economy, enhancing the Fed's capabilities at anticipating and reacting to systemic risks within the financial and investment contexts is a necessity. This argument is supported by the fact that major domestic investment banks have now become subsidiaries of bank holding companies, thereby augmenting the importance of a consistent and unified structure of supervision.[245] With the protection of individual depositors now directly intertwined with the stability of investment companies previously operating in relative isolation, systemic risk is no longer an abstract anomaly confined to the plush offices of Wall Street executives and investors—it is now a concern of all American taxpayers.

Therefore, as the primary guardian of banking stability, the Fed ought to be given greater powers to supervise investment banks and other financial companies whose fate can now affect the lives of millions of Americans. As Professor McCoy suggests, "where an investment company is located in a subsidiary of a bank or thrift, consolidating safety and soundness examinations in the deposit institution's primary federal

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[242] *Id*.

[243] Gramm-Leach-Bliley Act, 12 U.S.C. § 1820a(a) (2006).

[244] MCCOY, *supra* note 203, § 12.04(1)(a)(ii) (emphasis added) (internal citations omitted).

[245] *See* Bernanke, Atlanta II, *supra* note 231 ("Rather than addressing specific institutions or instruments in isolation, regulators should begin by identifying their objectives and then address the implications of the broad range of financial innovations for those objectives. By returning to the basics, we can increase the coherence, consistency, and effectives of the regulatory framework.").

banking supervisor would make for better informed examinations."[246] Of course, this is not to say that systemic risk should become a scapegoat for irresponsible reform measures which do more harm to the country's economic prowess than protect it. Because future systemic risks may be considered unavoidable occurrences of free market ideology and even human behavior, regulation alone will be insufficient in preventing all future occurrences of systemic threats.[247] Instead, a "private initiative that will complement official oversight in encouraging [responsible] industry-wide practices" is an essential feature of any future regulatory agenda.[248] Nonetheless, "market discipline often needs to be buttressed by government oversight,"[249] and the Fed should be granted greater powers over investment banks with respect to reporting, regulation, examinations, capital requirements, and enforcement.

1. *Reporting to the Fed*

Imposing tougher reporting and disclosure requirements on investment banks and their managers has the additional benefit of improving a firm's internal culture of risk appreciation and understanding. In other words, if investment banks are required to disclose quarterly or semi-annual reviews of balance-sheet status or investment outlooks, irresponsible risk taking will become less of a clandestine affliction.[250] Utilizing existing reporting models for commercial banks would prove useful in this regard,[251] as would repealing provisions of the GLBA which inhibit the Fed's examination of "functionally regulated subsidiaries."[252] No longer should the Fed be responsible for supervising the risks posed by investment banks "with one hand tied behind its back," and investment banks and their managers should be held responsible for filing accurate "quarterly reports of condition" directly with the Federal Reserve, instead of the SEC, CFTC,

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[246] MCCOY, *supra* note 203, § 12.04(1)(a)(ii).

[247] *See* Alan L. Beller, *Containing Systemic Risk: The Road to Reform—The Report of the CRMPG III, Aug. 6, 2008—Excerpts*, 1704 PRAC. L. INST. 19, 39 (2008) ("The fact that financial excess fundamentally grows out of human behavior is a sobering reality . . . . However, official oversight is not a substitute for the effective management of financial institutions, which is, and should remain, a private-sector function.").

[248] *Id.*

[249] Bernanke, Atlanta II, *supra* note 231.

[250] *See id.* (discussing how effective disclosures can limit the occurrence of reckless trade practices); *see also* MCCOY, *supra* note 203, § 12.03(2) ("Periodic reports of condition by individual institutions to regulators are the lifeblood of banking supervision and an important diagnostic tool for monitoring the financial health of banks and thrifts.").

[251] *See* MCCOY, *supra* note 203, § 12.03(2)–(3) (describing the types of reports and data that insured institutions must file with federal regulators).

[252] *Id.* § 12.03(1)–(2) ("Because of its enormous exposure to *losses* . . . the federal government requires every insured depository institution . . . to file detailed financial reports on a regular basis." (emphasis added)). Professor McCoy describes how the GLBA sought to streamline reporting requirements for companies subject to oversight by multiple regulators, but may have "swayed too far" in doing so—a concern made all the more apparent given the well publicized lapses of the SEC as of late. *Id.* § 12.03(2).

or other functional regulators.[253] Additionally, legislation aimed at creating new reporting standards may want to consider the value of independent auditing, public disclosures, and mandatory penalties for "false reports or late filings."[254] Finally, Chief Risk Officers or comparable executives within investment banks should develop a working relationship with Fed examiners that fosters enhanced transparency and promotes greater market discipline.[255]

2. *Regulation*

Granting the Fed greater regulatory powers over investment banks will necessarily conflict with the jurisdictional authority of the SEC. However, given the critical role played by the lender of last resort during systemic crisis, the Fed should be granted "the authority to set expectations and require corrective actions as warranted in cases in which firms' actions have potential implications for financial stability."[256] The Central Bank should also have the ability to establish prospective regulations designed to limit the need for emergency discount window loans. For example, by instituting a clear process by which the Fed can manage the anticipated insolvency of an investment bank, the likelihood that a disorderly failure will instill fear in the markets is reduced, as is the potential for banks runs and contagion.[257] Additionally, as Chairman Bernanke has argued, the Fed's oversight of "systemically important payment and settlement systems" must be explicitly delineated so that the Fed can ensure that these systems remain fluid in crisis situations.[258] As a benefit to the firms, greater regulation should, in turn, allow investment banks greater access to the Fed's "discount . . . window under nonemergency circumstances."[259] But, such access must not be seen as an excuse to ignore market discipline.[260] The SEC should develop policies intended to assist the Fed in overseeing the operations of investment banks, yet "consolidated supervision" of these firms is more efficient than the process currently in

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[253] *See id*. ("The Federal Reserve Board and its fellow agencies should not be dependent . . . on the SEC . . . for reports on interaffiliate transactions and other 'subtle hazards' that could endanger a bank or thrift's safety and soundness.").

[254] *Id*. § 12.03(2)–12.03(4).

[255] *See* FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET & INSTITUTIONAL RESILIENCE 22–26 (2008), *available at* http://www.financialstabilityboard.org/publications/r_0804.pdf (recommending that "[r]isk disclosures by market participants" be increased to improve transparency within the financial markets).

[256] Bernanke, FDIC, *supra* note 9.

[257] *See* Bernanke, Austin, *supra* note 186 (discussing the benefits of the FDIC's ability to manage the insolvency of commercial banks and how a similar system for securities firms may be needed).

[258] Bernanke, Fin. Servs., *supra* note 189.

[259] Kim Dixon & Karey Wutkowski, *Financial Regulation Reform—But Not Paulson's—Likely in 2009*, INS. J., Aug. 25, 2008, http://www.insurancejournal.com/news/national/2008/08/25/93050.htm.

[260] *See* Bernanke, FDIC, *supra* note 9 ("[A]ttention should be paid to the risk that market participants might incorrectly view the Fed as a source of unconditional support for financial institutions and markets, which could lead to an unacceptable reduction in market discipline.").

place.[261] Therefore, the Fed's supervisory role should be extended to include oversight of investment banking and financial services firms, which are now subsidiaries of depository institutions. New regulations necessary to protect economic stability should be adopted with the understanding that flexibility and some risk taking are vital to fostering growth and innovation.[262]

3. *Examinations*

Creating a detailed examination process for the Fed to use in overseeing financial services firms is critical. In keeping with its new role as consolidated supervisor of investment banks, the Fed's examination authority should be enhanced to mirror that which exists for traditional depository institutions.[263] For example, "[s]afety and soundness examinations" which generally assess a commercial bank's infrastructure in key areas such as "solvency," "management," and "information technology," ought to be implemented with new standards for investment banks.[264] Additionally, "compliance examinations" which focus on a firm's compliance with applicable "consumer and investor protection laws" should be instituted to ensure that investment banks maintain legitimate market operations.[265] A rating system that appraises vital elements of a firm's operations may be beneficial, and examinations should be conducted regularly so as to identify potential threats or risks within single or multiple institutions.[266] To accommodate the concerns of the private sector, an "appeals process" similar to that used for depository institutions would be useful in checking government discretion and improving the accuracy of examinations.[267] "To fulfill its responsibilities, the Fed would also need to have the ability to look at financial firms as a whole, much as the [Fed does] today when [it] exercise[s] [its] umbrella

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[261] *Id.*

[262] *See id.* ("[R]eforms in the oversight of these firms must recognize the distinctive features of investment banking and take care neither to unduly inhibit efficiency and innovation nor to induce a migration of risk-taking activities to institutions that are less regulated or beyond our borders.").

[263] *See* MCCOY, *supra* note 203, § 12.04(1)(b)–(4) (discussing in detail the examination process of "Federal bank examiners" over depository institutions).

[264] *Id.* § 12.04(1)(b).

> *Safety and soundness examinations* monitor the solvency of insured institutions, evaluate management and follow up on areas of needed improvement. Safety and soundness examinations include full-scope examinations, specialty examinations in areas such as information technology and trust operations, and special examinations that focus on specific issues of concern at an institution.

Id. (internal citations omitted).

[265] *Id.*

[266] *See id.* (describing how depository institutions are examined in accordance with specific guidelines under the "Uniform Financial Institutions Rating System").

[267] *See id.* § 12.04(2) (explaining how banking examinations may be subject to an independent review process).

authority over financial holding companies . . . ."[268] Increased examinations of investment banks will provide Fed officials with information necessary to enhance the efficacy of the government's containment of systemic risk, reducing threats to other sectors of the economy and protecting individual consumers. When appropriate, the results of examinations should be published to allow the interested public the opportunity to review the state of an individual firm's business model.[269] Of course, such disclosures must be mindful of the threat of bank runs that co-exists with the public's interpretation of a company's financial health.[270]

4. *Capital Requirements*

Another crucial factor in improving the Fed's ability to contain systemic risk is ensuring that investment banks have the necessary capital resources to prevent the liquidity crisis Bear Stearns and other institutions have recently faced. Leverage ratios must be controlled to guard against the possibility of future government bailouts and reduce the occurrence of moral hazard.[271] Fortunately, proposals such as those announced in Pillar 1 of the Basel II Capital Accord provide detailed and practical frameworks that the Fed can utilize in determining the best method for setting capital reserve minimums for investment banks.[272] Because depositors now have an interest in the solvency of securities firms, leverage ratios must remain conservative enough to protect against bankruptcy and illiquidity quagmires. For those depository institutions that have now become the parent company of investment bank subsidiaries, the Fed must make certain that the vast resources of a depository institution do not become indirect incentives for investment banks to assume more debt than the subsidiary can afford. Thus, to provide the most protection for depositors, reserve standards for investment bank subsidiaries should remain independent of those of the parent holding company. Also, sections 23A and 23B of the Federal Reserve Act must remain key safeguards in restricting the types and extent of transactions that depository institutions can engage in with their affiliates and counterparties.[273] At no time should

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[268] Bernanke, FDIC, *supra* note 9.

[269] *See* MCCOY, *supra* note 203, § 12.04(4) (describing how public disclosure of past examination reports may improve the "accountability and consistency" of bank examinations).

[270] *See id*. ("In sum, across-the-board disclosure of examination reports could provide valuable information to some market participants, albeit at the potentially high cost of occasional bank runs.").

[271] *See* Morris & Shin, *supra* note 17, at 21–26 (using case analysis to describe why future financial regulation must consider the possibility of leverage restraints on individual firms).

[272] *See* BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT & CAPITAL STANDARDS 12–14 (2005), *available at* http://www.bis.org/publ/bcbs107b.pdf (outlining the process for determining minimum capital requirements as a basis for improving banking regulation).

[273] *See* Federal Reserve Act, 12 U.S.C. §§ 371c(a), 371c-1(b) (2006) (prescribing restrictions on transactions with affiliates).

a "covered transaction" imperil the security and liquidity of any depositor's account,[274] and regularly conducted examinations should stress the consistency of an investment bank's capitalization to confirm that the subsidiaries' leverage does not affect the health of the depository institution.

5. *Enforcement*

How the Fed goes about enforcing its oversight authority over investment banks is open to vast commentary. Nonetheless, the existing structure of formal and informal[275] enforcement mechanisms for commercial institutions may again provide useful guidance in this respect. For example, aside from the "examination process[es]," "board resolutions and commitment letters," and "supervisory directives," which comprise the bulk of informal bank supervision, the Fed should also be allowed to impose "cease-and-desist orders," officer and director suspension (and removal or prohibition), and civil monetary penalties against securities firms when federal regulatory compliance is lacking, or the investment bank's practices deviate from "generally accepted standards of prudent operation."[276] Additionally, lawmakers may want to consider the potential benefits afforded by "agency adjudication"[277] and public disclosure[278] in insuring that investment banks maintain acceptable investment and risk portfolios. However, it is vital that a proper balance between regulatory enforcement and market independence be maintained. In this regard, enforcement mechanisms may in some circumstances be subject to judicial review,[279] with top Fed officials periodically assessing enforcement standards to confirm that regulation is not stifling market progression and economic growth.

At the risk of oversimplifying the problems inherent in creating a new regulatory framework for investment banks, the preceding discussion has offered several suggestions for improvement of the Fed's oversight authority in the financial services industry. Clearly, the topics focused on do not exist exclusively from one another or in isolation of other considerations which are relevant to this issue. For instance, complications will soon arise when one factors in the important issues of private sector reluctance, global central bank policy coordination,[280] and securities-

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[274] *See id.* § 371c(b)(7)A–E (defining covered transactions).

[275] *See* MCCOY, *supra* note 203, §§ 13.02, 13.03(4)–(10).

[276] *Id*. §§ 13.02, 13.03(3), 13.03(5), 13.03(6).

[277] *Id*. §13.03(9).

[278] *Id.* § 13.03(10).

[279] *See id.* § 13.03(1) (discussing the potential avenues of judicial review for formal enforcement mechanisms in the commercial banking context).

[280] *See* Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Fifth European Central Bank Conference (Nov. 14, 2008), *available at* http://federalreserve.gov/newsevents/speech/bernanke

specific regulation.[281] Nevertheless, each contribution to this topic encourages the reform that is essential to economic recovery.

B. *The Current Reality*

The global economic crisis that continues to wreak havoc in the United States and other countries is as far-reaching as it is complex. For nearly two years, the world has witnessed the destruction of financial powerhouses, the deterioration of the stock and credit markets, and repeated attempts by political leaders to rejuvenate the economy through unprecedented government programs. Unfortunately, the crisis demonstrates how regulatory inadequacies have allowed irresponsible and reckless trade practices to create a worldwide catastrophe not seen since the 1930s. "For years, too many Wall Street executives made imprudent and dangerous decisions, seeking profits with too little regard for risk, *too little regulatory scrutiny*, and too little accountability."[282] The excesses of greed and carelessness have been seen by all Americans who have suffered from the exploitation of investment products by financial firms and their managers. Moreover, vast sums of public money have been taken from the coffers of taxpayers in an effort to rescue the financial system from those who have profited from its unrestrained manipulation. As this disaster best illustrates, a robust and dynamic twenty-first century economy cannot survive in the midst of such abuses.

Because of the diversity of problems posed by the current recession, investment banking and financial services regulatory reform is likely to be a drawn-out process that may take years to complete. However, the existing regulatory structure is incapable of providing the type of oversight and supervision that is required of modern financial markets and the enterprises involved therein. Consequently, new policies are an inevitable and indispensable feature of stable financial growth, new investor confidence, and economic recovery in general.

VI. CONCLUSION

The story of Bear Stearns is in many ways a microcosm for the larger economic calamity that began in late 2007 and continues to this day. As Wall Street's fifth largest investment bank, Bear used aggressive tactics

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20081214a.htm (discussing the importance and challenges of ongoing policy coordination between central banks across the globe).

[281] For example, any new regulations imposed on investment banks must be implemented in a way that will complement the controls adopted for CDS, ABS, and other complex securities and derivative products.

[282] Pres. Barack Obama, Speech at George Mason University: American Recovery and Reinvestment (Jan. 8, 2009), *available at* http://www.marketwatch.com/news/story/text-obama-speech-economy/story.aspx?guid=%7B4C5C66C9-2BD5-4870-8FE2-02BC6B75F3E7%7D&dist=msr_1 (emphasis added).

rooted in unchecked speculation to acquire and sell exotic financial products whose value was uncertain and largely dependent on the continued success of the housing market. In the absence of strict oversight, Bear sold complex derivative investments that pushed the firm's debt beyond the point backed by readily available liquid assets. Then, when the housing bubble burst, Bear's infrastructure collapsed under the weight of its irresponsible balance sheet, bringing the securities firm to the brink of bankruptcy.

Constrained by antiquated laws providing only a limited number of options to choose from, the Central Bank intervened to prevent Bear Stearns's disorderly failure, fearing that the firm's downfall would touch off an uncontrollable domino effect among similar institutions. In doing so, the Fed committed billions of dollars of taxpayer money in an effort to prevent a larger disaster, the implications of which could not be fully predicted. Such actions raised important questions regarding the legality of the Fed's brokerage of the sale of Bear Stearns to JPMorgan, especially the risk posed to commercial depositors that had been a focus of federal laws aimed at precluding similar transactions. And despite the bailout, investment banks continued to fail, while others drastically changed their business structures to survive the loss of investor confidence that continues to shake the foundation of Wall Street itself.

Now, in the aftermath of the devastation of America's investment banking industry, the call for regulatory reform has been widespread and intense. As the past two years demonstrate, the federal government must be granted broader authority within the financial services industry to effectively manage systemic risks in a way that reduces the likelihood of future bailouts and reckless market practices. Still, this reform must also preserve the competitiveness of key sectors of the United States economy. Given the Fed's assumed role as steward over much of the existing investment banking landscape, it should be given the supervisory powers needed to fulfill its newfound responsibilities.

If one considers the development of the current economic crisis from a macro level, the comparisons to be drawn from the Bear Stearns incident are apparent. First, the demise of the housing market and the onset of the mortgage crisis precipitated the failure (or near failure) of some of Wall Street's largest institutions. In turn, these events threatened the vitality of the entire economy. Second, the federal government took unprecedented actions to bail out the financial system, injecting up to $700 billion of public money into the ailing credit and securities markets. But the economy continued its recessionary fall, with investors fleeing, unemployment rising, and growth stagnating. Finally, in the wake of this catastrophe, the Obama administration and Congress have promised sweeping regulatory programs designed to combat the failings of existing frameworks, while also strengthening economic resilience and progression.

In this way, both Bear and the larger crisis have followed the course from failure, to bailout, to calls for reform.