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# PRIVATE ENFORCEMENT OF SYSTEMIC RISK REGULATION

HEIDI MANDANIS SCHOONER<sup>†</sup>

## I. INTRODUCTION

The list of causes of the 2008 Financial Crisis is long, varied, and the subject of debate. Just as we continue to debate the causes of the Great Depression, we will likely continue to debate the causes of the 2008 Financial Crisis for many years to come. A common list of failures contributing to the Financial Crisis includes: global imbalances (excess savings in some countries and excess borrowing in others), erroneous monetary policy (sustained ultra-low interest rates), financial innovation (for example, the reliance on securitization of mortgages), risk management and internal control failure, market discipline failure, and regulatory failure.<sup>1</sup>

This Article does not attempt to decide the relative importance of any of these or other factors. This Article does assume, as discussed below, that regulatory failure is an important cause. The United States Congress directed the Financial Crisis Inquiry Commission (“FCIC”)<sup>2</sup> to examine, *inter alia*, the role of “[f]ederal and State financial regulators, including the extent to which they enforced, or failed to enforce statutory, regulatory, or supervisory requirements.”<sup>3</sup> The FCIC must submit its report to Congress later this year. Still, it appears fairly evident that our regulatory system failed to prevent a costly crisis. Of course, some might argue that the regulatory system failed because of its overactive role in financial markets. Others would claim that the regulatory system underestimated and under-regulated risk. Either way, the regulatory system failed to protect the economy from a significant systemic meltdown.

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1. For a more complete discussion of the possible causes of the Global Financial Crisis, see HEIDI MANDANIS SCHOONER & MICHAEL W. TAYLOR, *GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES* 280-84 (Elsevier 2010).

2. With the passage of the Fraud Enforcement and Recovery Act of 2009, Congress established a bi-partisan commission, the Financial Crisis Inquiry Commission, to examine the causes, domestic and global, of the financial crisis. The Commission’s report is due to Congress and the President on December 15, 2010.

3. Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5(c)(1)(B), 123 Stat. 1617, 1629 (2009).

Wise commentators note that reform is premature when the exact nature and causes of the financial crisis are yet to be determined.<sup>4</sup> Yet, proposals for regulatory reform hit the streets before anyone knew the extent of the crisis. The United States Department of the Treasury (“Treasury”) released its Blueprint for a Modernized Financial Regulatory Structure (“Blueprint”)<sup>5</sup> while President Bush was still in office and while the depth of the crisis remained unrealized. Soon after the election of President Obama, Treasury outlined a proposal that accounted for the full measure of the crisis.<sup>6</sup> On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>7</sup> (hereinafter the “Dodd-Frank Act”). The Dodd-Frank Act will have far-reaching impact on the financial services industry. The exact impact of the Dodd-Frank Act will not be known for some time because many of the implementation details have been left to rulemaking by the various regulatory agencies. This Article will focus on the key provisions of the Dodd-Frank Act that are most directly linked to regulating systemic risk.

The Dodd-Frank Act does not sufficiently address the problem of agency discretion generally, or the problem of an agency’s discretion to forebear, in particular. This seems a striking omission given the findings of the Congressional Oversight Panel (“COP”) and other research concluding that the regulatory failure in the 2008 Financial Crisis was not caused by agencies’ lack of regulatory authority (although the lack of statutory authority may have played a limited role).<sup>8</sup> Rather, the agencies exercised their considerable discretion in favor of not regulating. As discussed below, an agency might choose to refrain from enforcing existing laws or writing new regulations for many reasons. The public interest may justify some of those reasons but may not justify others. Nevertheless, it seems that agencies will always have considerable discretion and that an effective regulatory regime should include some check on that discretion. This Article focuses specifically on the issue of agency enforcement and considers whether private monitoring could enhance the current public enforcement regime. Part II discusses the nature of systemic risk and the realization in the wake of the 2008 Financial Crisis that existing forms of prudential

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4. Saule T. Omarova & Adam Feibelman, *Risk, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009).

5. U.S. Dep’t of the Treas., *Blueprint For A Modernized Financial Regulatory Structure* (Mar. 2008), available at <http://www.ustreas.gov/press/releases/reports/Blueprint.pdf>.

6. U.S. Dep’t of the Treas., *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (June 17, 2009), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

7. Pub. L. No. 111-203 (2010).

8. See *infra* Part IV.

regulation did not adequately address systemic risk. Part III briefly overviews the provisions of the Dodd-Frank Act that seek better regulation of systemic risk. Part IV discusses the preliminary findings regarding the causes of the 2008 Financial Crisis which conclude that regulatory failure was an important element. Part V discusses the current mechanism for public enforcement of prudential regulation. Part VI considers whether private enforcement might serve as a valuable enhancement to the public enforcement regime. Part VII proposes a hybrid public/private *qui tam* model of enforcement as a potentially valuable enhancement to systemic risk reform.

## II. SYSTEMIC RISK

The 2008 Financial Crisis spawned a cottage industry in the business of defining systemic risk.<sup>9</sup> Systemic risk may serve as a strange reminder of the only thing that many lawyers know about the law of obscenity—you can't define it but you know it when you see it.<sup>10</sup> Systemic risk seems to suffer from the opposite limitation. While systemic risk can be defined as a general matter, identifying the emergence of such risk is a significant challenge.<sup>11</sup> The nature of a

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9. This implies, of course, that no common definition has yet to emerge. See generally European Central Bank, *The Concept of Systemic Risk*, Fin. Stability Rev., Dec. 2009, at 134. For further discussions of the definition of systemic risk, see: Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008); Steven L. Schwarcz, *Keynote Address: Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549 (2009); Jean-Claude Trichet, President of the European Central Bank, *Systemic Risk*, Clare Distinguished Lecture in Economics and Public Policy at the Clare College, University of Cambridge (Dec. 10, 2009) [http://www.ecb.int/press/key/date/2009/html/sp091210\\_1.en.html](http://www.ecb.int/press/key/date/2009/html/sp091210_1.en.html); John B. Taylor, Professor of Economics, Senior Fellow at the Hoover Institution, Stanford University, *Dinner Keynote Speech at the Conference on Financial Innovation and Crises*, Fed. Reserve Bank of Atlanta: *Systemic Risk and the Role of Government* (May 12, 2009) [http://www.stanford.edu/~johntayl/Systemic\\_Risk\\_and\\_the\\_Role\\_of\\_Government-May\\_12\\_2009.pdf](http://www.stanford.edu/~johntayl/Systemic_Risk_and_the_Role_of_Government-May_12_2009.pdf); Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051 (2009); Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127 (2009); Amir E. Khandani, Andrew W. Lo, & Robert C. Merton, *Systemic Risk and the Refinancing Ratchet Effect*, (Harvard Business School, Working Paper 10-023, 2009).

10. In his concurring opinion, Justice Stewart wrote "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description [of hard-core pornography]; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it." *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964).

11. Peter Wallison makes a similar observation. He writes:

While the terms 'systemic risk' or 'systemic breakdown' can be defined in words, they cannot be used as an effective guide for policy action. We have no way of knowing when or under what circumstance the failure of a particular company will cause something as serious as a systemic breakdown — as distinguished from a simple disruption in the economy.

Peter J. Wallison, *TARP Baby: The Administration's Resolution Authority for Nonbank Financial Firms*, AM. ENTER. INST. FOR PUB. POL'Y RES., FIN. SERVS OUTLOOK, Sept. 2009, at 2.

systemic crisis may not be adequately captured or understood without years of retrospective analysis. Moreover, government action to stave off systemic crisis may prevent a crisis from occurring. Thus, we may never know whether there would have been a systemic event in the absence of such intervention.

In a recent report to the G20 by the International Monetary Fund, Bank for International Settlements, and Financial Stability Board, systemic risk is defined as “the disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.”<sup>12</sup> The reforms addressed in this Article are an attempt to mitigate such risk.

Of course, governments have long attempted to prevent systemic crisis. The primary mechanism for traditional systemic risk regulation has been the prudential regulation of banks. Prudential, or sometimes called “safety and soundness,” regulation traditionally sought to prevent systemic crisis by protecting banks from failure.<sup>13</sup> The 2008 Financial Crisis, however, challenged the assumption that systemic risk could be addressed by attempting to protect the solvency of individual banks (what is now called a “micro-prudential” approach to regulation). Markus Brunnermeier et al. wrote:

The current approach to systemic regulation implicitly assumes that we can make the system as a whole safe by simply trying to make sure that individual banks are safe. This sounds like a truism, but in practice it represents a fallacy of composition. In trying to make themselves safer, banks, and often highly leveraged financial intermediaries, can behave in a way that collectively undermines the system. Selling an asset when the price of risk increases, is a prudent response from the perspective of an individual bank. But if many banks act in this way, the asset price will collapse, forcing institutions to take yet further steps to rectify the situation. It is, in part, the responses of the banks themselves to such pressures that leads to generalised declines in asset prices, and enhanced correlations and volatility in asset markets.<sup>14</sup>

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12. International Monetary Fund, Bank for International Settlements, Financial Stability Board, *Report to G20 Finance Ministers and Governors, Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations*, Oct. 2009, at 5-6, available at <http://www.bis.org/publ/othp07.pdf>.

13. For a complete discussion of the foundation for the prudential regulation of banks, see HEIDI MANDANIS SCHOONER & MICHAEL W. TAYLOR, *GLOBAL BANK REGULATION: PRINCIPLES AND POLICIES* xii-xxi (Elsevier 2010).

14. MARKUS K. BRUNNERMEIER ANDREW CROCKETT, CHARLES GOODHART, AVINASH D. PERSAUD, & HYUN SONG SHIN, *THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION*, GENEVA REPORTS ON THE WORLD ECONOMY 11 vii Ctr. for Econ. Policy Research 2009.

This observation regarding the nature of systemic risk highlights two general deficiencies in our current system of regulation. First, banks are not the only systemically important financial institutions. Other financial institutions, such as investment banks and hedge funds, can also contribute to systemic crisis. Second, protecting the solvency of a financial institution does not always prevent systemic risk since a firm may take steps to protect its own solvency (for example, by selling assets), and that action, if repeated by other firms, may be what triggers the systemic crisis. Therefore, many reform proposals highlight the importance of adding a macro-prudential focus to the traditional micro-prudential regimes. Stated another way, such new regulatory regimes would not only focus on the solvency of commercial banks (micro-prudential) but would also consider the impact of the activities of all financial institutions on the financial system and real economy (macro-prudential).<sup>15</sup>

The purpose of this Article is not, however, to make the case for reform or expansion of systemic risk regulation.<sup>16</sup> The challenges to developing such a system are great especially given the potential for increasing moral hazard once systemic firms or activities are identified. As discussed in Part III, the Dodd-Frank Act adopts a macroprudential approach, and this Article does not attempt to decide whether the substance of that approach is ideal. Rather, this Article focuses on the question of whether reforms like those in the Dodd-Frank Act can be enhanced by including enforcement mechanisms outside of the existing public enforcement system.

### III. SYSTEMIC RISK REFORM PROPOSALS

Lawmakers and scholars continue to develop and refine their proposals for regulatory reform. Many of the proposals would have far-reaching impact on the financial services industry. Below is a very brief overview of the United States' efforts to enhance the regulation of systemic risk. United States' reforms address the limitations of the existing micro-prudential approach to systemic risk by expanding regulation to include firms other than banks and to focus on activities other than those primarily related to bank solvency.

In July of 2009, President Obama's Administration ("Administration") delivered its proposed systemic risk legislation to the United

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15. For a discussion of the outlines of a macro-prudential regime, see BRUNNERMEIER ET AL., *supra* note 14, at 25-30.

16. For a comprehensive discussion of current reform proposals, see Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009).

States Congress.<sup>17</sup> This proposal created a Financial Services Oversight Council, made up of eight members from the heads of each of the principle federal financial institution regulators, and replaced the President's Working Group on Financial Markets. The United States Federal Reserve would be tasked with regulating "Tier I" financial holding companies, i.e., any "financial firm whose combination of size, leverage, interconnectedness could pose a threat to financial stability if it failed."<sup>18</sup> Regulation of Tier I companies would be stricter than for other financial firms by imposing higher capital requirements, stronger liquidity, and more conservative risk management. The supervision of Tier I firms would be macro-prudential in that it would focus on risks to the system as a whole. Finally, the Administration's plan recommended the creation of a resolution regime for failing Tier I financial holding companies modeled on the existing special resolution regime under the Federal Deposit Insurance Act.

The Dodd-Frank Act adopts many of the important elements of the Obama Administration's reform proposals. It creates a Financial Stability Oversight Council<sup>19</sup> to identify systemic risk, to promote market discipline by eliminating expectations of government support, and to respond to emerging threats to U.S. financial stability.<sup>20</sup> Among many duties enumerated under Section 112(a)(2) of the Dodd-Frank Act, the Council shall require Federal Reserve supervision of systemically significant nonbank financial companies (hereinafter "systemic nonbank financial companies")<sup>21</sup> and make recommenda-

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17. Press Release, U.S. Dept. of the Treas., *Fact Sheet: Admin. Regulatory Reform Agenda Moves Forward*, TG-227 (July 22, 2009), <http://www.treas.gov/press/releases/tg227.htm>.

18. U.S. Dep't of the Treas., *Fin. Regulatory Reform, A New Foundation: Rebuilding Fin. Supervision and Regulation*, 10 (undated), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

19. Dodd-Frank Act, Pub. L. No. 111-203, § 111(b) (2010). Section 111(b) provides that the Council consists of the following voting members: The Secretary, the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection (a new bureau of the Federal Reserve established under the Dodd-Frank Act), Chairman of the Securities Exchange Commission, Chairperson of the FDIC, Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, Chairman of the National Credit Union Administration Board, and an independent member with insurance experience appointed by the President upon advice and consent of the Senate. Nonvoting members of the Council include the Director of the Office of Financial Research (a new office of the Treasury established under the Dodd-Frank Act), the Director of the Federal Insurance Office (a new office of the Treasury created under the Dodd-Frank Act), a State insurance commissioner, a State banking supervisor, and a State securities commissioner.

20. *Id.* at § 111(a)(1).

21. Prior to the passage of the Dodd-Frank Act, the Federal Reserve supervised bank holding companies, but not nonbank financial companies. A bank holding company is a company that owns or controls a bank. 12 U.S.C. § 1841(a). For these pur-

tions to the Federal Reserve regarding the imposition of heightened prudential standards on systemic nonbank financial companies and large, interconnected bank holding companies. The Council may determine that systemic nonbank financial holding companies should be subjected to Federal Reserve heightened supervision if “material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”<sup>22</sup>

Section 165 of the Dodd-Frank Act provides that the Federal Reserve shall impose more stringent prudential standards to systemic nonbank financial companies and bank holding companies with assets of \$50 billion or more. The Federal Reserve is required to establish more stringent prudential standards in the following areas: risk-based capital requirements and leverage limits;<sup>23</sup> liquidity requirements; overall risk management requirements; resolution plan<sup>24</sup> and credit exposure report; and concentration limits. The Federal Reserve may impose more stringent prudential standards which include contingent capital, enhanced disclosure, short-term debt limits, and such other prudential standards as the Federal Reserve or Council determines is appropriate.

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poses, a “bank” is generally an FDIC insured commercial bank, but (along with numerous other exceptions) not an insured thrift. 12 U.S.C. § 1843(c).

22. Dodd-Frank Act, § 113(a)(1). The Council’s determination is subject to judicial review. Section 113(h).

23. The Federal Reserve may avoid the imposition of enhanced risk-based capital requirements or leverage limits if the Federal Reserve, in consultation with the Council, determines that such requirements would be inappropriate for a particular company given its activities or structure, in which case, the Federal Reserve shall impose other, similar, standards. Section 165(b). Upon a finding by the Council that a systemically important nonbank financial company or a large bank holding company poses a grave threat to U.S. financial stability, the Federal Reserve must require such company to maintain a debt to equity ratio of no more than 15 to 1. Section 165(j).

24. Section 165(d) of the Dodd-Frank Act provides that resolution plans shall include: (1) information regarding the manner and extent to which any insured depository institution affiliated with the systemically important nonbank financial company or large bank holding company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company; (2) a full description of the ownership structure, assets, liabilities, and contractual obligations; (3) “identification of cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged;” and (4) any other information that the Federal Reserve and the FDIC jointly require by rule or order. Prior to the passage of the Dodd-Frank Act, the FDIC initiated the formal rulemaking, under then-existing law, with regard to resolution plans. The FDIC is seeking comment on a proposed rule requiring certain insured depository institutions that are subsidiaries of large, complex parent companies to submit resolution plans to the FDIC which demonstrate the insured institution’s ability to be separated from its parent company and to be wound down or resolved in an orderly fashion. FDIC, Special Reporting, Analysis and Contingent Resolution Plans at Certain Large Insured Depository Institutions, 75 Federal Register 27464 (May 17, 2010).



#### IV. THE LIMITATIONS OF THE ADMINISTRATIVE STATE: AGENCY DISCRETION AND FORBEARANCE

Regulatory regimes are not self-executing. The reforms discussed above require the support of institutions and the people employed by those institutions to achieve implementation. With regard to the implementation of systemic risk reform, much of the debate leading up to the passage of the Dodd-Frank Act centered on institutional structure, i.e., the design and identification of the agency to be responsible for systemic risk. For example, some reformers contend that systemic risk should be the responsibility of the United States Federal Reserve Board, while others propose a new regulatory body.

Of course, institutional design is important and can have a positive or negative impact on the effectiveness of an agency. The independence of an agency<sup>25</sup> from political pressure is often seen as a key to its effectiveness.<sup>26</sup> The need for adequate resources cannot be underestimated.<sup>27</sup> Clear goals and accountability are also fundamental to the agencies' success.<sup>28</sup> Yet, even in a regulatory regime in which the administrative agency or agencies are established with the optimal institutional structure,<sup>29</sup> the effectiveness of the regime will be limited. Even an independent agency will not be immune from political pressure. An appropriations-funded agency, as opposed to one funded from fees collected from the firms it regulates, will not ignore

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25. For a discussion of the relative independence of the federal banking agencies, see Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOY. CONSUMER L. REV. 43, 71-72 (2005); For a discussion of the importance of agency independence to the structure of prudential regulation, see Steven. A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503 (2000).

26. Some have argued that the lack of agency independence was a contributing factor in the 1980s savings and loan crisis. See Rosa Maria Lastra, *Central Banking and Banking Regulation*, 55 LONDON SCH. ECON. 329 (1996) (contending "that the US Savings and Loan Associations' debacle might have been prevented or at least mitigated had non-political considerations more firmly prevailed in their supervision").

27. For an interesting discussion of the role that the lack of SEC resources may have played in the Bernie Madoff scandal, see Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story*, 4-6 (Georgetown Law, Faculty Working Papers, Research Paper No. 1475433, 2009).

28. Michael Taylor, an international expert on agency structure, writes "each regulatory agency should have a clear and unambiguous mandate and should have a specific objective for which it can be held accountable." Michael Taylor, *Twin peaks*, FINANCIAL WORLD, Sept. 2009, [https://www.financialworld.co.uk/financial\\_world/Archive/2009/2009\\_09sept/Features/Michael%20Taylor/pdf/17268.pdf](https://www.financialworld.co.uk/financial_world/Archive/2009/2009_09sept/Features/Michael%20Taylor/pdf/17268.pdf).

29. A recent Government Accountability Office report found that "A regulatory system should ensure that regulators have independence from inappropriate influence; have sufficient resources, clout, and authority to carry out and enforce statutory missions; and are clearly accountable for meeting regulatory goals." GAO, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM, GAO-09-216, at 59-60 (Jan. 2009).

the interests of the industry.<sup>30</sup> Moreover, agencies will always have limits to their funding and therefore be forced to make difficult choices regarding resource allocation.

An agency's effectiveness is not only limited by its structure. Agencies, despite their design, exercise a great deal of discretion. Sometimes that discretion is not exercised in the public interest. Certainly, the improper exercise of agency discretion can be the result of incompetence or corruption. But, perhaps more likely, and therefore more troubling, is the fact that the sub-optimal exercise of agency discretion may be influenced by less salient human characteristics such as optimism, confidence, fear, or pessimism. Agencies are often criticized for their forbearance on the one hand, and over-zealousness on the other. Fundamentally, agency behavior is pro-cyclical. Agencies will be more likely to loosen their supervision, regulation, and enforcement when the markets are stable or on the upswing. They will be more aggressive in their supervision, regulation, and enforcement when markets and the economy are volatile or in a downturn.

Recognizing the importance of agency discretion, Markus Brunnermeier et al. called for rules seeking to eliminate some of that discretion:

[W]e propose . . . that objective criteria and pre-specified rules should be put forward to guarantee that financial regulation is strictly enforced. To ensure that the enforcement of these rules are credible, regulators must face the right incentive structure and enjoy a degree of independence that allows them to impose potentially unpopular steps. When everyone is calling for more regulation, e.g., as now, just after a crisis, it is not needed at all, since bank managers are timid and risk averse. When regulation is needed, no one wants it, because asset prices are rising, there is a boom, everybody is optimistic, and regulation just gets in the way . . . Almost every regulator/supervisor will seek maximum discretion. Because of the above considerations, regulation should be based on pre-set rules; otherwise, few regulator/supervisors will actually dare to face the odium of tightening in boom conditions.<sup>31</sup>

Significantly, the United States Congress tried to eliminate agency discretion when it passed the Federal Deposit Insurance Corporation Improvement Act of 1991<sup>32</sup> ("FDICIA"). FDICIA, passed in the wake of the savings and loan crisis of the late 1980s, directed the

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30. Of course, political and industry pressure on regulatory agencies is not always contrary to the public interest. On the other hand, such pressures are often not consistent with the public interest.

31. BRUNNERMEIER, CROCKETT, GOODHART, PERSAUD, & SHIN, *supra* note 14, at 33.

32. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991) (codified in scattered sections of 12 U.S.C. 1811).

federal banking agencies to exercise prompt corrective action once a bank fails to meet certain defined capital<sup>33</sup> and safety and soundness ("S/S") standards.<sup>34</sup> Professor Lawrence G. Baxter noted that as a result of FDICIA

the regulators have been stripped of their discretion to use capital levels and S/S ratings as merely *relevant factors* in their overall assessment of what enforcement or seizure action (if any) to take against troubled institutions. Instead, capital levels and S/S ratings have been transformed into *triggers* for the mandatory action by the regulators.<sup>35</sup>

One study found that FDICIA's prompt corrective action provisions ("PCA") did result in higher capital ratios and reduced portfolio risk.<sup>36</sup> Yet, PCA clearly did not prevent the recent crisis.<sup>37</sup> One reason may be the micro-prudential focus of PCA which, the recent crisis has shown, is too narrow in its approach to systemic risk. In addition to

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33. 12 U.S.C. § 1831o (2008). Prompt corrective action rules require bank regulators to place critically undercapitalized institutions in conservatorship or receivership within ninety days, unless the supervisor and the FDIC determine that other action would better serve the purposes of the statute. 12 U.S.C. § 1831(h)(3). Such determination may only be made if the bank (1) has a positive net worth; (2) is in substantial compliance with an approved capital restoration plan; (3) is profitable or has an upward trend in earnings; and (4) has reduced its ratio of nonperforming loans to total loans. Moreover, the exception to mandatory conservatorship or receivership only applies if the head of the appropriate banking agency and the chairman of the bank's board certify that the institution is viable and not expected to fail. 12 U.S.C. § 1831(h)(3)(c)(ii). Critically undercapitalized banks are subject also to certain mandatory operating constraints such as prohibitions on paying excessive compensation or bonuses. 12 U.S.C. § 1831(i).

34. 12 U.S.C. § 1831p-1(e)(1). If the appropriate banking agency determines that a bank has failed to meet the prescribed standards, the agency will require the institution to submit an acceptable plan specifying the steps that the institution will take to correct the deficiency. If the bank fails to submit an acceptable plan, or materially fails to implement a plan accepted by the agency, the agency must require the institution to correct the deficiency and may take supervisory action against the bank. 12 U.S.C. § 1831p-1(e)(2).

35. Lawrence G. Baxter, *Administrative and Judicial Review of Prompt Corrective Action Decisions by the Federal Banking Regulators*, 7 ADMIN. L.J. AM. U. 505, 528 (1994) (emphasis added).

36. RAJ AGGARDWAL & KEVIN T. JACQUES, ASSESSING THE IMPACT OF PROMPT CORRECTIVE ACTION ON BANK CAPITAL AND RISK, FED. RES. BANK OF NEW YORK ECON. POL'Y REV., Vol 4, No. 3 (Oct. 1998).

37. Rosengren and Peek predicted that PCA would not prevent the next banking crisis. Eric S. Rosengren & Joe Peek, *Will Legislated Early Intervention Prevent the Next Banking Crisis?* (B.C. Working Papers in Econ., 1996), available at <http://ssrn.com/abstract=34580>. They studied the New England banking crisis which occurred just prior to the passage of FDICIA. They concluded that if FDICIA's PCA provisions had been law prior to the New England banking crisis, it would have had little impact. They wrote that since PCA "imposes an essentially nonbinding constraint on bank supervisors, PCA is not likely to play a major role in preventing, or even mitigating, the next banking crisis. For a recent full discussion and analysis, see Gillian G. H. Garcia, *Failing Prompt Corrective Action*, 11 JOURNAL OF BANKING REGULATION, 171-190 (June 2010).

the deficient prudential approach, the fact remains that no matter how hard Congress may try, it is impossible to eliminate agency discretion. For example, while PCA limits agency discretion by requiring certain actions once statutory triggers are met, PCA allows the banking agencies to set the triggers and to determine the inputs for such triggers. PCA allows the banking agencies to set the capital and S/S standards and affords them discretion to determine whether such standards are met. In this way, even under statutory provisions like PCA which are meant to eliminate agency discretion, substantial discretion remains.

Several studies concluded that agency failure was a significant contributing cause of the 2008 Financial Crisis. Professor Patricia A. McCoy documented the regulatory failures that preceded the 2008 Financial Crisis. She concluded that federal banking regulators “had ample power to stop the deterioration in mortgage underwriting standards that mushroomed into a full-blown crisis. However, they refused to intervene in disastrous lending practices until it was too late.”<sup>38</sup>

In 2008, Congress created the Congressional Oversight Panel (“COP”) to review the state of the financial markets and the regulatory system.<sup>39</sup> In addition, Congress directed the COP to issue a special report on regulatory reform. In its special report, the COP’s findings regarding the performance of the banking regulators were similar to Professor McCoy’s conclusions. The COP concluded that

[s]tructural and organizational problems are certainly important . . . . But at root, the regulatory failure that gave rise to the current crisis was one of philosophy more than structure. In too many cases, regulators had the tools but failed to use them. And where tools were missing, regulators too often failed to ask for the necessary authority to develop what was needed.<sup>40</sup>

Moreover, a recent report issued by the United States Government Accountability Office (“GAO”) found that regulators had identified numerous weaknesses in the risk management systems of large, complex financial institutions. “However, the regulators said that they did not take forceful actions to address these weaknesses, such as changing their assessments, until the crisis occurred because the in-

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38. PATRICIA A. MCCOY, FEDERAL PREEMPTION, REGULATORY FAILURE AND THE RACE TO THE BOTTOM IN US MORTGAGE LENDING STANDARDS, in *The Panic of 2008* (Edward Elgar, forthcoming 2010).

39. For further information on the COP, see Congressional Oversight Panel, *About Us*, <http://cop.senate.gov/about/> (last visited Mar. 20, 2010).

40. CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM 19 (Jan. 2009), <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf>.

stitutions had strong financial positions and senior management had presented the regulators with plans for change.”<sup>41</sup> This suggests that even when regulators identify weaknesses, regulators are less likely to address aggressively those weaknesses during the boom years.

Concern regarding the effectiveness of regulators is not confined to the United States nor is it new. A well-known international study of the effectiveness of bank regulation by James R. Barth, Gerard Caprio Jr., and Ross Levine concluded, among other things, that:

The data provide ample support for the private interest view of government and surprisingly little support for the public interest view. Thus, from the laboratory of bank supervision and regulation, angels do not govern! Across the world there are insufficient checks and balances on government officials to induce them to behave in a way that boosts the functioning of banks. . . . [W]e find that the bulk of “hands-on” policies by the government tends to hinder bank development, reduce bank efficiency, intensify banking system fragility, and increase corruption in lending.<sup>42</sup>

Barth, Caprio, and Levine used their findings regarding the ineffectiveness of regulators to support a preference for market-based systems of regulation. This Article assumes that following the 2008 Financial Crisis little political support remains for abandoning regulation in favor of market-based solutions.<sup>43</sup> Yet, the inherent limitations of the administrative state identified by Barth, Caprio, and Levine remain crucial to addressing the effectiveness of regulatory reforms.

## V. PUBLIC ENFORCEMENT OF PRUDENTIAL REGULATION

Implementing the existing federal prudential regime depends, primarily, on the activities of the agencies regulating the financial services industry.<sup>44</sup> The regulation of financial institutions, commercial

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41. GAO, FINANCIAL REGULATION, REVIEW OF REGULATORS’ OVERSIGHT OF RISK MANAGEMENT SYSTEMS AT A LIMITED NUMBER OF LARGE, COMPLEX FINANCIAL INSTITUTIONS, GAO-09-499T (March 18, 2009) (Statement of Orice M. Williams Before the Subcommittee on Securities, Insurance, and Investments, Committee on Banking, Housing, and Urban Affairs), *available at* [www.gao.gov/new.items/d09499t.pdf](http://www.gao.gov/new.items/d09499t.pdf).

42. JAMES R. BARTH, GERARD CAPRIO JR., & ROSS LEVINE, *RETHINKING BANK REGULATION: TILL ANGELS GOVERN* 314 (Cambridge Univ. Press 2006).

43. That does not mean, however, that market-based solutions will not be a part of future reforms.

44. As amazing as it may seem, this discussion provides only a partial list of the federal agencies that regulate financial institutions and markets. For example, the Securities and Exchange Commission (SEC) is the agency responsible for regulating the securities markets to protect investors. As such, it is not a prudential regulator. However, the SEC’s role with regard to prudential regulation has not always been clear. Prior to the 2008 financial crisis, the SEC was the consolidated supervisor for large, complex firms engaged primarily in the securities sector. These firms included Bear

banks in particular, has a long history. The United States Congress established the first federal regulator, the Office of the Comptroller of the Currency (“OCC”),<sup>45</sup> during the Civil War. Responding to the banking panic of 1907, Congress established the United States Federal Reserve.<sup>46</sup> In response to the Great Depression, the Federal Deposit Insurance Corporation (“FDIC”) and federal deposit insurance were established in 1935.<sup>47</sup> The next banking crisis, the savings and loan crisis of the 1980s, brought the creation of the Office of Thrift Supervision (“OTS”).<sup>48</sup>

These banking agencies approach prudential regulation in very similar ways. All act as supervisors – conducting regular onsite and offsite examination of the banks under their charge.<sup>49</sup> They each have the authority to write regulations implementing the banking statutes.<sup>50</sup> And, regarding the focus of this Article, all have a range of enforcement powers. They can enforce law through informal agreement such as a memorandum of understanding. The banking agencies can also engage in more formal enforcement proceedings such as cease and desist orders,<sup>51</sup> civil money penalties,<sup>52</sup> and removal and

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Stearns & Co, Goldman Sachs & Co., Lehman Brothers, Inc., Merrill Lynch & Co, Inc. and Morgan Stanley & Co. Following the 2008 financial crisis, each of these firms either failed or reorganized as financial holding companies subject to Federal Reserve supervision. Thus, in September of 2008, the SEC announced the termination of its consolidated supervised entities program.

45. The OCC is the primary federal regulator for all nationally chartered commercial banks. 12 U.S.C. § 26, 93a. The OCC was created in 1863 with the passage of the National Bank Act., ch. 106, 13 Stat. 99, 101 (June 3, 1864) (codified as amended in scattered sections of 12 U.S.C.). The National Bank Act was actually adopted originally in 1863 as the National Currency Act, ch. 58, 12 Stat. 665-668 (Feb. 25, 1863).

46. Federal Reserve Act of 1913, ch. 6, 1, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.). The Federal Reserve is the primary federal regulator for financial holding companies, bank holding companies, and state-chartered commercial banks that are members of the Federal Reserve System. 12 U.S.C. § 248, 1844 (2006).

47. The FDIC is, among other things, the primary federal regulator for state-chartered commercial banks that are not members of the Federal Reserve System. 12 U.S.C. § 1813(q)(3) (2006).

48. The OTS is the primary federal regulator for savings institutions. 12 U.S.C. § 1462 (2006). Title III of the Dodd-Frank Act will eliminate the OTS and transfer its various powers to the Federal Reserve and the OCC.

49. Bank regulators are required by statute to “conduct a full-scope, on-site examination” at least once every 12 months for most banks and every 18 months for certain small banks. 12 U.S.C. § 1820(d)(1); § 1820(d)(4) (2006). In reality, the largest financial institutions have bank examiners onsite permanently.

50. This does not mean, however, that each of the banking agencies has the same rulemaking authority. For example, the Federal Reserve has sole authority to promulgate regulations under many consumer credit laws. *See generally* Ralph J. Rohner, “*For Lack of a National Policy on Consumer Credit . . .*”; *Preliminary Thoughts on the Need For Unified Federal Agency Rulemaking*, 35 BUS. LAW. 135 (1979).

51. 12 U.S.C. § 1818(b) (2008).

52. 12 U.S.C. § 1818(i)(2).

prohibition orders.<sup>53</sup> Under Section 162 of the Dodd-Frank Act, the Federal Reserve is authorized to utilize the same administrative enforcement powers against nonbank financial companies supervised by the Federal Reserve.<sup>54</sup>

Agencies must exercise considerable discretion to operate effectively. This is no different for the banking agencies, which exercise considerable discretion in their supervisory, regulatory, and enforcement activities. Where there is considerable discretion and power, one might reasonably look to find some balance against such power. The development of administrative law doctrine can be seen in large part as a response to the problem of agency discretion.<sup>55</sup> More specifically, judicial review is available to challenge both the agencies' rulemaking activities and their enforcement actions.<sup>56</sup> A bank might, for example, seek judicial review of a banking agency's decision to declare the bank insolvent.<sup>57</sup> Yet, judicial review may not serve as a practical check against agency forbearance. As discussed further in Part VI, both the question of Congressional intent to create a private cause of action against a financial institution (when not explicitly provided by statute) and the plaintiff's standing to sue may prevent judicial review from serving as a significant check on agency forbearance.

Public enforcement regimes might be enhanced without the assistance of private litigation or permanent additions to the agency's budget. Whistleblower statutes are often passed to increase the effectiveness of an enforcement regime by assisting in the detection of wrongdoing and reducing the costs of enforcement programs. The Securities and Exchange Commission ("SEC") has statutory authority to pay bounties to individuals who provide the SEC with information regarding insider trading.<sup>58</sup> Most significant to this discussion is that

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53. 12 U.S.C. § 1818(e)(1).

54. Dodd-Frank Act, Pub. L. No. 111-203, § 162(a). Under section 162(a), the Federal Reserve has the authority to bring enforcement actions against the nonbank financial companies that it supervises. The Federal Reserve also has back-up enforcement authority over subsidiaries (including banks) of such nonbank financial companies under section 162(b) and (c).

55. RICHARD J. PIERCE, JR., *ADMINISTRATIVE LAW TREATISE* 1227-28 (4th ed. 2002).

56. Section 702 of the Federal Administrative Procedure Act provides that a "person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof." 5 U.S.C. § 702 (1993).

57. *See, e.g., James Madison Ltd. v. Ludwig*, 82 F.3d 1085 (D.C. Cir. 1996) (court reviewed banks' challenge of the agency's decision to place banks into receivership).

58. 15 U.S.C. § 78u (1)(e) (2006). The bounty may not exceed ten percent of the penalty. The SEC has rarely exercised its authority to pay bounties. Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. (forthcoming 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1520697](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1520697). The SEC does, however maintain significant information for would-be informants on its website. U.S. Sec. and Exch. Comm'n, *Insider Trading: Information on*

federal bank regulators, with the concurrence of the Attorney General, may award bounties in an amount not to exceed twenty-five percent of the penalty or \$100,000, whichever is less.<sup>59</sup> Such bounties may be awarded to a person who provides “original information” which leads to the recovery of a criminal fine, restitution, or civil penalty under, among other things, the various administrative enforcement provisions of federal banking laws. Unfortunately, it does not appear that the bank regulators have had much opportunity (if any) to utilize this bounty program.<sup>60</sup>

While whistleblower bounty programs may serve to enhance public enforcement regimes, they also have drawbacks. Professor Jayne W. Barnard notes that the SEC’s bounty program has been plagued with more tips than it could process.<sup>61</sup> In addition, tips may be specious, stale, or inconsistent among informants. All of this can undermine any efficiency gained from encouraging whistleblowing.

Of course, whistleblowers themselves also face significant costs even when they report perceived wrongdoing internally to the board of directors. Paul Moore was a senior executive in charge of regulatory compliance at Halifax Bank of Scotland (“HBOS”) from 2002 through 2005. Moore told the HBOS board that the bank was growing too fast and that its practices posed serious risks to financial stability and consumer protection. Moore, who was fired, sued HBOS under whistleblower protection law, later settling the suit.<sup>62</sup> In the fall of 2008, at the height of the 2008 Financial Crisis, Lloyds TSB (“Lloyds”) acquired HBOS. Subsequently, Lloyds suffered heavy losses because of HBOS’s very weak loan portfolio.<sup>63</sup>

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*Bounties*, <http://www.sec.gov/divisions/enforce/insider.htm> (last visited Mar. 20, 2010). The Dodd-Frank Act provides new incentives and protections for securities whistleblowers. Dodd-Frank Act, §§ 922-24. The Dodd-Frank Act also provides whistleblower protections to financial institution employees who make disclosures to the new Bureau of Consumer Financial Protection. Dodd-Frank Act § 1057.

59. 12 U.S.C. § 1831k (2006).

60. I have a Freedom of Information Act request pending with the banking agencies seeking information regarding payment of bounties under federal banking law. Preliminary responses from the agencies have not produced any evidence to contradict my strong suspicion that no bounties have been paid.

61. Jayne W. Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. (forthcoming 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1520697](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1520697).

62. For further information on Paul Moore and HBOS see Partick Hosking, *HBOS sacked and gagged bank risk whistleblower*, TIMESONLINE, Feb. 10, 2010, [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5701380.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5701380.ece).

63. Philip Aldrick, *HBOS haunts Lloyds as bad debts hit £24bn*, Telegraph.co.uk, Feb. 26, 2010, <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7326998/HBOS-haunts-Lloyds-as-bad-debts-hit-24bn.html>.



## VI. PRIVATE ENFORCEMENT MODELS TO ADDRESS SYSTEMIC RISK

Private enforcement mechanisms might be seen as the next best thing to public (agency) enforcement.<sup>64</sup> While private enforcement mechanisms may encourage strike suits and suffer from collective action problems, private parties, like Paul Moore, may have access to important information unavailable to public agencies. Unlike programs that pay a bounty to the whistleblower, the incentive to act upon information is far greater when the informant may take control of the litigation and possibly reap a greater reward (greater than, for example, the \$100,000 maximum that bank regulators are allowed to pay).

The implied private cause of action under section 10(b)<sup>65</sup> and Rule 10(b)-5<sup>66</sup> of the Securities Exchange Act ("SEA") has received widespread attention and scrutiny. Rule 10(b)-5 is an anti-fraud rule which, among other things, makes it unlawful to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" in connection with the purchase or sale of any security.<sup>67</sup> A court first recognized an implied private cause of action in 1946.<sup>68</sup> Since then, the Supreme Court of the United States has handed down rulings that have both contracted and expanded the ability of private parties to sue under section 10(b).<sup>69</sup> The United States Congress attempted to address abusive section 10(b) class action lawsuits by passing the Private Securities Litigation Reform Act of 1995.

In contrast to the treatment of section 10(b) under the SEA, courts have been reluctant to imply a private cause of action under the federal banking laws. Richard Scott Carnell, Jonathan R. Macey, and Geoffrey P. Miller wrote that "[a]ttempts to establish private rights of action under comprehensive bank regulatory schemes have usually

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64. With regard to the enforcement of securities laws, scholars debate whether public or private enforcement is superior. See Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (Harvard Law Sch., Harvard Pub. Law, Working Paper No. 08-28). This article does not seek to evaluate the relative merits of public versus private enforcement. Rather, I claim only that a mechanism for private enforcement is an appropriate addition to a macro-prudential regulatory regime.

65. 15 U.S.C. § 78j(b) (2000).

66. 17 C.F.R. § 240.10b-5 (2006).

67. *Id.*

68. *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

69. For an example of contraction, see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (only actual purchasers or sellers have standing, not investors who decided not to trade). For an example of expansion, see *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (allowing a presumption that investors rely on false information).

founded on the argument that since Congress specifically gave federal bank regulators such wide-ranging enforcement rights, its failure to give private parties similar rights could not have been inadvertent.<sup>70</sup> In fact, since the recognition of an implied cause of action under section 10(b) in 1946, the Supreme Court has been generally more reluctant to find the Congressional intent to create such a right.<sup>71</sup>

The possibility of a private cause of action under federal banking laws suffers from hurdles in addition to the lack of Congressional intent to create a private cause action. Article III of the United States Constitution limits courts to resolving cases and controversies. Establishing standing to sue is fundamental to meeting the cases or controversy requirement and, at minimum, includes three elements: first, the plaintiff must establish injury-in-fact; second, the plaintiff must show a connection between the injury and the conduct alleged; and, third, the plaintiff must show a substantial likelihood that the requested relief will remedy the claimed injury.<sup>72</sup> Moreover, the question of standing, particularly the element of injury, relates to the nature of the statute in question. As Professor Richard J. Pierce explained, “Congress can enact a statute that creates a right the invasion of which constitutes a legally cognizable injury.”<sup>73</sup> As discussed above, however, courts have been generally unwilling to find Congressional intent to recognize injury to private parties in enacting the federal banking laws. This, in turn, undermines the finding of an injury that could establish the private party’s standing.

An example of traditional micro-prudential regulation is illustrative. In the United States and abroad, law and regulation commonly restricts the size of loans that a bank can make to an individual borrower.<sup>74</sup> Federally chartered banks (national banks) are prohibited,

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70. RICHARD SCOTT CARNELL, JONATHAN R. MACEY, & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* (Aspen Pub., 4th ed. 2009). *See, e.g.*, *Miller v. GE Capital Mortg. Serv.*, 124 Fed.Appx. 152 (4th Cir. 2005) (court found no implied cause of action under 12 U.S.C. § 1715u, which was intended to regulate mortgagees not protect mortgagors); *Smith v. Dearborn Fin. Servs.*, 982 F. 2d 976 (6th Cir. 1993) (finding no private cause of action under the Federal Credit Union Act); *but see Vega v. First Federal Sav. & Loan Ass’n*, 622 F.2d 918 (6th Cir. 1980) (finding an implied private cause of action under the Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2609-10)

71. A recent Supreme Court decision seems to bring into question the whole notion of an implied private cause of action. *Alexander v. Sandoval*, 532 U.S. 275, 286 (2001) (“private rights of action to enforce federal law must be created by Congress”).

72. *McCconnell v. FEC*, 540 U.S. 93, 225-26 (2003) (overruled on other grounds by *Citizens United v. Fed. Election Com’n*, 130 S.Ct. 876 (2010)).

73. RICHARD J. PIERCE, JR., *ADMINISTRATIVE LAW TREATISE* 1111 (Aspen Pub., 5th ed. 2002).

74. For a comprehensive discussion of lending limits in the United States and abroad, *see* SCHOONER & TAYLOR, *supra* note 1, at 183-93.

with exceptions, from lending more than fifteen percent of their capital to any one borrower.<sup>75</sup> The purpose of such lending limit statutes, inter alia, is to protect the financial condition of the bank.<sup>76</sup> Suppose Bank A, under relevant statutes and regulations, may not make a loan to one borrower in excess of \$5 million. Nevertheless, Bank A makes a loan to one borrower for \$5.1 million. Clearly, Bank A and its board are liable for the violation.<sup>77</sup> However, identifying the injured party is less clear. Bank A's solvency is potentially harmed and, therefore, perhaps a derivative claim by the bank's shareholders against the bank's directors is appropriate.<sup>78</sup> But, the party with greater incentive to sue Bank A is the borrower that received the \$5.1 million in loans.<sup>79</sup> The borrower, for example, might claim that an injury because Bank A lent it too much money. However, the borrower that received loans in violation of Bank A's lending limits may find difficulty establishing a private cause of action under the lending limit statute.<sup>80</sup> Difficulty establishing a private cause of action stems from the fact that limitations on lending were established to protect the solvency of the bank rather than to protect an individual borrower.<sup>81</sup>

A full analysis of the potential standing issues in suits involving systemic risk regulation is beyond the scope of this Article. However, this section does demonstrate that both the potential lack of Congressional intent to create a private cause of action and the potential for challenges to a private party's standing make private causes of action an imperfect supplement to public enforcement of systemic risk regulation.

The difficulties in establishing standing under existing federal banking laws will only be exacerbated by reforms geared toward developing a macro-prudential regime. By design, the macro-prudential

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75. 12 U.S.C. § 84 (2006).

76. Current regulation states that the purpose of the lending limit provisions is "to protect the safety and soundness of national banks by preventing excessive loans to one person, or to related persons that are financially dependent, and to promote diversification of loans and equitable access to banking services." 12 C.F.R. § 32.1(b).

77. For cases involving personal liability of members of the bank's board of directors see, *Larimore v. Conover*, 775 F. 2d 890 (7th Cir. 1985); *Del Junco v. Conover*, 682 F.2d 1338 (9th Cir. 1982).

78. Such a claim would likely be based on breach of state laws regarding the fiduciary duties owed by officers and directors rather than breach of the federal banking statutes.

79. Or, perhaps even more likely, the borrower has an incentive to raise the lending limit violation as a defense to Bank A's suit against the borrower for repayment of the loan.

80. See *Valente v. Dennis*, 437 F.Supp. 783 (E.D. Pa 1977) (holding that there is no private cause of action under 12 U.S.C. § 84).

81. *McConnell*, 540 U.S. at 225-26 (overruled on other grounds by *Citizens United v. Fed. Election Com'n*, 130 S.Ct. 876 (2010)).

regime looks beyond the solvency of an institution and toward the financial system in general. Therefore, to the extent that private parties have difficulty in establishing standing under the existing micro-prudential regime, the newer macro-prudential rules will create even greater challenges. For example, suppose bank regulators were to limit certain transactions between financial institutions that are deemed to pose a threat to financial stability. If Bank B engaged in such transactions, would a private party have standing to sue Bank B? It seems that such a suit would fail for lack of standing much like the lending limit example above. Unless the statute itself created a private cause of action, a court would likely be reluctant to imply a cause of action (because they generally are), and standing would be difficult to establish because the injury addressed by the statute would be injury to the financial system and greater economy, not a private harm.<sup>82</sup>

## VII. HYBRID ENFORCEMENT: QUI TAM MODEL

As discussed above, the macro-prudential reforms seek to improve the regulation of systemic crisis. The harms associated with systemic crisis are broad. By definition, systemic crisis affects the broader economy (not just financial markets and institutions).<sup>83</sup> Ultimately, much of the costs of systemic crisis are borne by the taxpayer. The true extent of the impact of the 2008 Financial Crisis on the U.S. taxpayers may remain unquantifiable. The figure is undoubtedly large. Consider just a few pieces of the taxpayers' bill. The government's takeover of Fannie Mae and Freddie Mac was one of the most significant events of the crisis. The Congressional Budget Office ("CBO") recently concluded that "the operations of Fannie Mae and Freddie Mac added \$291 billion to CBO's August 2009 baseline estimate of the federal deficit for fiscal year 2009 and \$99 billion to the total deficit projected for the 2010–2019 period."<sup>84</sup> The United States Congress appropriated \$700 billion for the Troubled Asset Relief Program. While much of the costs of that program are likely to be recovered, the

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82. That is not to say that systemic risk rules would never involve a private injury. For example, if the Administration's proposal were enacted and Tier I firms became subject to stricter capital requirements, one can imagine Tier I firm A suing Tier I firm B for failure to meet heightened capital requirements. Tier I firm A would claim injury based on its competitive disadvantage compared to Tier I firm B.

83. See *supra* note 12 and accompanying text.

84. Cong. Budget Office, *Background Paper: CBO's Budgetary Treatment of Fannie Mae and Freddie Mac* (January 2010), <http://www.cbo.gov/ftpdocs/108xx/doc10878/01-13-FannieFreddie.pdf>.

CBO predicts that ninety-nine billion dollars will not be recovered, and the Treasury predicts a \$117 billion deficit.<sup>85</sup>

This Article posits that public enforcement is an important but insufficient mechanism for a macro-prudential regime aimed at preventing systemic crisis (and protecting the taxpayer). As discussed above, federal banking laws do not offer meaningful private enforcement opportunities. Lucia Dalla Pellegrina and Margherita Saraceno conducted an interesting study on the indirect, positive impact that securities class action suits can have on bank stability.<sup>86</sup> They concluded that securities class actions may serve as “a Red Flag of bank instability” in that such actions tend to focus on banks that take on more risk and those that are less efficient, particularly those with high ratio of bad to good loans and a low interest margin. They concluded that the securities class action can serve as an effective complement to agency supervision of banks.

Pellegrina and Saraceno’s findings are significant and warrant further study. This Article suggests that reforms should include a private enforcement mechanism that directly addresses systemic risk. The model proposed in this section is meant to avoid some of the enforcement problems highlighted above, such as specious tips and issues of standing. The model proposed attempts to provide incentives for those with information regarding potential violations of the regulatory regime to act on such information.

The enforcement model proposed in this section borrows from another regulatory regime in which potential loss to the taxpayer is also a salient concern. The federal government procurement system spent \$531 billion in the 2008 fiscal year. The regulation of federal government procurement process has various goals,<sup>87</sup> but among the most important is the preservation of the integrity of a system that spends taxpayer money.<sup>88</sup> Fraud in any procurement system is unavoidable, but cannot be ignored. Congress passed the False Claims Act (“FCA”)<sup>89</sup> in 1863 to address widespread fraud in procurement during the Civil War.<sup>90</sup> The FCA imposes civil money penalties and treble

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85. Dan Fitzpatrick, *TARP Losses Projected Lower, to \$117 Billion*, WALL ST. J., March 2, 2010, at C3.

86. Lucia Dalla Pellegrina & Margherita Saraceno, *Securities Class Actions in the US Banking Sector: Between Investor Protection and Bank Stability* (CLEA 2009 Annual Meeting Paper, Paolo Baffi Centre Research Paper No. 2009-61, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1427814](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1427814).

87. Steven L. Schooner, *Desiderata, Objectives for a System of Government Contract Law*, 11 PUBLIC PROCUREMENT L. REV. 103 (2002).

88. “Transactions relating to the expenditure of public funds require the highest degree of public trust and an impeccable standard of conduct.” 48 C.F.R. § 3.101-1.

89. 31 U.S.C. § 3729 et. seq. (2006).

90. For a history of the FCA and amendments thereto, see U.S. ex rel. LaValley v. First Nat’l Bank of Boston, 707 F. Supp. 1351, 1354-56 (1988).

damages upon any person who knowingly presents a false claim to the government for payment.<sup>91</sup> The FCA includes private enforcement through qui tam proceedings.<sup>92</sup> The FCA authorizes a private party (“relator”) with evidence of fraud to sue, on behalf of the government, a government contractor who submits false or fraudulent claims for funds. If the Department of Justice decides to join the action brought by the relator, the DOJ will have the primary responsibility for the prosecution.<sup>93</sup> In the case of a successful prosecution, the relator is entitled to at least ten and not more than twenty-five percent of the proceeds of the action (depending on the extent of the relator’s contribution to the action) and to reimbursement of attorneys fees.<sup>94</sup>

Qui tam proceedings under the FCA are not without controversy,<sup>95</sup> but show strong evidence of success. Since 1986,<sup>96</sup> the government has recovered over fifteen billion dollars under the FCA. Sixty-four percent (9.6 billion) of those recoveries came from cases filed by relators. Relators were entitled to 1.6 billion of those recoveries.<sup>97</sup>

The qui tam model offers important advantages toward enhancing the enforcement of systemic risk regulation. First, and perhaps most important, the model taps the knowledge of those individuals with the best access to information relevant to violations of systemic risk regulation. Second, the qui tam model avoids the standing problems that arise when a private party seeks to enforce regulations that address a public harm. While objections to standing have been made under the FCA, courts have found standing (injury, in particular) based on the government’s assignment of its claim to the relator. The United States Court of Appeals for the Ninth Circuit has stated that the FCA “effectively assigns the government’s claim to qui tam plaintiffs . . . who then may sue based upon an injury to the federal

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91. 31 U.S.C. § 3729(a).

92. 31 U.S.C. § 3730(b). “Qui Tam” is short for “Qui Tam pro domino rege quam pro si ipso in hac parte sequitur” which means “who sues for the king as well as for himself in the matter.” The Attorney General may also bring actions under the False Claims Act. 31 U.S.C. § 3730(a).

93. 31 U.S.C. § 3730(c).

94. 31 U.S.C. § 3730(d)(1).

95. For a thorough discussion of the pros and cons of qui tam proceedings under the FCA, see Steven L. Schooner, *Fear of Oversight: The Fundamental Failure of Businesslike Government*, 50 AM. U. L. REV. 627, 666 (2001); William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799 (1996).

96. Congress amended the FCA in 1986 to encourage qui tam proceedings. *First Nat’l Bank of Boston*, 707 F. Supp at 1355.

97. STANLEY J. CZERWINSKI & THOMAS J. MCCOOL, GAO UPDATE OF STATE AND LOCAL GOVERNMENT FISCAL PRESSURES, GAO-06-320R (Jan. 31, 2009), available at [www.gao.gov/new.items/d06320r.pdf](http://www.gao.gov/new.items/d06320r.pdf).

treasury.”<sup>98</sup> Third, the *qui tam* model provides incentives that, unlike the incentives of public agencies, are not business cycle driven. The *qui tam* plaintiff’s incentives are based on the likelihood of recovery on the claim, and are not based on whether the economy is growing or contracting. Fourth, unlike the whistleblower statutes discussed above, the *qui tam* plaintiff receives a much greater stake in the claim because they must fund the litigation (unless the DOJ takes over the prosecution), they must bear the costs if unsuccessful, and they stand to reap a much greater reward if the proceeds of the action are large. Finally, law firms that develop expertise representing *qui tam* plaintiffs function as private attorney generals. While law firms representing *qui tam* plaintiffs will be most interested in pursuing large banks with deep pockets that have the ability to pay large fines and attorney fees, these are precisely the types of institutions that represent the greatest risk to the financial system.

Objections to *qui tam* proceedings in the federal procurement process apply equally or similarly to the use of *qui tam* proceedings for systemic risk regulation. First, the existence of *qui tam* might distort the incentives of bank employees who have information of violations. Rather than reporting such information immediately to the bank’s own compliance personnel, board, or its regulators, employees might be tempted to hoard such information until it is ripe for a lucrative claim. Second, bank competitors might use *qui tam* actions to gain market advantage. For example, a bank competitor might claim a violation by a bank to thwart competition.<sup>99</sup> Third, the availability of *qui tam* proceedings against deep pocket banks will encourage the growth of law practices representing *qui tam* plaintiffs whose interests are focused on generating attorney fees and maximizing penalties rather than identifying the most serious violations of law.

In addition to weighing the relative advantages and disadvantages of *qui tam* enforcement for systemic risk regulation, the development of the structure of such a system presents challenges. The main challenge to the development of a *qui tam* action to enforce systemic risk regulation is that Congress would have to amend the FCA to do so.<sup>100</sup> The advantage of a definitive statute, however, should not be

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98. U.S. v. Boeing, 9 F.3d 743 (9th Cir. 1993).

99. Of course, competitors often use regulation to gain advantage over competitors. Antitrust laws, most obviously, can be used opportunistically to gain advantage over a competitor.

100. Congress recently amended the FCA with the passage of the Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat. 1617 (2009). Significantly, the FERA amended 31 U.S.C. 3729(a)(2) which used to provide liability if a person “knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government.” 31 U.S.C. 3729(a)(2) (2009) (emphasis added). That provision now reads: “knowingly makes, uses, or causes

overlooked. Securities class action suits are plagued by their origins as actions implied by the United States Supreme Court rather than explicitly created by Congress.<sup>101</sup> Moreover, when Congress creates a private cause of action it may do so within carefully delineated limitations that can prevent the negative over-reaching effects of an implied cause of action.

Another challenge to a *qui tam* action to enforce systemic risk regulation is determining the exact nature of the statutory trigger. Would any violation of bank regulation be sufficient, or should *qui tam* be available only for those violations of law that relate to the prevention of systemic risk? This Article claims the special nature of systemic risk (and its potential impact on taxpayers) is a justification for the extension of *qui tam* actions, and, therefore, it would seem that the statutory trigger for such actions should be limited to those banking laws that address systemic risk.<sup>102</sup> As a practical matter, this would mean that violations of bank capital requirements by systemically significant firms, for example, would serve as a trigger, but violations of federal consumer protection laws would not.<sup>103</sup>

The measure of damages could present challenges to the extension of *qui tam* actions. Systemic risk regulations are intended to be prophylactic and, while violations may contribute to the failure of a financial institution, the ultimate harm caused by noncompliance is damage to the financial system as a whole and broader economy. Measuring actual harm in such circumstances could present insurmountable hurdles. Yet, *qui tam* recoveries need not be limited to actual damages. Rather, *qui tam* recoveries could be tied to existing civil money penalties under federal banking law.<sup>104</sup>

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to be made or used, a false record or statement material to a false or fraudulent claim.” 31 U.S.C. 3729(a)(1)(B) (2009). By eliminating the “to get” language, Congress intended to reverse *Allison Engine Co. v. United States ex rel. Sanders*, 553 U.S. 662, 128 S.Ct. 2123 (2008), in which the court found that “a person must have the purpose of getting a false or fraudulent claim “paid or approved by the Government“ in order to be liable. . . .” *Id.* at 2128.

101. In fact, Justice Stevens complained of the Court’s own “campaign to render the private cause of action under [10b-5] toothless.” *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 175 (2008) (Stevens, J., dissenting).

102. For example, the scope of *qui tam* proceedings could be limited to violations of law or regulation under the Dodd-Frank Act, Title I, which is specifically addressed at financial stability.

103. While this article has focused on prudential rules, financial institutions are also subject to federal laws intended to protect consumers. For example, the Truth in Lending Act (TILA), 15 U.S.C. § 1601-93r, requires lenders to disclose the terms and costs of their loans. I would limit the extension of *qui tam* to the violation of prudential rules and exclude the violation of laws intended to protect consumers, like violations of TILA.

104. See *Pierce*, *supra* note 55.



Finally, this proposed expansion of qui tam actions might be objectionable because of its potential application to other regulatory regimes. In other words, if qui tam is such an important enforcement mechanism for systemic risk regulation, then why not make such mechanism available in other regulatory schemes? Former professor and current Commissioner of the Federal Trade Commission William Kovacic wrote the following as a part of a call for further empirical research on the effectiveness of qui tam proceedings:

If expansive qui tam enforcement is sensible for government procurement, one might ask why it should not be adopted broadly for any number of other statutory schemes. Why, for example, should persons who detect violations of environmental statutes not be allowed to share in penalties that the government recovers? Why should standing to prosecute violations for employment discrimination statutes not be extended to individuals other than the victim? . . . If we distrust the government's exercise of prosecutorial discretion in the enforcement of public procurement laws, why should we tolerate it in other fields? In short, if robust decentralized bounty hunting makes sense for government contracting because it facilitates superior detection, punishment, and deterrence of illegal conduct, there seems little reason not to adopt such a mechanism for enforcing virtually all other legal commands.<sup>105</sup>

Distinguishing both government procurement and systemic risk regulation from most or many other regulatory regimes, however, may not be that difficult. Both government procurement and systemic risk involve large potential losses to the U.S. taxpayer. When a firm falsifies claims to Medicare, for example, the injury falls on the treasury. Similarly, when a financial institution engages in practices that cause systemic risk, the injury, too, is to the treasury (although perhaps less immediately). Other regulatory regimes can make similar claims. Violations of environmental statutes can lead to federal dollars spent to clean or restore the environmental damage. But, not all regulatory regimes carry the same claims.

For example, the Consumer Products Safety Commission ("CPSC") "is charged with protecting the public from unreasonable risks of serious injury or death from thousands of types of consumer products under the agency's jurisdiction."<sup>106</sup> Yet, the public harm addressed by the CPSC does not necessarily impact the U.S. Treasury

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105. William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 Loy. L.A. L. Rev. 1799, 1856 (1996).

106. U.S. Consumer Product Safety Commission, CPSC Overview, <http://www.cpsc.gov/about/about.html> (last visited Mar. 20, 2010).

and the taxpayer. If a manufacturer builds a defective toaster in violation of the CPSC regulations, the harm associated with that defect has little if no impact on taxpayers. On the other hand, the 2008 Financial Crisis demonstrates the impact of a systemic financial crisis on U.S. taxpayers. The threat to taxpayers perhaps justifies more aggressive attention to enforcement of macro-prudential regulation.

## VIII. CONCLUSION

The damage caused by the 2008 Financial Crisis invites important discussion of regulatory reform. Debate regarding the structure of the new financial regulatory regime has focused on whether existing agencies should be abolished or enhanced, whether new agencies should be created, who should head such agencies, and how the agencies should be funded. This Article suggests that these structural discussions should look beyond agencies and toward other institutions and individuals that might serve an important role in regulation. Private enforcement has been an important supplement to public enforcement in securities regulation. The securities class action suit has, however, been subject to much criticism. The *qui tam* model offers potential benefits over the pure private enforcement model. The *qui tam* model has been an effective means of enforcement in the public procurement regime in which fraud claims impact the American taxpayer. The 2008 Financial Crisis will leave the U.S. taxpayer with a hefty bill. Reform should consider new ways to prevent such crises by seeking to enhance the performance of public agencies which, despite all good intentions, will never be perfect.

