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DEPOLITICIZING FINANCIAL REGULATION

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Over the past few decades, scholars have called into question the ability of regulatory agencies to function effectively in furtherance of the public interest.[1] Since midcentury, they have amassed convincing evidence that agencies can be captured through, for example, "iron triangles" between Congress, agencies and those supposedly regulated.[2] More recently, regulatory scholars have articulated various theories of regulatory conduct and used differing terminology to describe capture. Nonetheless, there is broad agreement that special interests can act within the context of political subsystems, where isolated regulatory actors are subject to various forms of pressure, causing regulatory policies to serve special, rather than public interests.[3] These political subsystem actors often can subvert regulation when

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* Associate Professor of Law, Washburn University School of Law. Professors William Rich and Myrl Duncan reviewed an early manuscript of this Article and provided many helpful insights. Professor Jeffery Worsham and Professor Joe Peek also provided insights, in the areas of political science and economics, respectively. Eric Kraft provided valuable research assistance.

1. *See, e.g.*, Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1684-87, 1802-13 (1975) (summarizing the legal scholarship demonstrating the disintegration of the policy bases for administrative regulation and critiquing responses to problems of special interest domination and regulatory capture); *see also* Ronald A. Cass, *The Meaning of Liberty: Notes on Problems Within the Fraternity*, 1 NOTRE DAME J.L. ETHICS & PUB. POL'Y 777, 790 (1985) ("Take almost any government program at random, and a 'special interest' counter-majoritarian explanation can be found that is more plausible than the public interest justification for it.").

2. *See generally* CHARLES H. KOCH, JR., ADMINISTRATIVE LAW & POLICY § 7.12 (2d ed. 1997) (providing an overview of scholarship on problems of administrative regulation).

3. *See, e.g.*, Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 343 (1974) (stating the economic theory of regulation rejects the use of the term "capture" as "inappropriately militaristic," but recognizes that private interests may subvert regulation). Notably, scholars who have highlighted certain limitations that plague any particular theory of regulation have not rejected such

political conditions fail to provide appropriate checks and balances.[4] Congress itself is frequently co-opted in much the same fashion as are regulatory agencies.[5] This Article explores whether a certain degree of agency independence from the legislative and executive branches can break down iron triangles and provide a basis for effective depoliticized regulation, in the specific context of financial market regulation, where now there is a compelling need for such a regulatory framework. The Article concludes that the Federal Reserve Board's administration of monetary policy exemplifies the possibility of depoliticized regulation. The Federal Reserve Board has demonstrated that if Congress provides broad delegation of authority to a singular agency with a high degree of political independence, then effective regulation is

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theories as partial explanations of regulatory conduct. *See, e.g.*, Dorothy A. Brown, *The Invisibility Factor: The Limits of Public Choice Theory and Public Institutions*, 74 WASH. U. L.Q. 179, 211 (1996) (arguing that public choice theory of regulation fails to explain the ability of "unifying principles," such as racism, to thwart special interest attempts to capture legislation).

4. There is also a wide consensus among political science scholars that generally power is concentrated within political subsystems and exercised in favor of special interests. *See, e.g.*, JEFFREY WORSHAM, OTHER PEOPLE'S MONEY: POLICY CHANGE, CONGRESS AND BANK REGULATION 2 (1997). Professor Worsham observes, however, that the adherents of this focus upon powerful special interests speak "several distinct dialects." *Id.* at 3. Some scholars speak in terms of iron triangles whereas others speak of advocacy coalitions or capture theories. *See id.* Fundamentally, most ascribe to Professor Lowi's thesis that the regulatory state has transformed our democracy into government by special interests for special interests. *See id.*; *see also* THEODORE J. LOWI, THE END OF LIBERALISM 278-79 (2d ed. 1979) (impugning the regulatory state because centralized power facilitates "personal plunder rather than public choice" and is characterized accurately as "socialism for the organized, capitalism for the unorganized"). The classic definition of special interests is James Madison's definition of a faction in *The Federalist No. 10*. He stated:

> By a faction I understand a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion, or of interest, adverse to the rights of other citizens, or to the permanent and aggregate interests of the community.

THE FEDERALIST NO. 10, at 123 (James Madison) (Isaac Kramnick ed., 1961).

5. In fact, some have argued that "Congress is the key to the Washington establishment." MORRIS P. FIORINA, CONGRESS: KEYSTONE OF THE WASHINGTON ESTABLISHMENT 4 (2d ed. 1989). In other words, Congress created the system of bureaucratic regulation and sustains its basic structure. This is why all "iron triangle" or capture theories leave a substantial role for Congress. *See, e.g., id.*; *see also* Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 924-25 (1987) (acknowledging that Congress can be hijacked by special interests).

likely, free of special interest influence and of transitory political forces having less than rational agendas. While focusing upon a relatively narrow area of regulation, this Article argues that effective, relatively nonpolitical regulation can be achieved within the framework of our Constitution. Finally, using financial market regulation as a model, this Article addresses the conditions under which depoliticized regulation is most appropriate.

Financial market regulation provides an excellent context for considering these issues because of its spectacular regulatory failures and the current dynamics facing the regulatory structure governing our financial markets. The world financial system is becoming exceedingly complex. Even the most respected regulatory experts, including Federal Reserve Chairman Alan Greenspan, have observed that with the accelerating globalization of capital markets, regulators have insufficient knowledge to prevent a major catastrophe.[6] One major challenge is that the world is more economically interdependent than ever. New technology has given rise to new types of transactions, particularly derivatives transactions, that link financial institutions to markets around the globe.[7] One market crash, in far off East Asia for example, can roil financial markets in London, New York, and Frankfurt. In the summer of 1997, East Asian instability

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6. *See* Chairman Alan Greenspan, Understanding Today's International Financial System, Remarks Before the 34th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago (May 7, 1998) <http://www.federal reserve.Gov/boarddocs/speeches/1998/19980507.htm> (stating that increased understanding is needed to stem "a systemic disruption" beyond comprehension).

7. A recent example of these links is the failure of a huge "hedge fund" known as Long-Term Capital Management. *See* Steven Lipin et al., *Bailout Blues: How a Big Hedge Fund Marketed Its Expertise and Shrouded Its Risks*, WALL ST. J., Sept. 25, 1998, at A1. Apparently, this fund failed to account for the Russian financial meltdown of mid-1998 and lost billions in leveraged positions. *See id.* Financial institutions around the world, from New York to Zurich, had exposure to the fund. *See id.* The Federal Reserve Bank of New York orchestrated a $3.5 billion bailout to stem the market chaos that would have followed liquidation of the fund's assets. *See id.* Major United States financial institutions injected cash into the fund to avoid liquidation. *See id.* The final cost to American banks and securities firms is not known. One Swiss bank has already written off its entire $678.5 million exposure to the fund. *See id.* Amazingly, neither the financial institutions behind the fund nor the fund's management, which included two Nobel laureates in economics and a former vice chairman of the Federal Reserve, appeared to appreciate the risks of the fund's positions. *See id.*

took the financial world by surprise. The fact that regulators, investors, and financial experts equally failed to predict the gravity of the problems arising from the collapse of the "Asian Tigers" demonstrates how rapidly the financial world is evolving. This evolution has overwhelmed the legal system's ability to keep pace, and raises a high-stakes and compelling question: Is Congress institutionally capable of meeting challenges to regulation in this area on a timely and thorough basis?[8]

Concomitantly, globalization and technology have created incentives for financial institutions and other business organizations to consolidate and reach beyond national frontiers. The profit potential and increased girth of such consolidated entities necessarily mean that these institutions have enormous economic power.[9] In light of this and the increasing complexity of financial regulation, the democratic process seems particularly ill-suited for making informed decisions on matters of financial market regulation. Voters have insufficient knowledge, time, and interest to make appropriate electoral decisions on the basis of matters of financial market regulation.[10] In the absence of transitory factors, such as severe economic dislocation, the public is not aware of the course, much less the details, of financial market regulation. This creates a disconcerting vacuum: the money and

8. Even as early as 1987, Professor Langevoort recognized that the regulatory framework governing bank regulation was so obsolete that he argued the courts should take an active role in construing statutes in a manner that reflected changing economic realities. *See* Donald D. Langevoort, *Statutory Obsolescence and the Judiciary Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 729-33 (1987). Even then it was clear that the basic business of financial institutions was evolving rapidly. *See id.* at 673 ("Largely as a result of changes in available technology, the banking marketplace has changed radically."); *see also id.* at 676-680 (describing the effect of technological advances on the banking industry). *See generally* Thomas M. Hoenig, *Financial Modernization: Implications for the Safety Net*, 49 MERCER L. REV. 787, 787 (1998) ("Over the past twenty years the world of finance has changed dramatically.").

9. One example of such behemoths is Citigroup, the $48 billion financial services conglomerate formed as a result of a merger between Citicorp and Travelers Group in 1998. *See* Matt Murray, *Fed Approves Citicorp-Travelers Merger*, WALL ST. J., Sept. 24, 1998, at A3.

10. *See* Brown, *supra* note 3, at 181 (suggesting that special interests can control legislative outcomes "where the disorganized majority remains uninformed and uninterested").

influence of the regulated—the financial institutions or businesses themselves—can fill the vacuum and thus capture regulation.[11] Even when transitory factors awaken the electorate, the popular alarm frequently triggers an overreaction, or a less than rational reaction. This political failure leads to regulation that is dictated largely by the weight of money interests, or political overkill and "random agendas."[12]

To deal with these realities, the United States is burdened by a fragmented system of financial market regulation. The current, largely politicized system of financial market regulation has fragmented regulatory power in an unprincipled and chaotic fashion. Three factors have led to this irrational fragmentation. First, on those occasions when the electorate focused on financial market regulation, it often cast its eyes upon the system with a high degree of suspicion towards "big business."[13] Second, statutory obsolescence has led to an outdated regulatory framework.[14] Third, "big business" itself has seen strategic advantages in protecting itself from competition and weakening regulatory power.[15] After decades of pursuing this fragmentation, powerful interests now are seeking the ability to assemble financial su-

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11. Recently, observers have documented the pernicious influence of moneyed interests upon law and regulation. *See generally* WILLIAM GREIDER, WHO WILL TELL THE PEOPLE 12 (1993) ("Instead of popular will, the government now responds more often to narrow webs of power—the interests of major economic organizations and concentrated wealth and the influential elites surrounding them.").

12. STEPHEN BREYER, BREAKING THE VICIOUS CIRCLE 19-20 (1993). Justice Breyer's analysis of regulatory dysfunction is founded upon our government's efforts to regulate environmental risks. *See id. passim.* Many of his conclusions regarding systemic problems in environmental regulation also are pandemic to financial regulation. Justice Breyer describes "random agendas" as a problem that arises because the general public, for a number of reasons, fails to prioritize rational regulatory agendas. *See id.* at 19-20. This is transmitted through Congress to the agency, and results in regulatory agendas that are out of sync with an objective ranking of regulatory priorities. *See id.* at 19-21. The electorate also has failed, for various reasons, to achieve more perfect enlightment in the area of financial market regulation.

13. *See* Mark J. Roe, *A Political Theory of Corporate Finance*, 91 COLUM. L. REV. 10, 32-53 (1991) (demonstrating that populist suspicions towards "big business" as well as special interests, such as managers and financial institutions, led to regulatory fragmentation of the financial institution industry).

14. *See id.* at 48-53.

15. *See* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 5 (1971) (arguing that regulation frequently is utilized to discourage market entry and competition).

permarkets or "universal banks," without any central regulatory authority.[16] This fragmentation has led to a unique form of regulatory competition that has stifled the development of sound financial regulation. To make matters worse, the largest corporations in America can choose from fifty different sets of state laws for corporate governance. Financial market experts have recognized that it is inappropriate for the government to erect artificial barriers to competition and "to divide the financial world into discrete segments."[17] What has been understated, however, is that segmented regulation similarly is obsolete. This dimension of political regulation adds an additional factor, specifically regulatory competition, in the pressures giving rise to regulatory capture. Fragmentation of regulatory power spawns real, not theoretical, problems and in the case of the savings and loan crisis alone contributed to a $1 trillion regulatory fiasco.[18]

The current regulatory structure fails to balance appropriately the costs and benefits of regulatory policy. Concentrated benefits frequently are extended to powerful interests at the expense of the general public, particularly if the costs are spread over the long term. Similarly, regulation in its current state permits the absorption of easily concealed costs for the benefit of those interests that stand to achieve real benefits in exchange. Thus, diffused and deferred costs are underweighted in policymakers' decision-making processes. Political gridlock and agency infighting has led to the reality that America has a twenty-first-century economy that is governed by Depression-Era regulatory structures.[19] Consequently, American financial institutions and corporations are hobbled internationally and there are gaping holes in the country's regulatory infrastructure. In short, the regulation

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16. *See* Jonathan R. Macey, *The Inevitability of Universal Banking*, 19 BROOK. J. INT'L L. 203, 221 (1993) ("I argue that universal banking is not only desirable, it is inevitable."). Professor Macey notes that "everyone agrees that universal banking means expanded powers for banks." *Id.* at 203. Interestingly, however, Professor Macey does not consider the history of expanding financial institution activities in his analysis of the economic desirability of universal banking. Recent history shows that with expanded bank powers comes expanded bank risks.

17. ROBERT E. LITAN & JONATHAN RAUCH, U.S. DEP'T OF TREASURY, AMERICAN FINANCE FOR THE 21ST CENTURY 5 (1997).

18. *See infra* notes 372-417 and accompanying text.

19. Professor Langevoort attributes the problem of statutory obsolescence to "political inertia and special interest pressure." Langevoort, *supra* note 8, at 672.

of financial markets is seriously dysfunctional.[20] This Article posits that these problems reflect the inappropriate political influence that has corroded the public interest basis for financial regulation.

20. This Article limits its assessment of the success of regulation to the area of financial market regulation. Although a number of theories of regulation cast aspersions upon the very concept of regulation in the public interest, this Article argues that agency regulation *can* be an effective means of vindicating the public interest. One scholar has summarized concisely the competing theories of regulation:

> [P]ublic choice . . . holds . . . that agencies deliver regulatory benefits to well organized political interest groups, which profit at the expense of the general, unorganized public. The neopluralist theory also takes organized interest groups to be central to understanding regulation. On the neopluralist view, however, many interest groups with opposing interests compete for favorable regulation, and that competition is less lopsided than the public choice view contemplates. Because the result of interest-group competition often crudely reflects general interests, the neopluralist theory is less critical of the regulatory state than is the public choice theory. Like the neopluralist view, the public interest theory is also ambivalent toward regulatory outcomes. Whereas the neopluralist focuses on interest-group competition, however, the public interest theorist concentrates on the general public's ability to monitor regulatory decisionmakers. Where regulatory decisionmakers operate under conditions of significant public scrutiny, the public interest theory holds that regulatory outcomes tend to reflect general interest. Where, on the other hand, the relevant decisionmakers operate without any oversight, they tend to deliver regulatory benefits to well organized interest groups at the public's expense. Finally, the civic republican theory provides a picture of regulation rather different from all three of its counterparts. According to it, agency decisions, at least potentially, embody the polity's judgments about how competing regulatory values—such as highway safety versus traveler convenience, for example—are to be balanced. On this view regulation provides occasion for collective deliberation about regulatory means and ends.

Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 5 (1998). Professor Croley demonstrates persuasively that none of these theories squares with observable administrative practice. *See id.* at 166 ("[N]o theory of regulation is vindicated by a hands-on look at administrative process."). This Article does not attempt to contribute to any theory of regulation; instead, it focuses on a problem, the subversion of regulation in the area of financial markets; identifies distortions consistent with each of the above theories; and proposes a pragmatic legal solution to that problem.

This Article also recognizes that any major restructuring of financial market regulation needs to account for the enormous success of the American economy. Since the advent of regulated capitalism, in the mid-1930s, the American economy has posted impressive growth while avoiding any prolonged economic disruption. The burden regarding structural changes in economic regulation is rightfully upon those proposing change. A necessary corollary to this is that change should be narrowly tailored, and of proven efficacy, to address well-proven problems.

The foregoing discussion highlights the many needs of our modern economy with regard to financial regulation. First, regulatory policies must be determined through a process that maximizes the degree to which expertise may be brought to bear upon financial regulatory problems in order to respond to the challenges posed by globalization and increased complexity in financial markets. Second, regulation in this area must be able to respond to sudden changes in financial markets with rapid regulatory adjustments. Third, regulatory power must be centralized. Fourth, regulation of financial markets must be freed both of inappropriate political pressure and of inappropriate special interest influence. In short, financial market regulation presents a classic context in which an expert and independent agency is needed. Beyond this recognition, however, the questions that must be addressed are the degree of independence that is appropriate, and the legal structure needed to secure such independence.

This Article examines the degree to which depoliticizing financial market regulation can stem the problems discussed above. Financial market regulation is a vast subject matter; for purposes of this Article financial market regulation means the law of the capital markets of the United States. This Article attempts to articulate a theory of depoliticized regulation that can address the most obvious components of financial market regulation: the regulation of the public securities markets, as well as regulation of financial intermediaries such as banks, insurance companies, mutual funds, pension funds, and other financing institutions. Although presently there is no unified regulatory structure for these activities, this Article posits that there should be one. This Article demonstrates that the very fact that the regulatory system in this area has not been centralized is due to inappropriate and politically influenced regulation. Ultimately, this Article envisions centralized financial regulators with a great degree of political insulation. It is not possible, in the context of this Article, to review the history and failures of regulation in such a vast area. This Article searches instead for recurring patterns of regulatory failure in these areas, attempts to reach reasoned conclusions as to the causes of such failures, and articulates a proposed solution to these failures.

This Article recognizes that ultimately all law is political,[21] particularly under the United States Constitution. Inappropriate political influence nevertheless can be minimized and nearly eliminated. In other words, the political nature of legal regulation is best thought of as a continuum, where on one end purely political regulation exists (exemplified best, perhaps, by the federal government's budget process), and on the opposite end is the regulation that is most free of political influence (exemplified by the Federal Reserve Board's administration of monetary policy). Part I explores agency independence, including an analysis of the maximum degree of insulation from political influence possible under the Constitution, and the problems of regulatory capture. Part II assesses the efficacy of depoliticized regulation, with a particular focus upon the Federal Reserve's management of monetary policy regulation. Part III reviews the recurring problems of the current political regime of financial regulation. Part IV articulates a proposal for imposing further depoliticized regulation in the vital area of financial market regulation. This Article concludes that any reforms of our financial market regulatory structure should include an aspirational goal of creating regulatory agencies endowed with a high degree of political independence.

21. Indeed, even the United States Supreme Court has not escaped this reality. In February of 1937, President Roosevelt asked Congress to add up to six Justices to the United States Supreme Court. *See* William E. Leuchtenburg, *The Origins of Franklin D. Roosevelt's "Court-Packing" Plan*, 1966 SUP. CT. REV. 347-400. This plan responded to a series of Supreme Court decisions striking down important parts of Roosevelt's New Deal. *See id.* Roosevelt's initial plan was a smashing failure, but a second plan nearly succeeded in the summer of 1937. *See generally* William E. Leuchtenburg, *FDR's Court-Packing Plan: A Second Life, A Second Death*, 1985 DUKE L.J. 673 (describing a lesser-known, second attempt by Roosevelt to "pack" the Supreme Court in 1937). The Supreme Court defused Roosevelt's initial plan somewhat when it began to take a more expansive approach to federal power. *See id.* at 673. The failure of the second plan also can be attributed to the Court's broadened approach as well as the untimely death of the bill's primary supporter, Senator Joe Robinson. *See id.* at 687. This demonstrates that no lawmaking organ under our Constitution is immune from political pressure.

I. AN ASSESSMENT OF AGENCY INDEPENDENCE AND DEPOLITICIZATION

Administrative agencies date to the beginning of the Republic. The first Congress passed three statutes conferring administrative powers.[22] These agencies, like their modern counterparts, exercised adjudicative, legislative, and executive power.[23] By the early part of the twentieth century, administrative agencies became a popular choice for addressing a wide variety of social problems.[24] The Great Depression revealed serious deficiencies in the nation's economic structure and a number of agencies were created to address these shortcomings. Among these were the Securities and Exchange Commission (SEC), the National Labor Relations Board (NLRB), the Federal Deposit Insurance Corporation (FDIC), and the Social Security Board.[25] In our federal system of government, the President, with the advice and consent of the Senate, appoints the officers operating these agencies who thus do not face election. The explosive growth of agencies in the last one hundred years represents, therefore, a transfer of power from elected officials to nonelected officials. More fundamentally, the delegation of massive regulatory power to administrative agencies that are not directly responsive to electoral politics represents an additional check on democratic lawmaking.[26] Some commentators have recognized that the ad-

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22. *See* KOCH, *supra* note 2, § 1.3.

23. *See* BERNARD SCHWARTZ, ADMINISTRATIVE LAW § 1.13 (3d ed. 1991).

24. *See id.*

25. *See* KOCH, *supra* note 2, § 1.3. Unfortunately Congress has been far more adept at creating regulatory agencies than coordinating them. For an overview of the tangled web of bank regulation, see *Hearings on Financial Structure and Regulation Before the Subcomm. on Fin. Institutions of the Senate Comm. on Banking, Hous. and Urban Affairs*, 93d Cong. 619 (1973) (charting the jurisdiction of the three primary federal bank regulatory agencies). As complicated as this regulatory web is, when considering the regulatory environment facing the entire financial services industry, as this Article does, one must consider a myriad of other regulatory agencies. The most important of these are the SEC, and the regulator of the thrift industry, the Office of Thrift Supervision or its predecessor, the Federal Home Loan Bank Board (FHLBB).

26. Of course, one way to view this check on democratic lawmaking is as a recognition that voters cannot hope to comprehend all aspects of government regulation. This perspective views agency lawmaking as necessary to give meaning to the democratic process by providing for the election of leaders accountable for managing

vent of such vast administrative power amounts to the creation of a "fourth branch" of government.[27] Agencies can act with real independence from the executive and legislative branches only if endowed with a high degree of independence. Further, true independence from the executive and legislative branches depends upon many factors, including the breadth of the power delegated to the agency, its source of funding, its legal structure, and the degree of political commitment to the agency's independence.

At the height of the New Deal, the Supreme Court struck down delegations to agencies based on the principle that broad delegations of Article I power were not permissible.[28] Modern decisions have held, however, that Congress can delegate legislative power to administrative agencies and insulate those agencies from the "political winds that sweep Washington."[29] There are theoretical limits to the extent of such delegations. The Supreme Court has long held that Congress may delegate legislative power, without offending the constitutional requirement that Congress hold the legislative power of the federal government, as long as Congress provides intelligible principles to guide the agency in exercising delegated power.[30] Indeed, it has

government regulation.

27. *See, e.g.*, FTC v. Ruberoid Co., 343 U.S. 470, 487-89 (1952) (Jackson, J., dissenting) ("Administrative bodies . . . have become a veritable fourth branch of the government, which has deranged our three-branch legal theories."); REPORT OF THE PRESIDENT'S COMMITTEE ON ADMINISTRATIVE MANAGEMENT 7, 83 (1937) (referring to regulatory agencies as the "headless fourth branch of the Government").

28. *See, e.g.*, Carter v. Carter Coal Co., 298 U.S. 238, 311 (1936) (striking down delegation of governmental functions); A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 529 (1935) ("The Congress is not permitted to abdicate or to transfer to others the essential legislative function with which it is thus vested."); Panama Ref. Co. v. Ryan, 293 U.S. 388, 421 (1935) (stating that Congress can delegate broad administrative authority so long as Congress articulates the essential policies and standards).

29. CFTC v. Schor, 478 U.S. 833, 836 (1986) (upholding delegation to the Commodities Futures Trading Commission of the power to adjudicate commodities disputes).

30. *See* Loving v. United States, 517 U.S. 748, 771 (1996) (finding that "intelligible principle" guided the delegation of authority to the President to superintend court-martials); Touby v. United States, 500 U.S. 160, 166-67 (1991) (upholding delegation of power to the Attorney General to criminalize substance possession); Mistretta v. United States, 488 U.S. 361, 372 (1989) (upholding delegation of power

been sixty years since the Court last struck down legislative delegations, even though Congress often employs vague and sweeping delegations to achieve its goals.[31] Moreover, those decisions that have stricken delegations often involved delegation in its "most obnoxious form"—the administration of government powers by private actors.[32] Similarly, the delegation doctrine has also continued to operate as a rule of statutory construction, allowing the Court to interpret narrowly those delegations that may raise issues of excessive delegation.[33] Even in its most historically virulent form, the delegation doctrine has not operated to strike down delegations to government agencies of broad powers accompanied by reasonably specific articulations of policies and standards.[34] In short, the Constitution permits broad delegations of authority to administrative agencies.

The Constitution also limits the structural independence of administrative agencies so as to avoid the creation of a despotic agency without any political accountability or control. The Appointments Clause of Article II requires that the President ap-

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to United States Sentencing Commission to promulgate federal sentencing guidelines).

31. *See* ERNEST GELLHORN & RONALD M. LEVIN, ADMINISTRATIVE LAW AND PROCESS 16-18 (4th ed. 1997). *But see* Industrial Union Dep't v. American Petroleum Inst., 448 U.S. 607, 687 (1980) (Rehnquist, J., dissenting) (arguing that delegation should be nullified because it violated the Article I requirement of consensual government).

32.

> [I]n the very nature of things, one person may not be intrusted with the power to regulate the business of another, and especially of a competitor. And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property. The delegation is so clearly arbitrary, and so clearly a denial of rights safeguarded by the due process clause of the Fifth Amendment, that it is unnecessary to do more than refer to decisions of this court which foreclose the question.

Carter, 298 U.S. at 311 (citing *Schechter Poultry*, 295 U.S. at 537); *see also* KOCH, *supra* note 2, § 12.13[7] (1997 & Supp. 1998).

33. *See* National Cable Television Ass'n v. United States, 415 U.S. 336, 342 (1974) (interpreting the Independent Offices Appropriations Act narrowly to avoid finding excessive delegation).

34. Even before the New Deal, the Court had upheld broad delegations of power accompanied by such standards. *See, e.g.*, J.W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 409 (1898) (permitting delegation accompanied by an "intelligible principle" to guide agency).

point all "Officers of the United States" with the advice and consent of the Senate, and that "inferior Officers" be appointed by the President, courts of law, or heads of departments.[35] The President also retains supervisory authority to remove such officers, if those officials owe duties that may be characterized as essential to the discharge of the President's duties.[36] These officials must be removable at will in order for the President to execute Article II powers.[37] Nevertheless, though it is true that the heads of executive agencies, such as cabinet departments, serve at the pleasure of the President, the heads of independent agencies, typically commissioners or board members, may be removed only for "good cause," and may serve a fixed term.[38] Congress has provided the terms for commissioners that range between five and fourteen years.[39]

The creation of "independent" agencies has not been without controversy. Many have argued that "independent" agencies are unconstitutional because they exercise power without being subject to presidential control.[40] In *Bowsher v. Synar*,[41] Chief Justice Burger authored a draft opinion that would have held that any agency officer charged with the execution of law must

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35. U.S. CONST. art. II, § 2, cl. 2. This clause has been interpreted to require presidential appointment of any officeholder exercising significant lawmaking or administrative authority pursuant to the laws of the United States. *See* Buckley v. Valeo, 424 U.S. 1, 118-43 (1976).

36. *See* Morrison v. Olson, 487 U.S. 654, 690-92 (1988) (holding that Independent Counsel's discretion is not "so central to the functioning of the Executive Branch as to require . . . that the counsel be terminable at will by the President"); *see also* Ryder v. United States, 515 U.S. 177, 179 (1995) (reversing conviction reviewed by court which included civilians not appointed in accordance with the Appointments Clause).

37. *See Morrison*, 487 U.S. at 690-91.

38. *See id.* at 686-91 (noting that agency officials may be subject to removal only for "good cause," so long as such restrictions do not interfere with the presidential function of executing laws).

39. *See* ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, ADMINISTRATIVE LAW 604 n.4 (1993).

40. *See* Bernard Schwartz, *An Administrative Law "Might Have Been"—Chief Justice Burger's* Bowsher v. Synar *Draft*, 42 ADMIN. L. REV. 221, 223 (1990) (summarizing the arguments of those urging the unconstitutionality of independent commissions).

41. 478 U.S. 714, 726 (1986) (holding that "Congress cannot reserve for itself the power of removal of an officer charged with the execution of the laws except by impeachment").

be subject to removal solely by the President.[42] Certainly, this could have led to a challenge to the constitutionality of independent commissions. This same approach also has emerged in the opinions of Justice Scalia, such as his dissent in *Morrison v. Olson*.[43] According to Justice Scalia, the Constitution requires that all executive power be vested in the President.[44] This means the President must have "exclusive" control over all "executive" power.[45] Notwithstanding these reservations, it now appears well-settled that Congress may create agencies that are independent of executive control to the extent the President may remove its officers only for "good cause," so long as the removal restriction does not "impede the President's ability to perform his constitutional duty."[46] In fact, many Justices appear deeply committed to the institution of independent agencies.[47] At oral argument in *Bowsher*, when the government accused the petitioners of fear-mongering on the issue of the viability of independent commissions, Justice O'Connor replied: "They scared me."[48] Over the decades, independent commissions have endured challenge after challenge on grounds similar to those asserted in *Morrison*.[49] This leaves Congress with broad latitude to form agencies with independence from the executive.

Congress also controls agencies through its control of appropriations. Nearly all agencies depend upon annual congressional funding.[50] There are some government-owned or government-

42. *See* Schwartz, *supra* note 40, at 232.

43. 487 U.S. 654, 706 (1988) (Scalia, J., dissenting); *see also* Synar v. United States, 626 F. Supp. 1374, 1403 (D.D.C. 1986) (Scalia, Johnson, Gasch, JJ.) (holding that executive powers cannot be controlled by Congress).

44. *See Morrison*, 487 U.S. at 705.

45. *See id.*

46. *Id.* at 691.

47. *See generally* Schwartz, *supra* note 40 (discussing the creation of independent agencies).

48. Bernard Schwartz, *Administrative Law Cases During 1986*, 39 ADMIN. L. REV. 117, 117 (1987).

49. *See, e.g.*, Wiener v. United States, 357 U.S. 349 (1958) (holding that in the absence of a provision giving the President the right to remove a member of the War Claims Commission, a member may be removed only for cause); Humphrey's Ex'r v. United States, 295 U.S. 602, 619 (1935) (upholding a provision limiting the grounds for removal of FTC Commissioners to "inefficiency, neglect of duty or malfeasance").

50. *See* GELLHORN & LEVIN, *supra* note 31, at 42-43.

sponsored organizations that are not subject to presidential or congressional budgetary review.[51] These organizations, however, are not generally regulatory agencies.[52] Commentators maintain that control over an agency's budget and appropriations renders any distinction between independent agencies and executive agencies meaningless.[53] Naturally, an agency beholden to either the executive or the legislature hardly can ignore the wishes of the politicians or their influential constituents. Additionally, members of Congress often attach limits on agency discretion to appropriations bills.[54] Thus, any assessment of an agency's independence must include an analysis of the degree to which it is subject to the power of the purse.[55] Given the importance of an agency's financing in terms of its actual political independence, it is surprising that most proposals for regulatory reform have not focused on this element of an agency's legal structure.[56]

The legal structure of an agency is only part of the agency's political independence. No matter how independent an agency may appear based upon a cold legal analysis, ultimately the political branches have the power to restructure the agency,

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51. *See* ALLEN SCHICK, THE FEDERAL BUDGET 16 (1995).

52. *See id.*

53. *See, e.g.*, Alan B. Morrison, *How Independent Are Independent Regulatory Agencies?*, 1988 DUKE L.J. 252. Morrison argues that the difference between independent agencies and executive agencies is "not substantial." *Id.* at 253. This conclusion is based upon two suppositions: first, that an independent agency's budget is subject to political review; and second, that the President appoints annually the Chair of such agencies. *See id.* at 252. Neither of these conditions applies to the Federal Reserve, which is not mentioned in Morrison's analysis.

54. *See, e.g.*, DeAnne E. Parker, *Backdoor Tactics to Forest Management: The Emergency Salvage Timber Rider of H.R. 1944*, 16 J. ENERGY NATIONAL RESOURCES ENVTL. L. 216, 224 (1996) (noting that attaching substantive legislation to appropriations bills putatively violates congressional rules). Congress has not hesitated to use similar techniques in the area of financial regulation. *See, e.g.*, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (approving SEC's budget for fiscal year 1999 and restricting investors' rights in private securities litigation).

55. One detailed study of the appropriations process demonstrated its powerful effect upon agency action. *See* RICHARD F. FENNO, JR., THE POWER OF THE PURSE: APPROPRIATIONS POLITICS IN CONGRESS 219 (1966) ("Once the Committee's ability to hurt it is recognized, the most obvious way for the agency to ensure a favorable kind of relationship with the Committee is simply to do . . . what the Committee tells it to do.").

56. *See* BREYER, *supra* note 12, at 59-72; Croley, *supra* note 20, at 168.

abolish the agency or otherwise limit its independence. Independence turns, therefore, not only upon the agency's structure, but also upon the strength of presidential and congressional commitment to its independence. Although it is true that Congress creates administrative agencies in part to remove specified areas of regulation from such pressures, this does not mean that all agencies operate free from such pressures.[57] Typically, regulatory agencies are subject to a number of informal pressures from Congress.[58] Congress can limit an agency's jurisdiction, cut off its appropriations, or ruin a regulator's career. These levers mean that Congress informally can curtail agency independence even without legislating.[59] Consequently, agencies are responsive to congressional interests. Similarly, no agency would wish to incur the wrath of the President. In short, political independence depends upon political commitment to an agency's independence which in turn is dependent upon traditional, bipartisan support for the agency, its reputation, and the strength of the consensus supporting independence.

Thus, the degree of political independence of an agency can be determined by considering: (1) the breadth of its delegation; (2) the extent to which its governing body can be removed by the President; (3) the terms of the members of its governing body, especially its Chair; (4) the method of funding the agency; and (5) the degree to which the agency enjoys bipartisan, long-term political commitment to its independence. This is a more complete approach to agency independence than others that have traditionally focused upon the President's removal power. This multifactored assessment of political independence recognizes, for example, that an agency with a broader delegation of power is more insulated from judicial review and less prone to regulatory competition than an agency with narrower delegation. This Article proceeds from the position that a multifactored approach

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57. *See* AMAN & MAYTON, *supra* note 39, at 602-12 (describing the methods of congressional oversight available).

58. *See id.*; *see also* Thomas Romer & Barry R. Weingast, *Political Foundations of the Thrift Debacle*, *in* POLITICS AND ECONOMICS IN THE EIGHTIES 182 (Alberto Alesina & Geoffrey Carliner eds., 1991) (describing the various forms of informal pressures).

59. *See* Romer & Weingast, *supra* note 58, at 183-84.

to independence provides a fuller explanation of agency action, and serves as the foundation for determining the ability of an agency to resist political pressure and special interest influence.

Why would Congress ever wish to create entities with law-making authority that are beyond its direct control? The reasons are both familiar and subtle. First, "delegations take lawmaking out of a region of representative government and into a zone of government by specialists presumed to act according to more disinterested and scientific judgments of good social policy."[60] Second, delegation to agencies "makes possible a greater range and volume of lawmaking" through the administrative regulation process.[61] Third, Congress may seek to set up agencies specifically designed to circumvent problems posed by excessive political influence, either to stem the influence or to allow an agency to resolve an issue mired in gridlock.[62] Fourth, Congress may seek to pass laws regulating specific areas but recognize that political regulation may be unsaleable politically.[63] Each of these factors explains why Congress endows a given agency with a certain degree of independence.[64] In essence, the determination of the degree of independence should turn upon congressional recognition of its own institutional limitations to govern regulation in a given area.

Some commentators hypothesize that power is ceded when legislators determine they can extract increased rents by divorc-

60. AMAN & MAYTON, *supra* note 39, at 7.

61. *Id.*; *see also* Mistretta v. United States, 488 U.S. 361, 379 (1988) (stating that delegation is particularly appropriate for "intricate, labor-intensive task[s]"), *aff'd*, 873 F.2d 1446 (8th Cir. 1989).

62. *See* Chevron U.S.A. Inc. v. Natural Resources Defense Council, 467 U.S. 837, 865 (1984).

63. *See* JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT 239-40 (1989).

64. In a detailed study of independent agencies conducted in 1949, a commission headed by former President Herbert Hoover (the Hoover Commission) stated that independent agencies were "created not only to provide for the orderly dispatch of complicated controversies by bodies deemed expert in their respective fields, but also to eliminate abuses that had crept in and, at the same time, to promote an adequate and healthy control." U.S. COMM'N ON THE ORG. OF THE EXECUTIVE BRANCH OF THE GOVERNMENT, THE HOOVER COMMISSION ON ORGANIZATION OF THE EXECUTIVE BRANCH OF THE GOVERNMENT 430 (1949) [hereinafter HOOVER COMMISSION REPORT].

ing power from Congress.[65] Such a cynical view of congressional behavior ignores the fact that administrative delegations seem positively correlated to exogenous economic disruptions.[66] The possibility that Congress sometimes acts specifically out of a desire to enact good policy should not be ignored completely.[67] Congressional representatives, like humanity in general, are not capable of always acting as "rational maximizers," but are capable of subjugating their immediate self-interest to a greater good; in short, Congress can act in accordance with the public interest.[68] A more likely conclusion is that many different motivations coalesce to cause Congress to part with power.[69] Either way, Congress does not tend to cede legislative power unless there is a compelling case for doing so.

The original policy basis for independent agencies, therefore, was that they would: (1) professionalize and provide expertise to regulatory policy; (2) provide a stable and consistent basis for regulatory continuity; (3) allow for constant regulatory adaptation to changing conditions; and (4) eliminate the political influence of special interests.[70] Beginning in 1887, with the formation of the Interstate Commerce Commission, and culminating in the

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65. *See, e.g.*, William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875, 877 (1975) (arguing that legislation is supplied to those who pay the highest rents); Geoffrey P. Miller, *An Interest-Group Theory of Central Bank Independence*, 27 J. LEGAL STUD. 433 (1998) (arguing that legislators depoliticized monetary policy to extract higher rents from contributors).

66. *See, e.g.*, AMAN & MAYTON, *supra* note 39, at 2 (noting that the Great Depression accelerated the creation of agencies).

67. *See* WILSON, *supra* note 63, at 239 (suggesting that scholars who posit that Congress always acts out of a desire to get re-elected would do well to ponder the lengths to which Congress has gone to weaken its influence).

68. *See* Farber & Frickey, *supra* note 5, at 925 ("[W]e were somewhat surprised by the strong empirical evidence" showing that Congress can act in accordance with the public interest); *see also* Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279, 279 (1984) (stating that the view of "political actors as narrowly egocentric maximizers" poorly predicts legislative outcomes); James B. Kau & Paul H. Rubin, *Self-Interest, Ideology and Logrolling in Congressional Voting*, 22 J.L. & ECON. 365, 384 (1979) (finding that ideology influences congressional voting).

69. *See* Farber & Frickey, *supra* note 5, at 925 ("Although the public interest is indeed a factor, so too are the efforts of numerous interest groups.").

70. *See* MARVER H. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 137-43 (1955).

Progressive Movement of the early twentieth century and the New Deal, Congress began minting independent agencies to attack a wide array of ills.[71]

By midcentury, however, commentators began to question whether independent agencies could deliver upon their promises. Moreover, there has been growing cynicism among scholars about whether regulatory agencies can ever function in the public interest.[72] These scholars have catalogued the sources of pressure acting upon regulators that prevent agencies from vindicating the public interest. One commentator has observed that independence from the executive may isolate an agency from sources of political strength within the executive branch, and allow the agency to be molded into "a friendly protector of private interests rather than an aggressive agent of the public welfare,"[73] and a means to provide "regulated groups with privileged access to government."[74] In other words, the regulated can capture the regulators through the co-opting of career-minded or budget-maximizing bureaucrats and fund-raising legislators focused perpetually upon the next election.[75] Similarly, Congress, subject to re-election in biannual elections, is quite sensitive to campaign contributions, other forms of campaign support, patronage, and even outright bribes.[76] Congress, in turn, can exert pressure over administrative agencies, which must appear before Congress annually to obtain its budget approval.[77] Commentators also have recognized the high degree of social pressure that can be exerted upon regulatory agencies, ranging from prospective employment to social functions.[78]

By the 1970s, economists, political scientists, and legal scholars were debating which theories best explained the domination of regulation by special interests.[79] More recently, scholars have

71. *See id.* at 13-71.

72. *See supra* notes 1-3 and accompanying text.

73. BERNSTEIN, *supra* note 70, at 266.

74. *Id.*

75. *See* Posner, *supra* note 3, at 337; Stigler, *supra* note 15, at 3.

76. *See, e.g.*, Brown, *supra* note 3, at 182; Landes & Posner, *supra* note 65, at 877; Stigler, *supra* note 15, at 12-13.

77. *See supra* notes 53-54 and accompanying text.

78. *See* BERNSTEIN, *supra* note 70, at 211.

79. *Compare* Stigler, *supra* note 15, at 3 (articulating a theory of regulation gov-

expanded the theory of capture beyond administrative agencies to policy-making organs generally, and have de-emphasized the role of "monied interests." They recognize instead the general power of special interests to act as advocacy coalitions.[80] Thus, there has been a growing consensus over the years that regulation is often highjacked, at least to some extent, from serving the general public interest to serving special private interests.[81] Perhaps the question that should be posed is not whether so-called independent agencies are subject to capture (they are), but whether there exists a threshold of independence beyond which an agency is highly resistant to capture.[82]

The Federal Reserve Board (the Fed) is an example of just how politically independent an agency may be, particularly in the area of monetary policy.[83] Congress created the Fed pursu-

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erned by supply and demand for regulation and therefore allocated in accordance with the needs of special interests), *with* L. HARMON ZIEGLER & G. WAYNE PEAK, INTEREST GROUPS IN AMERICAN SOCIETY (1964) (articulating theory that over time regulated interests dominate regulation).

80. *See generally* PAUL A. SABATIER & HANK C. JENKINS-SMITH, POLICY CHANGE AND LEARNING: AN ADVOCACY COALITION APPROACH 211-46 (1993) (analyzing an advocacy coalition framework).

81. *See, e.g.*, Croley, *supra* note 20, at 167 ("[R]ent-seekers' success requires much more than providing legislators with political resources, and thus the exploitation of the many by the few hardly appears a foregone conclusion. Instead, special-interest domination seems more or less likely depending upon the procedural opportunities available to other interests."); Farber & Frickey, *supra* note 5, at 925 ("The empirical evidence, however, clearly does not support a sanguine view of the legislative process. Although the public interest is indeed a factor, so too are the efforts of numerous interest groups. These interest groups threaten to push the political process in the direction of a self-interested search for economic gain."); Posner, *supra* note 3, at 356 (concluding that although empirical evidence is not strong, "the success of economic theory in illuminating other areas of nonmarket behavior leads one to be somewhat optimistic that the economic theory will eventually jell"); Stigler, *supra* note 15, at 3 (articulating economic theory of regulation and concluding that "[a] central thesis of this paper is that, as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit").

82. Indeed, Professor Bernstein's landmark study of independent commissions specifically excluded the Federal Reserve Board. *See* BERNSTEIN, *supra* note 70, at 8 n.2.

83. In addition to acting as the nation's primary money supply regulator, the Fed also regulates bank holding companies. In its capacity as a regulator of bank holding companies, however, the Fed's authority is circumscribed because much banking regulatory authority rests with the Office of the Comptroller of the Currency, which has authority over national banks. For a more detailed discussion of this regulatory competition, see *infra* notes 440-66 and accompanying text.

ant to the Federal Reserve Act of 1913,[84] in the wake of the catastrophic Panic of 1907.[85] The Fed administers the Federal Reserve System,[86] which is responsible for maintaining an "elastic currency," acting as a lender of last resort for the banking system and discounting commercial paper.[87] It is difficult to conceive of an administrative agency with more power and more political independence than the Fed.[88] Indeed, the Fed has the power to issue currency without limitation.[89] Although certain agencies have enjoyed a high degree of political insulation at times, rarely have agencies enjoyed a long-term consensus that they should operate free of political influence. For example, the Legal Services Corporation has alternated between being a political punching bag and enjoying political insulation.[90]

The Fed enjoys both a depoliticized structure and a long-term commitment from the political branches to its continued independence.[91] The President, with the advice and consent of the Senate, appoints Fed members to fourteen-year terms and they

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84. Ch. 6, 38 Stat. 251 (codified as amended at 12 U.S.C. §§ 221-522 (1994 & Supp. 1996)).

85. Noted economists have recognized the importance of the Panic of 1907 in bringing about the Federal Reserve Act. *See, e.g.*, MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 138, 156-63 (1963). The Panic of 1907 resulted from the failure of a major New York Bank, which triggered a series of cascading bank failures. *See id.*

86. The Board does so by setting reserve requirements, governing the discount window and controlling the Federal Open Market Committee. *See* 12 U.S.C. §§ 248, 263 (1994).

87. *See* Federal Reserve Act, 38 Stat. 251 (1913) (establishing the Federal Reserve System and enumerating its powers and duties).

88. *See generally* THIBAUT DE SAINT PHALLE, THE FEDERAL RESERVE 56 (1985) (stating that the Fed's power has greatly increased since its creation in 1913); Alfred C. Aman, Jr., *Bargaining for Justice: An Examination of the Use and Limits of Conditions by the Federal Reserve Board*, 74 IOWA L. REV. 837, 845-51 (1989) (describing the structure and leadership of the Fed).

89. *See* 12 U.S.C. § 248(d) (1994 & Supp. 1996).

90. *See generally* Charles J. Cooper & Michael A. Carvin, *The Price of "Political Independence": The Unconstitutional Status of the Legal Services Corporation*, 4 B.U. PUB. INT. L.J. 13, 13-16 (1994) (recounting instances of presidential and congressional tampering with the basic mission of the Legal Services Corporation).

91. *See* WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 12 (1987) ("The Federal Reserve System was the crucial anomaly at the very core of representative democracy, an uncomfortable contradiction with the civic mythology of self-government. Yet the American system accepted the inconsistency. The community of elected politicians acquiesced to its power.").

are removable only for cause.[92] The chairman of the Fed is appointed for a four-year term.[93] The Fed members' terms are staggered so that one of the seven members' terms expires every two years.[94] Thus, a president who serves only a single term may have only two members they may appoint. The length of terms for both Fed members and the chairman are the longest terms enjoyed by any agency.[95] The Fed governors also enjoy competitive salaries for public servants; as of 1994, governors earned $123,100 annually and the chairman earned $133,600 annually.[96] In addition, governors are prohibited from serving in the banking industry for two years after exiting the Fed if they fail to complete their entire fourteen-year term.[97] All of this means that the Fed is the beneficiary of a high degree of structural independence.

Originally, the Secretary of the Treasury and the Comptroller of the Currency, both executive officers, served on the Fed, but the Banking Act of 1935[98] terminated their membership.[99] The Banking Act of 1935 also increased the tenure of the Fed governors from twelve to fourteen years,[100] and centralized further the control of monetary policy in the Board.[101] The purpose of the Banking Act was to endow the Fed with more political insulation so that it could exercise its control over monetary policy in a way that represented the "general public interest" and did not operate in accordance with "a majority of special interests."[102] The Banking Act was an essential part of President Roosevelt's economic recovery plan and he intervened personally to assure its passage.[103] The Banking Act represents the commencement of the Fed's modern existence in that the Banking Act definitively

92. *See* 12 U.S.C. §§ 241, 242.
93. *See id.* § 242.
94. *See id.*
95. *See supra* notes 39, 53 and accompanying text.
96. *See* 5 U.S.C. §§ 5313-5314 (1994).
97. *See* 12 U.S.C. § 242.
98. Ch. 614, 49 Stat. 684 (codified as amended at 12 U.S.C. § 241 (1994)).
99. *See* 12 U.S.C. § 241.
100. *See id.*
101. *See, e.g.*, 12 U.S.C. § 263.
102. H.R. REP. NO. 74-742, at 1, 6 (1935).
103. *See* WORSHAM, *supra* note 4, at 44-45.

vested monetary policy in the Fed and assured that it was endowed with a high degree of independence.

The Fed is also remarkably independent of the appropriations process. The Fed has the power to assess member banks to supply funds for its operating expenses.[104] In 1933 Congress declared these funds not to be "[g]overnment funds or appropriated moneys."[105] As a result, the expenditure of these funds is essentially free of congressional oversight.[106] Similarly, the Fed has the power to determine freely the compensation of its employees without being restricted by government service pay scales.[107] All of this insulation from political influence has prompted Professor Aman to state that the Fed is "one of the most powerful and independent federal agencies engaged in economic regulation."[108] This may be somewhat of an understatement; the Fed is the only regulatory agency that is totally self-funded and free from the appropriations process.[109] Occasionally the Fed has been subject to government budgetary oversight and audit, but the general rule is that it need not annually submit its budget to Congress for approval.[110]

The Fed is required to make certain reports regarding its activities, including an annual report of its operations to the

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104. *See* 12 U.S.C. § 243.

105. *Id.* § 244.

106. *See generally id.* §§ 243-244 (granting to the Fed the power to decide how to spend the money collected from member banks).

107. *See id.* § 244.

108. Aman, *supra* note 88, at 838-39; *see also* JOHN T. WOOLLEY, MONETARY POLITICS: THE FEDERAL RESERVE AND THE POLITICS OF MONETARY POLICY 1 (1984) ("Among powerful governmental institutions, the Federal Reserve is surely in the first rank.").

109. *Cf.* EXECUTIVE OFFICE OF THE PRESIDENT OF THE U.S., BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1999 app. 1165 (1998) (stating that the Fed's operations are not included in the budget and its budget is not reviewed by the President).

110. *See* 12 U.S.C. § 244. The Government Accounting Office has reviewed the Federal Reserve's operations. *See Fed Chief Takes Exception to GAO's Critical Report*, WALL ST. J., Apr. 17, 1996, at C22 (reporting Chairman Greenspan's response to GAO report finding that the Fed suffered from lax internal controls); *see also* U.S. GOV'T ACCOUNTING OFFICE, FEDERAL RESERVE BANKS: INTERNAL CONTROL, ACCOUNTING, AND AUDITING ISSUES (1996) (reporting the results of a GAO audit of the Dallas Federal Reserve Bank); John R. Wilke, *Showing Its Age: Fed's Huge Empire, Set Up Years Ago, Is Costly and Inefficient*, WALL ST. J., Sept. 12, 1996, at A1 (summarizing the GAO's findings of budgetary excesses at the Fed).

Speaker of the House.[111] The Fed also must report every sixty months to Congress on the availability of credit to small businesses.[112] The Fed must keep records of its determinations regarding monetary policy and must disclose these records to Congress.[113] The most celebrated Fed disclosure is the Chairman's semiannual testimony on economic conditions pursuant to the Full Employment and Balanced Growth Act of 1978.[114] Although these reporting requirements may well increase the political accountability of the Fed, they hardly represent a substantial check upon the Fed's control of monetary policy.

The Fed also has been delegated broad, almost unlimited, power over monetary policy.[115] The Fed has three tools giving it tight control over the nation's money supply. It has great influence over short-term interest rates by virtue of its control over the discount rate[116] and the federal funds rate.[117] The discount rate is the interest rate the Fed charges depository institutions that wish to borrow from it; consequently the Fed directly influences the cost of money for a depository institution.[118] The Fed also has the power to accelerate or decelerate the money creating credit process of the commercial banking industry due to its control over reserve requirements.[119] The Fed also controls the Federal Open Market Committee which expands or contracts the money supply by buying or selling government bonds.[120] With its

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111. *See* 12 U.S.C. § 247.
112. *See id.* § 252 (Supp. 1997).
113. *See id.* § 2479(a).
114. Humphrey Hawkins Full Employment Act, Pub. L. No. 95-523, 92 Stat. 1887 (codified as amended at 12 U.S.C. § 225a (1994)).
115. As Thiebaut de Saint Phalle has observed: "Very few of us realize the extent to which all of us are dependent upon the decisions . . . of the Federal Reserve Board." DE SAINT PHALLE, *supra* note 88, at xvii. Because of their control of monetary policy, the Fed's decisions determine "whether our economy grows; whether inflation reduces our standard of living; whether the interest rates on our mortgages rise; perhaps even whether our jobs exist." *Id.*
116. *See* 12 U.S.C. § 357.
117. *See id.* § 347.
118. *See* DE SAINT PHALLE, *supra* note 88, at 12.
119. *See* 12 U.S.C. § 461.
120. *See id.* §§ 263, 355; *see also* DE SAINT PHALLE, *supra* note 88, at 11 ("Put in simple terms, the [Fed] can increase the money supply by buying government securities . . . and decrease the money supply by selling government securities."). Technically, the open market operations are conducted under the authority of the Federal

tight control over the money supply, the Fed may well be the most powerful economic actor, domestically and internationally.

In the last few decades, economists have increasingly recognized the dominance of monetary policy in influencing economic output.[121] The guidance from Congress on the goals the Fed should achieve in administering monetary policy are so general as to be essentially devoid of meaning in practice, requiring the Fed to maximize output and maintain price stability.[122] Economists generally have recognized that the Fed is so powerful that its policies can dictate whether the general economy expands or contracts.[123] In other words, the Fed can induce recessions that cut incomes and cost jobs or induce economic expansions that increase incomes and employment.[124] Increasingly, the Fed not only holds sway over domestic economic conditions, but also over global economic conditions.[125] Thus, the Fed has been endowed with both vast powers and the highest degree of political insulation.

Of course, political independence explains only a part of an agency's accountability. The judiciary reviews a wide array of

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Open Market Committee. *See* 12 U.S.C. § 263. The Federal Open Market Committee directs Federal Reserve banks, located throughout the country, to actually implement open market operations. *See id.* § 355. The Committee consists of all seven governors of the Fed, plus five representatives of the Federal Reserve banks. *See id.* § 263. The Fed essentially controls the Federal Reserve banks. *See generally* 12 U.S.C. §§ 248(f), (j), 302, 305, 341 (authorizing the Fed to control the composition and activities of member banks).

121.

> The monetarist proposition that monetary changes are responsible for business cycles was [initially] widely contested, but by the end of the 1960s the view that monetary policy had important effects on aggregate activity was generally accepted. The obvious importance of monetary growth in the inflation of the 1970s restored money to the centre of macroeconomics.

Phillip Cagan, *Monetarism*, *in* THE NEW PALGRAVE, THE WORLD OF ECONOMICS 449, 451 (John Eatwell et al. eds., 1991); *see also* FRIEDMAN & SCHWARTZ, *supra* note 85, at 686-95 (describing actions taken by the Federal Reserve System that resulted in changes in output).

122. *See* 12 U.S.C. § 225a.

123. *See* FRIEDMAN & SCHWARTZ, *supra* note 85, at 687-91.

124. *See id.*

125. *See* DE SAINT PHALLE, *supra* note 88, at xxiii ("The actions of the Federal Reserve Board determine whether the global economy will function in an inflationary or a deflationary cycle. . . . ").

agency decisions. The judiciary will not allow agencies to take action that is contrary to their governing statutes. The courts also will ensure that agencies adhere to concepts of due process. Within these broad limitations agencies largely operate with little judicial interference.[126] Indeed, certain areas of agency action essentially are nonreviewable because of prudential limitations the judiciary has imposed upon itself, such as standing limitations.[127] For example, the Fed's power over monetary policy probably is not reviewable because these decisions are committed to the agency's discretion[128] and it is unlikely that any particular person could establish any statutory "core of interests" intended for protection.[129] The courts thus far have refused to extend jurisdiction to any purported victim of the Fed's policy.[130] Similarly, the Fed has exempted itself from the rule-making provisions of the Administrative Procedure Act (APA)[131] with regard to its control over monetary policy.[132] With its very broad delegation, the Fed operates virtually free of judicial restraint in conducting monetary policy.[133]

In the final analysis, the Fed is only as independent of political influence as the politicians permit.[134] The Fed enjoys the

126. *See, e.g.*, Chevron U.S.A. Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984) (holding that reasonable agency determinations will be upheld).
127. *See id.* at 844.
128. *See, e.g.*, Lincoln v. Vigil, 508 U.S. 182 (1993) (holding that the Indian Health Service's decision to discontinue a program was not subject to review under the Administrative Procedure Act); Heckler v. Chaney, 470 U.S. 821 (1985) (holding that a decision by the Food and Drug Administration was not subject to review under the Administrative Procedure Act).
129. *See, e.g.*, Association of Data Processing Serv. Org. v. Camp, 397 U.S. 150 (1970) (setting forth the "legal interest" test plaintiffs must satisfy to sue an agency).
130. *See, e.g.*, Melcher v. Federal Open Mkt. Comm., 836 F.2d 561 (D.C. Cir. 1987) (affirming the district court's dismissal of the Senator's cause of action on the basis of its equitable discretion); Committee for Monetary Reform v. Board of Governors of the Fed. Reserve Bd., 766 F.2d 538 (D.C. Cir. 1985) (holding that members of a group of private interests harmed by monetary policy lacked standing to challenge Fed action or structure); Reuss v. Balles, 584 F.2d 461 (D.C. Cir. 1978) (holding that a Congressman lacked standing to challenge the composition of the Federal Open Market Committee of the Fed).
131. 5 U.S.C. §§ 551-559, 701-706 (1994).
132. *See* 12 C.F.R. § 272.5 (1999) (embodying the Fed's determination that it is in the public interest for the Fed to set monetary policy free from strictures of the APA).
133. *See supra* note 128 and accompanying text.
134. *See* DE SAINT PHALLE, *supra* note 88, at 77 ("While the Fed is independent

highest degree of commitment to its political independence. Presidents from Eisenhower[135] to Carter have publicly affirmed their commitment to the Fed's independence.[136] The current administration is also committed to the Fed's continued independence.[137] Treasury secretaries have defended the independence of the Fed.[138] The Fed is aware that Congress can revoke its independence or narrow its powers at any time. Consequently, the Fed exercises its independence with a sensitivity to this ultimate vulnerability. The Fed is particularly vulnerable because of its vast power and its perceived lack of accountability.[139] Nevertheless, Congress has neither the incentive nor the institutional capability for monitoring the Fed. Monetary policy is too complicated and risky to encourage congressional interference with the Fed.[140]

Over the years, the Fed appears to have acted, at times, to foil political initiatives when economic policy so demanded.[141] Still,

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from direct control, either by the administration or Congress, it was created by Congress, and the Fed is fully aware that Congress can at any time change its mandate, responsibilities, or powers.").

135. *See id.* at 76 ("[The Fed] is not under the authority of the President and I personally believe it to be a mistake to make it definitely and directly responsible to the political head of state.'" (quoting President Eisenhower)).

136. GREIDER, *supra* note 91, at 152 ("As you well know, I don't have control over the Fed, none at all. It's carefully isolated from any influence by the President or the Congress. This has been done for many generations and I think it's a wise thing to do.") (quoting President Carter)).

137. *See Clinton and Greenspan: The Odd Couple*, BUS. WK., July 14, 1997, at 48 [hereinafter *The Odd Couple*] (quoting President Clinton attributing good relations with the Fed to the administration's defense of Fed independence); Dean Foust, *Alan Greenspan's Brave New World*, BUS. WK., July 14, 1997, at 44 (stating that the Treasury Secretary does not second-guess Fed policy).

138. *See, e.g.*, *Financial Institutions and the Nation's Economy "Discussion Principles": Hearings Before the Subcomm. on Fin. Insts. Supervision, Regulation and Ins. of the House Comm. on Banking, Currency and Hous.*, 94th Cong. 597, 604 (1976) (statement of Deputy Treasury Secretary Stephen Gardner); *The Federal Reserve System After Fifty Years: Hearings Before the Subcomm. on Domestic Fin. of the House Comm. on Banking and Currency*, 88th Cong. 1231-32 (1964) (statement of Treasury Secretary Douglas Dillion).

139. *See supra* note 91.

140. Senator William Proxmire explained the reasons for Congress's "extremely thin" oversight of the Fed in an interview with Professor Woolley. *See* WOOLLEY, *supra* note 108, at 137.

141. *See* DE SAINT PHALLE, *supra* note 88, at 76. The next Part of this Article assesses some of the more significant instances of unpopular Fed policy initiatives.

the Fed has also taken great pains to avoid influencing elections.[142] As a consequence, the Fed has avoided any significant political initiative to constrain its power or restrict its independence. The Fed's success at this balancing act has served as a major prop to its independence. Another prop to Fed independence is the financial community's belief that Fed independence is crucial to a sound currency and emblematic of the government's commitment to fighting inflation.[143] In the area of financial market regulation, the Fed has achieved a remarkable level of political independence.[144] A key element of the Fed's independence, both as a matter of legal structure and political commitment, is the strength of the policy basis of its independence.[145]

The reasons why Congress created the Fed and endowed it with such extraordinary independence and power seem clear. The primary reason given for the Federal Reserve Act of 1913 was to "furnish an elastic currency."[146] Although modern economic theory associates money supply manipulation to monetary policy, in 1913 an "elastic currency" referred to a more basic economic need.[147] Specifically, Congress was far more concerned with "seasonal" currency needs and the mobility of reserves (or liquidity) to meet the cyclical agricultural demand for money.[148]

See infra notes 197-300 and accompanying text.

142. *See* WOOLLEY, *supra* note 108, at 125-30 (studying the conduct of monetary policy in election years and concluding that the Fed tries to "lie low").

143. For example, Professor Woolley reported that in the 1980s, when the Reagan Administration threatened to curtail Fed independence, the Reagan Administration retreated based upon the sentiments of the financial community. *See* WOOLLEY, *supra* note 108, at 118; *see also Fears for Trade and the Fed, Too*, N.Y. TIMES, May 27, 1990, § 3, at 4 (reporting that Wall Street supports the political independence of the Fed). *But see* Sheri Berman & Kathleen R. McNamara, *Bank on Democracy: Why Central Banks Need Public Oversight*, FOREIGN AFF., Mar.-Apr. 1999, at 2 (arguing that central banks need democratic control).

144. *See generally The Odd Couple*, *supra* note 137, at 48.

145. Contemporary financial observers have recognized the importance of political commitment to central bank independence. *See, e.g.*, *Central Banks: America v. Japan: The Rewards of Independence*, ECONOMIST, Jan. 25, 1992, at 19 (observing that even though the Fed has superior *legal* independence when compared to the Bank of Japan, the Japanese central bank enjoys a greater *political* commitment to fighting inflation).

146. H.R. REP. NO. 63-69, at 1 (1913).

147. *See* FRIEDMAN & SCHWARTZ, *supra* note 85, at 189-96.

148. *See* H.R. REP. NO. 63-69, at 5; *see also* FRIEDMAN & SCHWARTZ, *supra* note 85,

These seasonal disruptions in currency demand caused panics and bank runs that, in turn, triggered severe economic contractions in 1907, 1896, 1893, 1890, 1884, and 1873.[149] These panics had increased the saliency of banking law reform in the public's political consciousness. The Democratic Party, for example, included a provision in its 1912 platform for banking law reform designed to relieve currency shortages.[150] By the time of the passage of the Banking Act of 1935, Congress explicitly understood the relationship between money supply and output, and reconceived the Fed's role from mere currency "accommodation" to protector of "business stability."[151] The independence Congress extended to the Fed must be viewed as a recognition of the dangers of political influence over monetary policy. Commentators have long demonstrated that politicians face an irresistible urge to inflate currencies for political gain.[152]

Even though the full impact of the Fed's control of monetary policy as a means of determining macroeconomic output was not fully appreciated in 1913, the power granted to the Fed was still vast. The Fed could print money.[153] In 1913, the backing of the currency was a hot political issue;[154] thus, the granting of this power to the Fed demonstrates that Congress consciously understood that the "independent" agency it was creating would wield tremendous power.[155] Yet, Congress still endowed the Fed with tremendous independence. The Federal Reserve Act of 1913 is nothing less than a reaffirmation of the suspicions of unbridled democracy that lie at the foundation of our constitutional system. In the context of the power to create money, the 1913 Act

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at 192-93 (discussing the need for "some form of currency that could be rapidly expanded . . . and some means of enabling banks to convert their assets into such currency").

149. *See* H.R. REP. NO. 63-69, at 4.

150. *See id.* at 7-8.

151. H.R. REP. NO. 74-742, at 9 (1935).

152. *See generally* Miller, *supra* note 65, at 436-45 (discussing the rent-extraction motivation for inflation).

153. *See* Federal Reserve Act of 1913, ch. 6, § 11, 38 Stat. 251 (codified as amended at 12 U.S.C. § 248(d) (1994)) (giving the Fed the power to issue Federal Reserve Notes).

154. *See* WOOLLEY, *supra* note 108, at 35-39.

155. *See id.* at 39-40.

evinces a deep-seated suspicion that invariably politicians would manipulate the money supply and debase the currency in an effort to assure re-election. Simply put, Congress decided that the political process could not be trusted with the power to print money in a modern economy.[156] Consequently, the Fed was, as Senator Carter Glass, a chief sponsor of the Act, stated during the Act's debates, "'to be wholly divorced from politics.'"[157] This desire for depoliticizing monetary policy reflects the strength of the policy basis of the Fed, and hence the strength of the political commitment to its independence.

The independence of the Fed should be contrasted with the "independence" of other financial regulators.[158] For example, the SEC is governed by a regulatory commission, which is appointed by the President for five-year terms and must have a bipartisan composition.[159] Nevertheless, SEC commissioners serve at the pleasure of the President.[160] Moreover, the SEC is not funded independently and must go to Congress for its annual appropriation.[161] Consequently, the SEC has been subject to significant legislative incursions upon matters that were putatively left to its discretion. For example, Congress occasionally has pressured the SEC to alter its disclosure rules.[162] Recently, Con-

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156. *See* GREIDER, *supra* note 91, at 267. Internationally and historically, the fear of a democratically controlled money supply is at the heart of arguments in favor of central bank independence. *See* ROSE MARIA LASTRA, CENTRAL BANKING AND BANKING REGULATION 13 (1996). Empirical evidence suggests that the theoretical rationale for central bank independence is well supported. *See id.* at 15-18.

157. *See* GREIDER, *supra* note 91, at 281 (quoting Sen. Glass).

158. Many commentators have assessed the degree of independence enjoyed by central banks. *See, e.g.*, Miller, *supra* note 65, at 446 n.25. No commentator, however, has translated the essential elements of central bank independence into factors that can be used to understand agency independence generally. *See generally* LASTRA, *supra* note 156, at 10-60 (providing a detailed overview of the elements of independence, in the context of various central banks, and concluding that central bank independence is a useful means of achieving stable money and a sound currency). Notably, these assessments of central bank independence generally conclude that the Fed has long been one of the few independent central banks in the world. *See id.* at 1.

159. *See* 15 U.S.C. § 78d (1994).

160. *See id.*

161. *See id.* § 78kk.

162. *See* STAFF OF SENATE SPECIAL COMM. ON THE YEAR 2000 TECH. PROBLEM, 106TH CONG., INVESTIGATING THE IMPACT OF THE YEAR 2000 PROBLEM 14, 79-92

gress also invaded the SEC's discretion to define securities fraud.[163] Indeed, in the 1999 appropriation bill funding the SEC, Congress included a significant amendment to the securities laws: specifically, the Securities Litigation Uniform Standards Act of 1998 (the Uniform Act).[164] Traditionally, the federal securities laws provided remedies to investors that were cumulative of state law remedies.[165] This meant that the federal securities laws could only operate to extend increased protection to investors. The Uniform Act, however, preempts state law with regard to securities litigation involving publicly traded companies. Combined with the Private Securities Litigation Reform Act of 1995 (PSLRA),[166] the Uniform Act means that the federal securities laws now operate to restrict investor remedies only.[167] Initially, the SEC did not support the Uniform Act.[168] Those who argue that all protective regulation is turned invariably to the advantage of the regulated would not be surprised with this result.[169]

(1999) (summarizing congressional pressure on the SEC to improve disclosure rules regarding disclosure of the year 2000 technology problem and costs that businesses would absorb).

163. The SEC has retained discretion to define most securities fraud since its creation pursuant to the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78j. In 1995, Congress undertook the first major initiative to redefine securities fraud, pursuant to the Private Securities Litigation Reform Act of 1995. This initiative will be analyzed in detail below. *See infra* notes 343-64 and accompanying text.

164. Pub. L. No. 105-353, 112 Stat. 3227.

165. *See* 15 U.S.C. §§ 77p, 78bb.

166. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).

167. *See* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Actions*, 65 U. CIN. L. REV. 3, 40-41 (1996) (stating that the protection of federal law has been destroyed).

168. *See* Rachel Witmer, *Gramm, Domenici, Dodd Introduce Bill to Federalize Securities Class Actions*, 66 U.S.L.W. 2220 (Oct. 14, 1997). The SEC ultimately gave conditional support to the Uniform Act, even though its own studies showed that any such legislation was "premature." *Sec. Litig. Abuses: Hearing Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. 10-13 (1997) (statement of Arthur Levitt, Chairman, SEC).

169. There is strong evidence that many innovative regulatory reforms from the Progressive Era of the early twentieth century ultimately benefitted the powerful interests that were supposedly the target of regulation. Gabriel Kolko has undertaken exhaustive research showing that business leaders in industries subject to such reforms welcomed government regulation and dominated "progressive" reforms. *See* GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN HISTORY, 1900-1916, at 3 (1963).

The New Dealers who led the charge to federalize investor protection would be horrified.[170]

Even if agencies like the SEC enjoyed the same structural and institutional independence as the Fed, they would remain vulnerable to capture because their power is highly fragmented. For example, regulatory experts recognized as early as 1949 that the fact that regulatory power was splintered among numerous federal agencies and shared with each of the states undermined the federal program of bank regulation.[171] The Hoover Commission recognized that this allowed banks to play supervisory authorities against each other and that banks could escape regulatory mandates by choosing their regulator.[172] Consequently, these agencies do not have the same ability to make decisions free of political influence. They must pay heed to the regulated or lose the ability to exercise significant regulatory power. When a regulated industry has the ability to choose their regulator, a giant channel towards capture is opened. There is no similar regulatory competition in the area of regulating monetary policy. Thus, except for the Fed's control of monetary policy, financial regulation is prone to the same shortcomings of politicized regulation that are pervasive in the modern regulatory state.[173]

Recently, scholars in the area of administrative regulation, led by Justice Stephen Breyer, have argued that depoliticization of administrative regulation can be used to address problems inherent in the regulatory process.[174] Justice Breyer argues that

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170. One visionary was Ferdinand Pecora. Pecora served for 17 months, from January, 1933 to July, 1934 as counsel to the Senate Committee on Banking and Currency, during the time of the hearings on the 1933 Act and 1934 Act. *See* FERDINAND PECORA, WALL STREET UNDER OATH 3 (Reprints of Economic Classics ed. 1968) (1939). Pecora published a summary of those congressional hearings because "[a]fter five short years, we may now need to be reminded what Wall Street was like before Uncle Sam stationed a policeman at its corner. . . ." *Id.* at xi. Pecora predicted that the public would forget the hazards of a deregulated financial system. *See id.* at ix-x.

171. *See* HOOVER COMMISSION REPORT, *supra* note 64, app. N at 116.

172. *See id.*

173. *See supra* notes 1-3 and accompanying text.

174. *See, e.g.*, BREYER, *supra* note 12. Other than Justice Breyer's approach, commentators have had surprisingly little to say about remedying the shortcomings of administrative regulation.

> Up to now, most regulatory scholars resisting the public choice theory's calls for deregulation have instead taken a very different track, turning

three fundamental problems infect agency regulation. First, the public is subject to various forms of cognitive dissonance which results in a failure to rationally weigh costs and benefits of various regulatory programs.[175] It would not surprise anyone, for example, that ordinary citizens, preoccupied with family obligations, social relationships, full-time employment, financial challenges, saving for retirement and college, and faced with a vast array of information and intellectual attractions, ranging from the existence and meaning of black holes to whether the President had sex with a young intern, may not always have the time or resources to determine which environmental risks, for example, are the greatest.[176] Second, Congress, in responding to political pressures, necessarily transmits poor public perception, combined with its own institutional infirmities, into law.[177] Breyer highlights the fact that Congress enacts one statute at a time and often fails to look at problems in a unified fashion across overlapping committee jurisdictions.[178] Third, administrative agencies, necessarily acting in an environment of great uncertainty, and with competing agendas and constituencies, often take inconsistent approaches to similar problems, resulting in uncoordinated regulation.[179] This vicious circle creates misregulation plagued by tunnel vision, irrational agendas, and incon-

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> to courts as the ultimate safeguard against the danger of rent-seeking. While that approach is sensible enough, especially given that judges are relatively insulated from the types of political pressures that produce undesirable regulations, there is no reason to place such a heavy burden on courts alone. Nor can it be clear just what oversight role is most appropriate for the courts, absent deeper understanding of exactly what they are overseeing. Between delegation and judicial review lies the black box of administrative process. Reformers who would preserve the regulatory regime should open it.

Croley, *supra* note 20, at 168; *see also* Joseph P. Tomain & Sidney A. Shapiro, *Analyzing Government Regulation*, 49 ADMIN. L. REV. 377, 398 (1997) (proposing a model of regulation that focuses on the roles of policy, politics, and law, and urging scholars to improve regulation through a fuller understanding of the context in which it operates and its goals).

175. *See* BREYER, *supra* note 12, at 33-39.

176. *See id.*

177. *See id.* at 39-42.

178. *See id.*

179. *See id.* at 42-50.

sistency.[180] In short, Justice Breyer has identified a series of malfunctions in agency regulation generally that are not dissimilar to the problems that other scholars contend generally plague regulation—all resulting from too much political influence in the agency process.[181]

Justice Breyer's articulation of the problems of regulation focuses on issues endemic to environmental risk regulation. The scope of his solution is, however, without any such limitation. Justice Breyer posits that "[a] depoliticized regulatory process might produce better results."[182] Breyer argues for the creation of a group with interagency jurisdiction and political insulation to coordinate and rationalize regulation.[183] This group would have authority to impose its decisions and would have the power to build a coherent risk-regulating system adaptable across agencies.[184] These "superregulators" would be chosen from a specific career path that would add their expertise to regulation and be given civil service protection.[185] The career path would require service in Congress, the Office of Management and Budget, and administrative agencies.[186]

Certainly, Justice Breyer's proposal has generated criticism.[187] Not the least of these is that such a proposal tends toward an undemocratic, elitist government.[188] Critics have already launched

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180. *See id.* at 50.

181. *See id.* at 50-51. A more expansive discussion of Justice Breyer's diagnosis focuses on the institutional infirmities plaguing regulatory agencies and Congress. *See* STEPHEN BREYER, REGULATION AND ITS REFORM 1-11 (1982). The common themes of political salience, complexity, inappropriate political influence, institutional infirmity, and fragmentation appear to form the basis of each diagnosis of the problems of government regulation.

182. BREYER, *supra* note 12, at 55-56.

183. *See id.* at 59-72, 80-81.

184. *See id.* at 60-61.

185. *See id.* at 59-61, 67-68.

186. *See id.* at 59-60.

187. *See, e.g.*, David A. Dana, *Setting Environmental Priorities: The Promise of a Bureaucratic Solution*, 74 B.U. L. REV. 365, 385 (1994) (arguing that Justice Breyer "does not pay sufficient attention to the role of interest groups" in assessing regulatory efficacy).

188. *See* Eric J. Gouvin, *A Square Peg in a Vicious Circle: Stephen Breyer's Optimistic Prescription for the Regulatory Mess*, 32 HARV. J. ON LEGIS. 473, 487 (1995) (stating that Breyer should have responded to arguments that "Congress has already delegated too much authority to agencies without sufficient accountability").

such attacks upon the current regulatory structure, even without a group of superregulators with civil service protection and insulation.[189] No doubt, these critics are correct that depoliticizing regulation and delegating power to administrative agencies lessens democratic influence, often over important areas of our society. Nevertheless, in appropriate circumstances such depoliticization and delegation is both consistent with, and supportive of, the American republican tradition. Specifically, American government has always been designed both to limit and to accommodate democratic influences.[190] From the beginning of the Republic, certain issues were not a matter of politics. The Founders specifically contemplated a depoliticized system of legal regulation.[191] Thus, the President serves a four-year term, subject only to the drastic remedy of impeachment, and Senators serve six-year terms.[192] Article III judges enjoy tenure during "good behavior."[193] American citizens, in fact, elect leaders; so long as these leaders are accountable to voters for all of their policy decisions, including their supervision of agencies, delegation cannot be termed antidemocratic, in any traditional sense.[194] Thus, the question really should be not whether Justice

189. *See* DAVID SCHOENBROD, POWER WITHOUT RESPONSIBILITY: HOW CONGRESS ABUSES THE PEOPLE THROUGH DELEGATION 196 (1993) (stating that the delegation of power to agencies reduces popular participation in lawmaking). Professor Schoenbrod launches the broadest possible attack on administrative regulation: that delegation to administrative agencies of legislative and executive power is unconstitutional and antidemocratic. *See id.* at 20-21. This Article posits that the increased complexity of our society mandates broad delegations to administrative agencies. To argue that Congress is capable, for example, of administering monetary policy is to ignore the reality of such complexity. *See id.* at 13.

190. *Cf.* THE FEDERALIST NO. 10, at 127 (James Madison) (Isaac Kramnick ed., 1987) ("[I]t may be concluded, that a pure democracy, by which I mean a society consisting of a small number of citizens, who assemble and administer the government in person, can admit of no cure for the mischiefs of faction."); Julian N. Eule, *Judicial Review of Direct Democracy*, 99 YALE L.J. 1503, 1522 (1990) ("If the Constitution's Framers were keen on majority rule, they certainly had a bizarre manner of demonstrating their affection.").

191. *See* Eule, *supra* note 190, at 1525.

192. *See* U.S. CONST. art. I, § 3, cl. 1; *id.* art. II, § 1, cl. 1; *id.* art. II, § 4.

193. *See id.* at art. III.

194. Issues of agency independence necessarily implicate issues of agency accountability. Nevertheless, an optimal tradeoff in these values can be achieved, and noted commentators in the area of financial regulation have recognized that central bank independence can accommodate such an optimal tradeoff. *See* LASTRA, *supra*

Breyer's proposal for depoliticization is undemocratic, but whether broader depoliticization is possible without the constitutionally dubious excesses of Justice Breyer's proposal. This Article responds affirmatively to that inquiry.

As society has become more complex, and many legal issues consequently demand a higher degree of expertise, the ability of the electorate to make informed decisions is compromised. Rapid evolution in specific areas of legal regulation compromises the ability of even a republican form of government to respond. Political scientists as well as legal scholars have recognized the pernicious effects upon sound regulation that follow from these realities.[195] Under these circumstances, placing issues of low political saliency before a traditional regulatory agency can invite special interests to obtain regulatory largess. Congress, on the other hand, often lacks sufficient institutional expertise and flexibility to manage certain areas of government activities.[196] Moreover, Congress itself is often prone to distributing largess. With these realities in mind, the next Part demonstrates that circumstances can exist to render depoliticized regulation, in accordance with the Constitution, an effective means to support our democratic government—by taking areas of low political visibility, and shedding the light of uncorrupted expertise upon them.

II. AN ASSESSMENT OF DEPOLITICIZED REGULATION

This Part assesses the success of depoliticized regulation, with a specific focus on the Fed. As demonstrated above, the Fed is endowed with a high degree of independence from the political process.[197] The emphasis of this Part is an attempt to determine

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note 156, at 20-24; *see also* Rebecca L. Brown, *Accountability, Liberty, and the Constitution*, 98 COLUM. L. REV. 531, 565 (1998) ("Indications from the time surrounding the drafting and ratification of the Constitution suggest that . . . the view of accountability that the founding community held . . . is a view of accountability as a notion of blame.").

195. *See, e.g.*, SCHOENBROD, *supra* note 189, at 119-21 (highlighting how the lack of congressional expertise results in delegation to agencies that also suffer from political pressures when deciding how to regulate).

196. *See id.*

197. *See supra* text accompanying notes 83-97.

whether depoliticized regulation delivers upon its promise of a sounder basis for regulation. This discussion does not focus on the Fed's use of this power and independence to discharge its economic objectives.[198] Economists have long debated, for example, whether the Fed should focus on setting economic aggregates, interest rates or money stocks, and politicians have debated the relative value of stemming unemployment or inflation.[199] Instead, this discussion focuses on the success of the Fed in conducting monetary policy free of political influence. This Part also assesses whether the putative benefits of depoliticization have been realized.

The Fed's authority over monetary policy is somewhat accidental.[200] After the Panic of 1907, many believed that an elastic currency was needed to stem bank runs and provide liquidity for

198. As has been discussed, one bedrock belief that justifies the independence of the Fed is that political control of the money supply is undesirable because politicians will be tempted to stimulate the economy with easy money in order to enhance their ability to get re-elected. The empirical evidence suggests that central bank independence, such as that enjoyed by the Fed, does serve to mitigate inflation. *See* LASTRA, *supra* note 156, at 15-18. *But see* Berman & McNamara, *supra* note 143, at 4 (arguing that although there is some evidence that central bank independence leads to lower inflation, there is no convincing evidence that it contributes to real economic performance).

199. *Compare* FRIEDMAN & SCHWARTZ, *supra* note 85, at 676 (concluding that changes in money stock determine changes in economic activity), *with* James Tobin, *Monetary Policy: Rules, Targets and Shocks*, 15 J. MONEY, CREDIT & BANKING 506, 517 (1983) (arguing that "for periods long enough for velocity shocks to be identified and offset, a nominal GNP or final sales target is much preferable to any intermediate monetary aggregate"). Congress half-heartedly entered this debate in 1975. *See* H.R. Con. Res. 133, 94th Cong. (1975) (enacted). This resolution required the Fed to target monetary aggregates and attempt to lower interest rates. *See id.* Congress, however, gave the Fed explicit authority to deviate from its announced targets. *See* H.R. REP. NO. 94-91, at 4 (1975) (explaining that the Fed can deviate from the resolution if it deems the announced targets unachievable). Because this resolution was the culmination of a legislative initiative to impose real restraints upon the Fed, at a time when the Fed was quite vulnerable politically, this instance of legislative activity shows just how politically independent the Fed is. *See, e.g.*, WOOLLEY, *supra* note 108, at 144-47 (stating that "HCR 133 was toothless").

200. *See* GREIDER, *supra* note 91, at 282 (stating that it was assumed during the Federal Reserve debates that the gold standard would continue to stabilize the value of money); WOOLLEY, *supra* note 108, at 40-41 ("The founders of the Federal Reserve System assumed that the gold system and the real bills doctrine provided objective and appropriate criteria for regulating the money supply.").

the financial system.[201] Certainly, the Fed has power over the nation's money supply,[202] but this was not the main point of the Act.[203] The link between aggregate output and monetary policy was not fully understood in 1913; indeed, it was not until after World War II that monetary policy was fully appreciated.[204] At the time of the Federal Reserve Act, the Fed actually was considered a "collection of supercorrespondent banks," rather than a key economic policymaker.[205] There is no mention in the legislative reports accompanying the Act of the Fed's responsibility for monetary policy and, similarly, no mention of the Fed having the power to determine output, prices, and growth.[206] Congress did not predict in 1913 just how powerful its creature would become.[207] Nevertheless, Congress did knowingly endow the Fed with unparalleled power and independence.[208] The Banking Act of 1935, and to a lesser extent other New Deal adjustments to the nation's regulatory structure, represents a conscious decision by lawmakers to expand the Fed's power and independence.[209] Congress took these steps at a time when issues of financial reform were at the forefront of public debate.[210] Ultimately then, the Fed's independence is a reflection of a political determination that the Fed should have vast power that could be exercised free of political influence.

The Fed in its infancy hardly appreciated its economic power. Indeed, the modern Fed really did not exist until 1935.[211] Shortly after 1935, the Fed seems to have botched its economic responsibilities and engineered the premature death of an otherwise promising recovery from the Great Depression in 1937.[212] There-

201. *See* WOOLLEY, *supra* note 108, at 34-35.
202. *See, e.g.*, 12 U.S.C. §§ 411-21 (1994).
203. *See* WILLIAM C. MELTON, INSIDE THE FED 4 (1984).
204. *See supra* note 121 and accompanying text.
205. MELTON, *supra* note 203, at 4; *see also* DE SAINT PHALLE, *supra* note 88, at 56 ("There was nothing in the Federal Reserve Act of 1913 that gave the Federal Reserve Board the vast powers it has today.").
206. *See* DE SAINT PHALLE, *supra* note 88, at 55-56.
207. *See id.*
208. *See id.*
209. *See supra* notes 98-104 and accompanying text.
210. *See id.* at 46-55.
211. *See* GREIDER, *supra* note 91, at 313.
212. *See id.* at 320.

after, the Fed adopted a policy of almost total passivity until after World War II.[213] Thus, through World War II and the period immediately thereafter, the Fed generated little or no political controversy.[214] It was not until about 1950 that the Fed really began to exercise its monetary policy might.[215] The present analysis is primarily concerned with the period after 1950; however, it is significant that in its detailed analysis of independent regulatory agencies, the Hoover Commission in 1949 singled out the Fed for its "many excellencies" in discharging its regulatory obligations, particularly in its management of monetary policy.[216]

In 1950 the Fed had its first significant policy differences with the executive branch. After the start of the Korean War, the Fed wanted to pursue a restrictive monetary policy to control an expanding economy.[217] The Treasury Department desired lower interest rates so that it could manage its wartime debt less expensively.[218] President Truman stepped in to moderate the conflict. Apparently, Truman sided with the Fed, and on March 4, 1951, the agencies executed the Treasury-Federal Reserve Accord, which recognized that ultimate authority for monetary policy rested with the Fed.[219] Although this accord was a mutual promise of cooperation, it became a declaration of independence for the Fed because it explicitly recognized that the Fed had discretion to monetize the debt by issuing Federal Reserve Notes in exchange for bonds or to allow increased government borrowing to increase interest rates.[220] The fact that Truman did not push the administration's position and allowed the Fed to maintain its independence with respect to monetary policy was a significant step in assuring the political independence of the Fed.[221] Those economists who have attempted to quantify central

213. *See* JOHN KENNETH GALBRAITH, MONEY: WHENCE IT CAME, WHERE IT WENT 214 (1975).
214. *See id.*
215. *See* DE SAINT PHALLE, *supra* note 88, at 75.
216. HOOVER COMMISSION REPORT, *supra* note 64, app. N at 109.
217. *See* DE SAINT PHALLE, *supra* note 88, at 75.
218. *See id.*
219. *See id.*
220. *See* GREIDER, *supra* note 91, at 327-28; DE SAINT PHALLE, *supra* note 88, at 75.
221. *See* GREIDER, *supra* note 91, at 327-28.

bank independence focus specifically upon the central bank's ability to set monetary policy free from the government's need to finance operations.[222] On this score, the Fed rates high marks. After the 1951 agreement, the Fed had the power to conduct monetary policy free from the executive's fiscal policy.

The question of whether banking interests, or other special interests, have captured Fed monetary policy is somewhat more complicated.[223] Banks are a "transmission belt" of the Fed's monetary policy.[224] The Fed can manipulate monetary conditions, but it cannot force banks to lend or to lend at specified rates.[225] Particularly with respect to long-term lending rates, the Fed is at the mercy of the banking industry's inflationary expectations and confidence in business conditions.[226] The Fed must, therefore, maintain the confidence of the banking industry.[227] Congress has recognized this need from the beginning of the Federal Reserve System by providing for the creation of the Federal Advisory Council (FAC).[228] The FAC consists of powerful banking

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222. *See* Miller, *supra* note 65, at 446 n.25.

223. This Article assesses the Fed's performance under its modern depoliticized structure. This structure was not completely in place until the passage of the Banking Act of 1935. *See supra* notes 98-110 and accompanying text. Prior to that, the banking industry had a large voice in the promulgation of monetary policy, through their control of the district banks and the voice of those entities in making monetary policy. *See* DE SAINT PHALLE, *supra* note 88, at 56-57. Scholars have found that under this regime, the Fed allowed the interests of the banking industry to dominate, monetary policy—even to the extent of causing tight monetary policies in the depths of the Great Depression which greatly exacerbated that calamity. *See* Gerald Epstein & Thomas Ferguson, *Monetary Policy, Loan Liquidation and Industrial Conflict: The Federal Reserve and the Open Market Operations of 1932*, 44 J. ECON. HIST. 957, 982-83 (1984) (concluding that the Fed tightened money in 1932-33 to enhance bank profits from government securities while disregarding the detrimental effect on the rest of the economy). These findings are not very relevant to an analysis of the institution that the Fed is today.

224. E. Gerald Corrigan, *Are Banks Special?*, *in* FEDERAL RESERVE BANK OF MINNEAPOLIS ANNUAL REPORT 1, 11 (1982).

225. *See generally* Tom Herman, *Many Banks Gripe but Higher Prime Rate May Help Some Become More Profitable*, WALL ST. J., Dec. 17, 1980, at 29 (explaining how banks often set their own interest rates).

226. *See* Corrigan, *supra* note 224, at 11.

227. *See* WOOLLEY, *supra* note 108, at 86 ("Securing confidence means considering in a focused way the long-term interest of finance and vigorously fighting inflation.").

228. *See id.* at 114-16 (explaining that the FAC was added to assuage the disappointed commercial bankers).

interests that are granted privileged access to the Fed through regular, formal meetings.[229] Scholars studying the minutes of these meetings have concluded that the Fed dominates the sessions and uses them to obtain important information from the banking industry; thus, these scholars have concluded that the Fed is not controlled by the FAC.[230]

Often, the FAC has been an unmitigated failure in seeking to influence Fed policy. In the late 1970s, the FAC complained that the Fed's refusal to pay interest on the reserves maintained by member banks with the Federal Reserve System constituted a discriminatory tax upon members.[231] Congress, at the Fed's urging, responded by requiring *all* banks to keep interest-free balances with the Fed.[232] The Fed seems to use the FAC to gather important information and influence bank industry conduct.[233] The FAC is perhaps best viewed then as an institutional mandate to consider information obtained from the banking industry in making decisions regarding monetary policy. This institutional mandate may be mistaken for obsequious behavior by a regulator beholden to the industry it regulates.[234] Nevertheless, nearly all observers agree that the banking industry does not control the Fed's monetary policy machinery, and that the Fed regularly undertakes monetary initiatives that are contrary to the short-term interests of the banking industry it regulates.[235]

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229. *See* 12 U.S.C. §§ 261-62 (1994).

230. *See* WOOLLEY, *supra* note 108, at 77 (citing G.L. BACH, MAKING MONETARY AND FISCAL POLICY 178-79 (1971)).

231. *See* GREIDER, *supra* note 91, at 154.

232. *See id.* at 154-55.

233. *See* WOOLLEY, *supra* note 108, at 77.

234. *See* GREIDER, *supra* note 91, at 114-15.

235. *See, e.g.*, BACH, *supra* note 230, at 178 (stating that the Fed considers itself "responsible to Congress and the public rather than to the banking industry"); MAXWELL NEWTON, THE FED 249 (1982) ("[T]he Federal Reserve System has presided over a major decline in the very institutions it was supposed to support and nurture—the banks of the United States."); WOOLLEY, *supra* note 108, at 85-87 (acknowledging that the Fed often does what bankers need instead of what they want and often acts contrary to bankers' short-term preferences). *But see* Wright Patman, *The Federal Reserve System: A Brief for Legal Reform*, 10 ST. LOUIS U. L.J. 299, 300 (1969) (stating that the Federal Reserve has "shockingly" close ties to the banking industry). It is interesting that Congressman Patman's critique of the Fed appears to be motivated by the Fed's open defiance of the President. *See id.*

For example, in October of 1979 the Fed determined that interest rates needed to rise rapidly.[236] As a politically attractive means of achieving this, the Fed began to target monetary aggregates instead of interest rates, which in turn increased interest rate volatility, at least in the short-term.[237] Understandably, banks, as lenders, would like stable interest rates.[238] Targeting monetary aggregates instead of a given interest rate level naturally leads to increased interest rate volatility. There is little doubt that this increased interest rate volatility hurt the banking industry, as the relative value of outstanding loans declined and commercial banks lost deposits to relatively more attractive money market mutual funds.[239] Such instances of demonstrable harm to the banking industry in the name of economic stability are inconsistent with any theory of monetary policy capture.[240]

In fact, on a general basis, banks prefer prosperity. With prosperity the demand for loans increases and bank balances expand. Rates of default decline, and banks can make money even on many imprudent loans. When the Fed undertakes a restrictive monetary policy these conditions do not prevail, and in an extreme recession even sound loans can lead to losses.[241] Any time the Fed tightens money, therefore, the banking industry suffers. Yet, the Fed has undertaken several rounds of very restrictive monetary policy in recent decades.[242] Thus, at least with respect to the Fed's administration of monetary policy, there is strong evidence that the Fed's powers have not been "captured."

As mentioned above, unlike agencies that suffer from persistent problems of regulatory competition, the Fed enjoys a regula-

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236. *See* WOOLLEY, *supra* note 108, at 82.

237. *See id.* at 82-83.

238. *See id.* (suggesting that banks are hurt by interest rate variability).

239. *See* Herman, *supra* note 225, at 29.

240. Commentators have distinguished the Fed's control of monetary policy from its regulatory power in assessing its susceptibility to capture. *See* WOOLLEY, *supra* note 108, at 85. The thesis of this Article tracks this distinction by focusing only upon the Fed in its capacity as chief monetary policy regulator, and not upon its general bank regulatory role.

241. *See generally* Stuart I. Greenbaum et al., *Monetary Policy and Banking Profits,* 31 J. FIN. 89 (1976) (explaining the impact of monetary policy on bank profits).

242. *See infra* notes 256-82 and accompanying text.

tory monopoly over the administration of monetary policy. Congress has, in fact, jealously guarded the Fed's turf.[243] For example, in the late 1970s the Fed began to lose members. As interest rates rose, the cost of maintaining interest-free reserves at the Fed increased. By early 1980, Chairman Volcker testified to Congress that the Fed was in danger of losing full control of monetary policy because Fed membership was in danger of dropping to below sixty percent of the banking industry.[244] Congress responded quickly.[245] In 1980, it required that *all* depository institutions adhere to Fed-dictated reserve requirements and report to the Fed.[246] Congress thus demonstrated its commitment to the Fed and the Fed's exclusive control over monetary policy, giving the Fed no need to consider the policies of any regulatory competitor.[247]

Of course, the banking industry can always lobby the President or Congress, even if it cannot directly influence the Fed. This raises the issue of whether the Fed truly is independent of the political branches. Before this issue can be properly assessed, however, independence must be considered in context. Specifically, no commentator seriously believes that the Fed should be completely independent of elected leaders, even if our constitutional system permitted such a structure.[248] Such unbridled power is utterly inconsistent with our republican tradition. Instead, independence must be considered on a relative basis. Some political accountability is both desirable and mandated by the Constitution.[249] Given its functions, the Fed appears ideally independent.[250] The Fed can defy powerful politicians, but is also

243. *See* GREIDER, *supra* note 91, at 154-63 (recounting the political maneuvering leading up to the Depository Institutions Deregulation and Monetary Control Act of 1980).

244. *See id.* at 157.

245. *See id.* at 162.

246. *See* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified in scattered sections of 12 U.S.C.).

247. *See* WOOLLEY, *supra* note 108, at 70.

248. *See, e.g.*, LASTRA, *supra* note 156, at 49-59.

249. *See supra* notes 35-37 and accompanying text.

250. *See* BACH, *supra* note 230, at 209 ("The present degree of 'independence' from the White House is about right."). Some commentators in the past have disagreed vehemently with the performance of the Fed as well as its political independence. *See, e.g.*, Edward J. Kane, *External Pressure and the Operation of the Fed*, *in* POLIT-

aware that ultimately it must be accountable to the will of the people.[251]

As mentioned above, over the years both legislators and presidents have made strong statements endorsing the Fed's political independence. One commentator has stated: "few members of Congress really want to control monetary policy."[252] This reflects several facts. First, Congress understands fully its own institutional limitations in managing monetary policy. Congress has neither the time nor the dexterity to really control monetary policy.[253] Indeed, it could be disastrous if monetary policy became locked up in Congress due to competing power coalitions. Second, there appears to be strong consensus among influential policymakers that monetary policy must be administered free from special interest influence.[254] Politicians, no doubt, also have appreciated the political cover that comes with having the Fed as a scapegoat for economic disruptions. There is broad consensus that all of this amounts to a strong bipartisan commitment to the Fed's independence.[255]

This does not mean that the Fed does not have conflicts with the President or Congress. On the contrary, the Fed constantly is subject to political conflict, and thereby subject to political pressure. For example, in 1979 the Fed dramatically tightened

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ICAL ECONOMY OF INTERNATIONAL AND DOMESTIC MONETARY RELATIONS 211, 211-32 (Raymond E. Lombra & Willard E. Witte eds., 1982) (criticizing the Fed for catering to political pressure from Congress and the White House). Most of these attacks emanate from the period of the early 1980s when the nation faced severe economic challenges and the Fed was under a barrage of criticism. *See, e.g., id.* More contemporary commentators take a more benign position with respect to the Fed. *See, e.g.,* CARL H. MOORE, THE FEDERAL RESERVE SYSTEM 169 (1990) (stating that Paul Volcker managed the crisis of the early 1980s, restored market confidence, and halted inflation). Financial regulation experts have long recognized that political independence does not imply a lack of accountability. *See* LASTRA, *supra* note 156, at 49-59. Indeed, "an independent central bank needs to be accountable" or when it takes unpopular actions it will be destroyed. *Id.* Free societies cannot be expected to tolerate unaccountable power. *See id.*

251. *See* MOORE, *supra* note 250, at 169 (quoting former Fed Chairman Martin: "The Fed cannot, in the long run, act contrary to the wishes of the people as expressed through their elected officials").

252. WOOLLEY, *supra* note 108, at 191.

253. *See id.* at 190-91.

254. *See supra* text accompanying note 102.

255. *See* Kane, *supra* note 250, at 212.

money at the beginning of the presidential election cycle.[256] On August 16, 1979, seven days after Chairman Paul Volcker was sworn in, the Fed raised the discount rate to an all-time high of 10.5%.[257] Then, in October of 1979, the Fed became serious about fighting inflation and allowed key short-term rates to climb to eighteen percent.[258] In March of 1980, the Fed even went so far as to impose credit controls.[259] In mid-1980, the economy suffered a severe recession, as the gross national product shrank by ten percent, the sharpest contraction in thirty-five years.[260] Jimmy Carter lost the election of 1980 and key supporters attributed the defeat, at least in part, to the Fed's tight money policies.[261]

President Carter attacked the Fed's policies but never attacked the Fed's independence.[262] Carter likened the Fed's independence to the independence of the judiciary.[263] Thus, as the election slipped away, the President of the United States was reduced to telling voters, that although he disagreed with the Fed's policy, he had no influence over it.[264] The Fed had allowed a sitting President to perish upon the battleground of monetary policy.[265] Even more impressive is that Chairman Volcker acted with such monetary restraint just a short time after President Carter appointed him to his post with the Fed.[266] For the most

256. *See* GREIDER, *supra* note 91, at 76.
257. *See id.*
258. *See id.* at 125.
259. *See id.* at 185-86.
260. *See id.* at 185; *see also* DE SAINT PHALLE, *supra* note 88, at 112 (discussing the history of credit controls).
261. *See* GREIDER, *supra* note 91, at 218; MELTON, *supra* note 203, at 61 ("The Fed confounded such skeptics by making policy progressively tighter as the economy rebounded. Interest rates promptly retraced their earlier declines and marked new records, with predictable consequences for Carter's reelection campaign. Henceforth, inflation would be combated through a continuing policy of monetary restraint—with no gimmicks.").
262. *See* GREIDER, *supra* note 91, at 152; *see also* WOOLLEY, *supra* note 108, at 125 (discussing Carter's "electioneering" and concluding that "what is more telling is that Carter resisted the temptation to attack for so long").
263. *See id.* at 217.
264. *See id.*
265. *See id.* at 214.
266. *See id.* at 217-18. Contemporary observers maintained that financial markets forced President Carter's hand into appointing a chairman far more conservative than he would have preferred. *See The Dollar Chooses a Chairman*, BUS. WK., Aug.

part, the Fed's tightening had occurred despite objections from the Carter White House.[267] The Fed had successfully resisted political pressure and instead tamed inflation.[268]

Another example of the Fed's ability to defy even Presidents occurred during the Reagan Administration. Shortly after the 1980 election the administration announced $540 billion in tax cuts.[269] Simultaneously, the administration announced hundreds of billions in defense spending increases.[270] Fed Chairman Volcker concluded: "'There is no way we can avoid a clash between monetary restraint . . . and the growth of economic activity.'"[271] In other words, Volcker was signaling his intent to counter any fiscal stimulus with tighter monetary policy. Soon enough, the Fed allowed short-term rates to reach as high as 20.5%.[272] The Fed even went so far as to lobby members of Congress against the President's tax cut program.[273] Unemployment soared as twelve million Americans were out of work.[274] The gross national product declined sharply.[275]

With constituents starting to feel real pain, and with the 1982 elections fast approaching, both political branches undertook

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6, 1979, at 20. Still, it seems clear that by hurting a sitting president, considerations other than politics motivated Volcker.

267. *See* GREIDER, *supra* note 91, at 214-15. The White House had requested that the Fed impose credit controls. *See id.* at 184. The Fed resisted; in the end, however, the Fed was not institutionally prepared for a public showdown with the President. *See id.* Nevertheless, the administration persistently opposed the Fed's interest rate increases. *See id.* at 120.

268.

> The Volcker Fed's great achievement was to arrest decisively the inflation spiral that by 1979 had been accelerating for well over a decade. From its peak rate (on a year-over-year basis) of almost 15 percent in early 1980, the consumer price index decelerated to a mere 3 percent rate by the end of 1983. Most economists would have thought so massive a slowdown impossible to achieve in such a short span of time, and almost none had sufficient foresight to predict it. But if the scale of the disinflation was monumental, so were the costs of achieving that success.

MELTON, *supra* note 203, at 191.

269. *See* GREIDER, *supra* note 91, at 353.

270. *See id.*

271. *Id.* at 355 (quoting Chairman Volcker).

272. *See id.* at 402.

273. *See id.* at 398.

274. *See id.* at 454.

275. *See id.* at 507.

initiatives striking at the heart of the Fed's independence. James Baker, the White House Chief of Staff, began to lobby the Fed for a more expansionary monetary policy.[276] At the same time, Treasury Secretary Donald Regan proposed that the Fed become a subagency of the Treasury Department, directly accountable to the President.[277] Congressional efforts to strip the Fed of power ranged from forcing the Fed to abandon its reliance upon monetary aggregates to a congressional resolution commanding the Fed to reevaluate its monetary policy.[278] Significantly, financial interests did not react favorably to suggestions that the Fed be stripped of independence.[279] Despite real concern about its institutional independence, the Fed held monetary policy tight and resisted the highest degree of challenge to its institutional independence.[280] The Fed had scored a major political victory.[281] It had again fulfilled its basic mission to forsake political pressures and constrict growth to stem inflation.[282]

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276. *See id.* at 490.

277. *See id.* at 490-91; WOOLLEY, *supra* note 108, at 118.

278. *See* GREIDER, *supra* note 91, at 474-75. Periodically, Congress has taken stabs at curtailing the Fed's independence, but no serious initiative to impose real restraints upon the Fed has ever gained enough steam to become law. *See, e.g.*, Patman, *supra* note 235, at 323-26 (providing an example of a legislative initiative to restrict Fed independence).

279. *See* Vartanig G. Vartan, *Independent Fed Is Supported*, N.Y. TIMES, June 28, 1982, at D7.

280. *See* GREIDER, *supra* note 91, at 491-94.

281. From an economic point of view the Fed arguably exercised excessive restraint in monetary policy. At least one former Federal Reserve Board economist has concluded that the Fed's policy erroneously caused "extra and *unintended* disinflation" and an unintentional "economic depression" in 1981-82. MICHAEL G. HADJIMICHALAKIS, THE FED. RESERVE, MONEY AND INTEREST RATES: THE VOLCKER YEARS AND BEYOND 10 (1984). During this period unemployment reached a high of 10.8%. The economy also contracted 5.3% in the fourth quarter of 1981 and 5.9% in the first quarter of 1982. *See* GREIDER, *supra* note 91, app. B. at 724-25. Nevertheless, the sheer magnitude of the Fed's shortcomings, and the real pain spawned by them, are a testament to its resistance to political pressures.

282.

> [N]one of the postwar expansions died of natural causes—they were all murdered by the Fed over the issue of inflation. Once an expansion got under way and unemployment came down, wage and price inflation would pick up. Then the Fed, like a matron at a sock hop, would, as the recently deceased Fed Chairman William McChesney Martin observed, "take away the punch bowl just when the party gets going."

Rudi Dornbusch, *Growth Forever*, WALL ST. J., July 30, 1998, at A18.

This is not to say that the Fed is never subject to political influence. The Fed, under Chairman Arthur Burns, has been subject to controversial allegations that it specifically manipulated monetary policy in order to influence the election of 1972.[283] There is also strong evidence that the Fed allows its desire to avoid the appearance that it is manipulating monetary policy to influence elections, to cause it to refrain from policy steps it otherwise may take.[284] These concerns do not subvert the thesis of this Article. First, this Article fully recognizes that under the Constitution no lawmaking actor can be immune from political pressure. Second, this Article argues that some political responsiveness is a good thing; that is, an agency with no degree of political responsiveness would likely cease to exist.[285] Third, it is fully consonant with the Fed's mission to guard jealously its independence, even if this requires the Fed to play politics.[286] Finally, a politically ambitious Fed chairman probably could influence monetary policy based upon inappropriate political pressure. The question, however, is simply whether the Fed is sufficiently independent that it *can* resist political pressure. All

283. There is little question that in 1972 the Nixon Administration wanted the Fed to ease monetary policy. Nixon's advisors admit they played hardball with Chairman Burns, in an attempt to obtain favorable monetary conditions for the election of 1972. *See* GREIDER, *supra* note 91, at 342; WILLIAM SAFIRE, BEFORE THE FALL 619-20 (1975). The administration even suggested a plan to pack the Fed, much akin to FDR's court-packing plan. *See* GREIDER, *supra* note 91, at 342. What is far more controversial is the question of whether Chairman Burns intended to influence monetary policy to enhance President Nixon's chances of success in the election of 1972. *Compare* WOOLLEY, *supra* note 108, at 155 (arguing that monetary policy in 1972 reflected the Fed's defense of its political autonomy in response to the Administration's attack upon its independence), *with* Sanford Rose, *The Agony of the Federal Reserve*, FORTUNE, July 1974, at 91, 186-90 (suggesting election manipulation).

284. *See* SHERMAN J. MAISEL, MANAGING THE DOLLAR 117 (1973) ("Federal Reserve policy has always been to avoid, if possible, taking any major monetary actions as elections approach."); WOOLLEY, *supra* note 108, at 129 (arguing that even though it seems to avoid "partisan manipulation," the Fed "tries to lie low" during presidential elections); *Of Bulls and Bears and Financial Clockwatchers*, ECONOMIST, Nov. 19, 1994, at 85 (arguing that the Fed avoided raising rates until after the 1994 election).

285. *See supra* note 20 and accompanying text.

286. *See* Dornbusch, *supra* note 282, at A18 ("The Fed is a keenly political institution simply because that is the only way it can maintain the independence necessary to make good policy.").

of the above is consistent with the suggestion that the Fed has a high degree of resistance to inappropriate political influence, even if it is not absolutely immune from such influence.[287]

There can be little dispute that the Fed has demonstrated well a key advantage of agency delegation: the rapidity of its policy changes in response to fluctuating economic conditions. In one recent period of just over a year, the Fed changed key interest rates seven times.[288] Congress could never hope to be so nimble. Effective monetary regulation does not permit subjugation to the regular legislative process,[289] because monetary policy is so important to so many groups that it is very likely that Congress would become a battlefield of competing interests. In other areas, Congress has been persistently deadlocked and important reforms have been delayed. There is every reason to believe that banks, thrifts, the real estate and construction industry, the retail industry, the auto industry, and even the government itself, which all have stakes in containing inflation or interest rates, would lobby Congress and frequently freeze it from acting at all. Instead, the Fed has proven that it is capable of moving quickly and decisively. Similarly, the Fed has also been able to move very quickly to stem potential financial meltdowns—most famously in October, 1987, when the Fed flooded the markets with liquidity immediately after the 1987 crash.[290] Virtually all commentators acknowledge the Fed's success in this area.[291]

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287. In sum, the Fed has the ability to impose harsh policies against the wishes of the political branches; at times, the Fed nevertheless chooses to adhere to political considerations in setting monetary policy. *See* DE SAINT PHALLE, *supra* note 88, at 76-77.

288. *See* Foust, *supra* note 137, at 50; *see also* WOOLLEY, *supra* note 108, at 164 (showing in figure 8.2 that from the end of 1972 to mid-1973 the Fed dramatically engineered a series of rate increases that moved the federal funds rate from about 5% to nearly 11%).

289. The Hoover Commission explained the advantages of agency regulation in this respect in 1949. *See generally* HOOVER COMMISSION REPORT, *supra* note 64, app. N at 431 (discussing the bipartisan composition of independent regulatory commissions).

290. *See* Foust, *supra* note 137, at 47.

291.

> The leeway the Fed enjoys on the inflation front is particularly important in case of a stock market disaster. A minor correction surely won't lead the Fed to cut rates—the three hawks on the board won't stand for it,

Another benefit to expect from diminished political influence over regulation is the improved expertise in regulation. In a detailed study of the Fed's hiring practices with respect to top positions, Professor Woolley demonstrated that: (1) Fed officials are drawn from responsible financial positions in the private sector or academia; (2) the Fed hires personnel from elite backgrounds, such as prestigious educational institutions, more frequently than other government agencies, and at rates comparable to the private sector; and (3) Fed officials appear to vote independently of the positions previously held.[292] All of this demonstrates that the Fed has assembled a staff of professionals who vote independently of parochial interests. This is consistent with the observations of others who have studied the Fed, for example, that the Fed is operated by officials "drawn from the broad American middle class" and are "splendid proof of an American meritocracy."[293] According to regulatory theorists analyzing the causes of agency capture, one of the sources of capture is the temptation of agency staffers to allow the prospect of lucrative private employment to influence agency decisions.[294] Professor Woolley determined that former Fed officials, however, do not achieve high posts in private finance, but instead migrate to nonfinancial positions.[295] Finally, although Professor Woolley concluded that the banking industry naturally had some control over key personnel decisions, he also found that "it is very doubtful that the influence of the bankers through the recruitment process is sufficient to guarantee them detailed control of policy."[296]

> nor will the chairman. But if a massacre gets underway, just as in 1987, Mr. Greenspan is sure to act very quickly. This ensures that markets won't melt down, which in turn rules out one potent source of recession, namely a precipitous unbounded loss of confidence.

Dornbusch, *supra* note 282, at A18. In May of 1973, the Fed raised the short-term Fed Funds rate nearly three quarters of one percent; at the time this was the largest one-month increase in history. *See* Rose, *supra* note 283, at 188.

292. *See* WOOLLEY, *supra* note 108, at 67-68 (examining data from 1955 to 1982).

293. GREIDER, *supra* note 91, at 71.

294. *See supra* text accompanying note 78.

295. *See* WOOLLEY, *supra* note 108, at 67; *see also* 12 U.S.C. § 242 (1994) (imposing two-year postemployment restriction upon Fed members who fail to serve their entire 14-year term).

296. WOOLLEY, *supra* note 108, at 75.

So what does all of this mean? First, one must observe that there is no credible empirical, anecdotal, or logical basis for concluding that monetary policy, at least in modern times, has ever been hijacked by special interests regarding a major monetary policy decision.[297] Second, although the Fed is not free of political influence transmitted through the executive or legislative branches, it is sufficiently independent that the political branches are quite challenged in influencing monetary policy and seem to have no ability to influence it on behalf of any one special interest. Instead, politicians have a difficult enough time attempting to influence monetary policy in order to enhance their electoral chances. The historical and empirical record suggests that the Fed has not exercised its power over monetary policy for the benefit of special interests.[298]

The Fed thus demonstrates the central points of this discussion: important economic regulation can be secured against the pernicious influences of special interests. Benefits of expertise, regulatory flexibility, and stability of policy can be secured, while special interest influence can be quelled. Monetary policy should not be subject to electoral politics because voters cannot be expected to master its intricacies. Though this recognition makes administrative regulation more appropriate, the economic stakes are so enormous that special interests cannot be permitted to influence such regulation. Consequently, Congress has endowed the Fed with the power to move quickly and expertly in administering monetary policy—essentially free from the influ-

297. *See id.* at 85-87 (summarizing available evidence and concluding that "bankers do not shape Federal Reserve decisions in an ongoing, detailed way"). To the extent any regulatory theorist holds that regulation is inexorably dominated by the regulated, Professor Woolley has shown that from 1979 to 1982, when a financial crisis gripped our nation, the Fed overruled bankers on several issues. *See id.* at 87.

298. *See supra* notes 217-35 and accompanying text. Of course, there is always the argument that "[t]he Federal Reserve is part of a larger system of power that is dedicated to maintaining an economic system producing vastly disproportionate distributions of wealth." WOOLLEY, *supra* note 108, at 188. This view fails to acknowledge, however, that the American system of regulated capitalism has delivered vast wealth on a fairly wide-spread basis. In any event, this Article approaches the question of special interest capture from the point of view of the Fed's role in our system, which is to provide a stable currency and thereby foster growth. *See* 12 U.S.C. § 225a (1994 & Supp. III 1997).

ence of special interests. This, in turn, informs the question of when depoliticized regulation is appropriate. This Article argues that depoliticization is an appropriate means of improving regulation, and not an attack on our republican tradition, when: (1) the voting public has insufficient time, interest and resources to make informed electoral decisions; (2) powerful interests exist that may benefit disproportionally from regulatory policy; (3) the costs of misregulation are diffused and deferred; (4) the regulatory environment evolves quicker than Congress can legislate; (5) competing power blocks may persistently "freeze" Congress; and (6) the regulated area is so complex that a high degree of expertise is necessary for effective regulation.[299]

The Fed is faced with a regulatory environment that fits these conditions like a glove. Monetary policy is an ideal area for depoliticization.[300] The remainder of this Article evaluates and applies this model of depoliticized regulation to other areas of financial market regulation. A necessary predicate to this exercise is a clear understanding of the shortcomings of the current regulatory framework. Thus, Part III focuses on the problems inherent to the present regulatory approach, in order to determine if it too presents a set of circumstances appropriate for depoliticized regulation.

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299. Professor Grundfest has recognized a set of conditions under which government can be subverted by special interests, which dovetails the factors discussed above. He derives these factors from the specific context of the savings and loan debacle:

> In most situations, there is a delicate ecological balance that prevents Congress from being too generous in the favors it grants any one constituency. The balance, however, is vulnerable to the tactics of a rogue constituency that 1) has a broad geographic base; 2) pursues a noncontroversial ideology that is popular with the middle class; 3) actively finances congressional campaigns; and 4) is willing to exploit Congress's fiscal blind spots. A constituency that combines these four characteristics can strong-arm Congress into providing unconscionable benefits, while claiming that it imposes no costs on the federal treasury.

Joseph A. Grundfest, *Lobbying into Limbo: The Political Ecology of the Savings and Loan Crisis*, 2 STAN. L. & POL'Y REV. 25, 26 (1990). Professor Grundfest essentially posits that regulation can be hijacked by exploiting complexity, low issue salience and manipulating the political process.

300. Internationally, monetary policy is vested in independent central banks to an increasing extent. *See* LASTRA, *supra* note 156, at 1.

III. AN ASSESSMENT OF POLITICAL REGULATION OF FINANCIAL REGULATION

Political scientists long have recognized that administrative agencies, congressional oversight committees, and the business interests of the regulated may form an "iron triangle": a political subsystem that can subvert public policy in favor of policy choices dictated by select interest groups.[301] The regulation of banks, other financial institutions, and financial markets generally, naturally is more inclined to succumb to these influences because these are "money" industries.[302] Regulation is complicated further due to the presence of deposit insurance, which creates a unique moral hazard because poor banking may lead to costs that the government absorbs instead of making reckless decisions.[303] Federally guaranteed deposit insurance can be a particularly attractive subsidy from a particular lawmaker's point of view; in the vast majority of circumstances the subsidy will never impose any cost upon the government during the lawmaker's life. Typically, deposit insurance is a deferred cost to the government that is imposed only about once a generation.[304] Deposit insurance is illustrative of another dynamic of financial market regulation: the economic stakes can be huge.[305] As is certainly the case in other areas of regulation, this enormous economic power, and the size of the economic stakes, expose a major flaw in our two-party system: a major check in our politi-

301. *See, e.g.*, WORSHAM, *supra* note 4, at 1-19 (citing several other authorities holding this same view).

302. One observer has noted that the Senate Banking Committee is a "money" committee. *See* GREIDER, *supra* note 11, at 66 ("'If you're on Banking or the Finance Committee, you don't even have to open your mouth. They'll throw money at you over the transom.'" (quoting Sen. Bumpers)).

303. *See* CONGRESSIONAL BUDGET OFFICE, THE ECONOMIC EFFECTS OF THE SAVINGS & LOAN CRISIS 11 (1992) (defining "moral hazard" in the context of the savings and loan crisis).

304. *See generally* Grundfest, *supra* note 299, at 25 (assessing the politics of the savings and loan crisis and stating that "under current budgeting procedures some constituencies can manipulate Congress to provide massive private benefits at substantial public cost").

305. *See id.* at 32 (referring to deposit insurance and stating that "few industries have been able to persuade Congress to bankroll them to the tune of up to $500 billion").

cal system can be eliminated if both parties can be co-opted.[306] When combined with low issue saliency, this environment is ripe for special interest abuses. Simply stated: "When it comes to financial regulation, the norm is for business to be conducted by those intimately connected to the enterprise with as little outside involvement as possible."[307]

Professor Jeffrey Worsham has undertaken a detailed study of agency regulation in the context of the banking industry.[308] His conclusions provide a detailed explanation of the dynamics of banking regulation. Though Professor Worsham's study is limited to the banking industry, his findings provide a strong basis for generally explaining the dynamics of financial market regulation. Indeed, history demonstrates that the regulatory maladies he identifies permeate financial market regulation.[309]

Worsham's study offers a number of conclusions that support the thesis of this Article. First, ordinarily the banking industry dominates banking regulation.[310] In a detailed study of the mechanics and output of the legislative process, Professor Worsham concluded that organized interests generally "reign supreme;"[311] that is, the banking industry is at the head of a bank-dominant

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306. One dramatic example of this breakdown in our system is the savings and loan fiasco of the 1980s. Even though a multibillion dollar taxpayer bailout was in the works during 1988, it was not even a minor election-year issue. According to a lobbyist at the American Bankers Association: "Everyone knew [what] the game was: Democrats don't bring this up, Republicans don't bring this up. Because a firefight on this issue will have more bodies on both sides than anyone wants to lose." GREIDER, *supra* note 11, at 73.

307. WORSHAM, *supra* note 4, at 21.

308. *See id.* at 17 ("[T]his study examines the evolution of subsystem arrangements in a single policy area—financial regulation—over a period of roughly 100 years.").

309. *See generally id.* at 24-47 (discussing the role of special interests in financial regulation determination from the mid-1800s to the mid-1900s).

310. *See id.* at 46 ("[B]ank-dominant coalitions are the norm in the financial subsystem."). It is noteworthy that Professor Worsham's analysis assumes that the Fed's independence is the result of a transitory coalition that displaced the bank dominant coalition in the wake of the high issue saliency generated by the Great Depression. *See id.* at 44-45.

311. *Id.* at 83. Professor Worsham's study utilizes a mapping approach to tracking the influence of special interests to specific policy outcomes. He does this by analyzing participation profiles of those participating in congressional hearings, analyzing the source of bills introduced, and analyzing the content of regulatory outputs. *See id.* at 49-85.

coalition that includes the banking industry itself, the federal banking regulators, and congressional committees.[312] This political subsystem produces legislation that benefits banks disproportionately.[313] This is particularly so when legislation can deliver concentrated benefits in exchange for diffuse or deferred costs.[314] For example, the costs of relaxing regulation targeted at the safety and soundness of bank activities are deferred and diffused, while the benefits of relaxation accrue in the form of increased profits to the banking industry.[315] These iron triangle tendencies are inconsistent with sound regulation.[316]

Second, though the bank-dominant coalition is the norm, transitory factors often subvert this coalition's power.[317] Issue salience is the bane of special interests.[318] When issues attract little public attention, special interests can impose their will with relative ease.[319] Conversely, when issues attract a high degree of public interest, special interests can be defeated.[320] Ordinarily, issues relating to financial market regulation do not attract the attention of the public. Thus, the bank-dominant coalition can work its will because of the public's general disinterest in financial market regulation, except in times of financial crises.[321]

Worsham applies his theory, convincingly, to the passage of the Bank Holding Company Act of 1956,[322] by demonstrating

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312. *See id.* at 3 (defining dominant coalitions as consisting of regulators, regulated and congressional elements).

313. *See id.* at 129.

314. *See id.*

315. *See id.* at 103 (noting that bank-dominant equilibrium has little concern for safety and soundness regulation).

316. *See* Roe, *supra* note 13, at 16 (stating that regulation of corporate financial structure is not determined solely by economic efficiency but also by "powerful political constraints").

317. *See* WORSHAM, *supra* note 4, at 130-35.

318. *See id.* at 4 (noting that special interest "coalitions thrive under conditions of little competition and low issue salience").

319. *See* Croley, *supra* note 20, at 5 (explaining that public interest theory suggests that low levels of public scrutiny allows special interests to subvert regulation).

320. *See* Brown, *supra* note 3, at 202-22 (demonstrating how the media can mobilize disorganized majorities). Professor Brown concludes that "public choice theory works best when it analyzes legislative issues that are not important to the majority of voters." *Id.* at 215.

321. *See* WORSHAM, *supra* note 4, at 25.

322. Pub. L. No. 84-511, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-50

that it initially had its genesis in the New Deal initiatives of the 1930s.[323] Because such legislation was introduced in the late 1930s instead of the early 1930s, Worsham concludes that the "subsystem players"—the "regulators and regulated"—were able to prevent any restrictive legislation.[324] By 1938, issue saliency for such reform was simply too low to thwart the special interest subsystem players.[325] By 1956 they were able to modify the New Deal initiative enough to divert the regulatory energy to a fundamentally favorable outcome.[326] In its final form, the Bank Holding Company Act insulated the banking industry from competition against insurance companies, like Transamerica, and generally expanded the powers of banks.[327] Subsystem players—specifically the banking industry and its regulators—were able to achieve a result that protected the competitive turf of the banking industry and expanded investment opportunities.[328] To secure the Act's passing, the Fed acceded to the American Bankers Association's insistence that the Act include a loophole for bank holding companies owning a single bank.[329] This was key because it resulted in expanded bank activities;[330] hence, the original New Deal initiative of curtailing bank holding companies to achieve a safer and sounder banking system was subverted completely.[331]

Economic dislocation can create political pressure for reform and lead other political actors, like the President, to wrest power from the bank-dominant coalition.[332] The Great Depression led to the New Deal, which emphasized safety and soundness in

(1994)).

323. *See* WORSHAM, *supra* note 4, at 89-92.

324. *Id.* at 92.

325. *See id.* at 103.

326. *See id.* at 104.

327. *See id.* at 103-05; *see also* John D. Hawke, Jr., *Reflections on the Ongoing Effort to Modernize Financial Services Regulation*, 49 MERCER L. REV. 777, 777 (1998) (stating that the Bank Holding Company Act has "served principally to divide markets among politically influential segments of the financial services industry").

328. *See* WORSHAM, *supra* note 4, at 104.

329. *See id.* at 103.

330. *See id.*

331. *See id.*

332. *See id.* at 131.

regulation.[333] The banking industry's ability to influence regulation receded and a variety of significant reforms, including the abolition of the state and federal dual regulatory regime, made it onto the congressional agenda.[334] Transitory factors other than economic dislocation may increase the salience of a particular issue of bank regulation.[335] For example, the bank bailout crisis of the 1980s produced major legislation that dramatically restructured the regulatory environment, and even abolished key parts of the iron triangle.[336] Although these transitory factors occasionally serve to reduce industry domination, they do not assure that regulation is sound fundamentally or that our system of financial regulation is the best economically.[337] For example, although political concerns awakened Congress to the savings and loan industry pillaging the Treasury, there was no real systematic review of deposit insurance and government guarantees in order to assure that this form of subsidy was well-controlled and dispensed only in appropriate circumstances.[338]

Professor Worsham's findings can be extended from banking regulation to financial market regulation generally. Specific examples of subsystem and iron triangle regulation can be drawn from the corporate governance area, the securities regulation area, and more recent forays of Congress into the financial institution reform area. All of these examples demonstrate that in a political environment financial market regulation is subject to "capture" by the very interests that are supposed to be regulated. Concentrated benefits are extended to these interests in exchange for deferred and diffused costs. Economic dislocation or issue salience may counteract these tendencies, but—given the

333. *See id.* at 41-43.

334. *See id.* at 40.

335. *See id.* at 11, 135.

336. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 401(a) 103 Stat. 183, 354 (codified in scattered sections of 12 U.S.C.) (abolishing the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation); *see also* Grundfest, *supra* note 299, at 31-32 (arguing that political consequences of the savings and loan debacle caused Congress to exact retribution against the savings and loans industry and its lobbying organization).

337. *See* Roe, *supra* note 13, at 65-67.

338. *See* Grundfest, *supra* note 299, at 32-33 (analyzing risks from $750 billion in loan guarantees).

complexity of the subject matter and the rapid evolution of the regulatory environment—increased public awareness does not necessarily restore sound regulation.

Transitory factors are also important in attracting the attention of the President.[339] President Roosevelt was the agenda setter and ultimate source of political muscle that reformed the nation's financial structure in the wake of the Great Depression.[340] In terms of the structure of our financial regulation regime, presidential leadership has been essential historically. For example, President Wilson was a primary supporter of the Federal Reserve Act and President Roosevelt was the primary mover behind the New Deal Bank regulatory initiatives as well as the federal initiative to regulate the securities markets.[341] Presidents, though, are busy and easily distracted by foreign affairs or other matters.[342] The natural consequence is that in the absence of transitory presidential interest, policy is subject to domination by special interests.

The enactment of the Private Securities Litigation Reform Act of 1995 (PLSRA)[343] demonstrates these points. This Act quite simply stacked the deck against private securities plaintiffs in order to protect powerful business interests from the costs of litigation.[344] Congress passed this Act even though there was no convincing empirical support of any need for such regulation[345] and even though there was no evidence that the business interests pushing for the "Reform Act" were suffering unjustifiably.[346] Commentators had argued that the private securities litigation system suffered from problems of extortionate settlements,

339. *See* WORSHAM, *supra* note 4, at 46.
340. *See id.*
341. *See id.*
342. *See id.* at 103-04.
343. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.).
344. *See* Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1093 (1999) (concluding that the PSLRA "merely rigs private securities claims so that defendants almost always win").
345. *Private Securities Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of Senate Comm. on Banking, Hous. and Urban Affairs*, 103d Cong. 114 (1993) (statement by SEC Enforcement Director William R. McLucas that the SEC staff found evidence of a securities litigation crisis "inconclusive").
346. *See* Ramirez, *supra* note 344, at 1085-87.

which in turn caused economic damage.[347] Nevertheless, the remedies for such problems far exceeded these justifications.[348] Indeed, Congress could have remedied these problems with far more narrow solutions—such as imposing a mandatory arbitration regime—but chose instead simply to rig such litigation in favor of defendants.[349] These putative defendants essentially captured Congress through a concerted, well-funded lobbying effort.[350] They received rather concentrated benefits in the form of relief from litigation costs. The cost of these benefits were deferred by a slow erosion of investor confidence and diffused throughout the investing public.[351] Although such costs may come due only once a century, when they are paid, the viability of capitalism itself can be called into question.[352] Although the issue reached some level of saliency, public resistance was muted by portraying the Act as aimed at "entrepreneurial lawyers."[353] Consequently, the PSLRA is an exemplary case of congressional capture.[354] In the final analysis the public could not comprehend the complexity of the issue and had little incentive to resist the vested business interests.[355] The SEC, the primary securities

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347. *See id.* at 1055-56 n.1.

348. *See id.* at 1093; *see also* Office of the Gen. Counsel, Sec. and Exch. Comm'n, *Recent Legislative Developments Affecting the Work of the Securities and Exchange Commission, in* 2 THE SEC SPEAKS IN 1996, at 647, 651 (1996) (stating that the PSLRA includes provisions that "extend[ ] beyond frivolous litigation").

349. *See* Ramirez, *supra* note 344, at 1095-96.

350. *See id.* at 1087 n.156.

351. Congress has emphasized investor "protection" as an important, even compelling, policy objective because "it is a basic teaching of this nation's financial history that continued economic health fundamentally depends upon the maintenance of investor confidence." H.R. REP. NO. 94-123, at 43-44 (1975); *see also* H.R. REP. NO. 73-1383, at 5 (1934) (emphasizing the importance of investor confidence to the stability of our economic system).

352. *See* 15 U.S.C. § 78b (1994) (stating that securities markets are "frequently" subject to manipulation, excessive speculation, and unreasonable fluctuations causing national economic emergencies).

353. Ramirez, *supra* note 344, at 1069 n.50.

354. *See* GREIDER, *supra* note 11, at 39 ("[I]t is not an exaggeration to say that democracy itself has been 'captured.'").

355. *See, e.g.*, Ann Reilly Dowd, *Look Who's Cashing in on Congress*, MONEY, Dec. 1997, at 132 (listing the PSLRA as the best example of the relationship between laws, money, and lobbying, noting that the PSLRA was backed by a $29.6 million war chest); *see also* 141 CONG. REC. S17,976 (daily ed. Dec. 5, 1995) (statement of Sen. Boxer) (citing *USA Today* for the proposition that the PSLRA was a "blatant payoff" for campaign contributions from powerful business interests).

regulator, did not retain sufficient agency power to define investor remedies.[356] Consequently, the special interests prevailed.

Another problem area for the SEC has been staffing. In the early 1980s, when deregulation was in vogue, SEC staffing suffered. Unfortunately, the securities markets were just beginning an era of expansive growth.[357] The SEC found itself seriously underfunded.[358] The Reagan Administration's emphasis on deregulation, backed by incomplete scholarly exposes on the problems plaguing regulatory agencies, thus left financial markets woefully underpoliced at a critical time.[359] Frauds of unprecedented magnitude resulted.[360] Michael Millken devised a new type of securities market, for junk bonds, built upon a "foundation of fraud and manipulation."[361] The SEC eventually uncovered a multibillion dollar investment scheme that Prudential-

356. For its part, the SEC has, over the years, taken apparently inconsistent positions on the whole issue of private securities litigation reform. *See, e.g.*, Paul Beckett, *Levitt's Stance on Reform Act Surfaces Again*, WALL ST. J., Nov. 3, 1997, at B12; *see also supra* notes 158-69 (detailing further the SEC's role in legislative reform). It is clear that the SEC did not support the PSLRA. *See* Office of Gen. Counsel, Sec. and Exch. Comm'n, *supra* note 348, at 651 (stating that the bill extended beyond its policy basis, and would have a negative effect on meritorious claims). Unfortunately, the final letter that SEC Chair Arthur Levitt sent to Congress regarding the PSLRA failed to voice any sign of objection from the SEC, instead stating that the bill addressed "[our] principal concerns." 141 CONG. REC. S17,935 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato). In fact, the press reported that the SEC supported the PSLRA only after it had been threatened with budget cuts and other forms of congressional penalties. *See* Scot J. Paltrow, *SEC Chief Shift on Investor Bill Is Linked to Senate Pressure*, L.A. TIMES, Nov. 22, 1995, at D1 (quoting Andrew R. Vermilye, legislative director to Senator Richard H. Bryan, that Senators "threatened to turn off the lights" at the SEC). Ultimately, without denying that political pressure was applied, Levitt made clear that he opposed the PSLRA. *See* 141 CONG. REC. S17,994 (daily ed. Dec. 5, 1995) (statement of Sen. Bryan). The SEC's inability to object forcefully to the PSLRA betrays its lack of real independence.

357. *See* H.R. REP. NO. 98-101, at 1-5 (1983) (noting that the SEC enforcement budget declined by 11% from 1979-83, during a time period when public offerings increased by 96% and trading volume in securities increased 82%); *see also The Market Reform Act of 1989: Joint Hearings Before the Subcomm. on Sec. and the Sen. Comm. on Banking, Hous., and Urban Affairs*, 101st Cong. 11 (1989) (statement of Sen. Sasser) [hereinafter *Joint Hearings*] (noting approval of 18% increase in SEC funding after it was "underfunded throughout the 1980s at a time when volume and complexity in the markets has increased enormously").

358. *See Joint Hearings*, *supra* note 357.

359. *See, e.g.*, Croley, *supra* note 20, at 166-68.

360. *See* Ramirez, *supra* note 344, at 1089-91.

361. *Id.* at 1090.

Bache Securities fraudulently sold to thousands of retirees and other conservative investors, involving a web of scandal-ridden limited partnerships.[362] Vast networks of nefarious insider trading festered in the darkness of deregulation.[363] Though the costs of this debacle are difficult to calculate, the carnage in terms of real lives ruined is astounding.[364]

Another area that demonstrates the distorting effects of politics upon financial regulation is our nation's fragmented financial regulatory structure. Professor Roe, for example, has demonstrated persuasively that corporate finance has been influenced by political factors that have prevented corporate finance from evolving in accordance with economic pressures.[365] Professor Roe focused on populist and progressive distortions of financial market structure, convincingly demonstrating that these elements, suspicious of concentrated financial domination by "Wall Street," influenced the structure of corporate finance.[366] Other important elements have similarly distorted financial regulation. For example, financial institutions themselves work to decentralize regulatory power and protect their turf from other potential competitors.[367] It is an open secret that the insurance industry would rather be regulated by "50 monkeys than one big gorilla."[368] Thus, industry too seeks to fragment regulatory power, even if indirectly so, and to take advantage of the regulatory permissiveness that results. Industry also seeks fragmentation because of the ease of wielding political influence at the state

362. *See id.*

363. *See id.*

364. *See id.*; *see also* 141 CONG. REC. S17,945 (daily ed. Dec. 5, 1995) (statement of Sen. Bryan); John R. Emshwiller, *How Career Swindlers Run Rings Around SEC and Prosecutors*, WALL ST. J., May 12, 1995, at A1 (reporting the suicide of a Missouri farmer who was wiped out by a securities swindler).

365. *See* Roe, *supra* note 13, at 11 (attributing the fragmentation of financial institutions to politics).

366. *See id.* at 32-45.

367. *See id.* at 45-53 (stating that "interest group pressures were critical" to the political efforts to fragment financial power, small banks wanted to hobble large money center banks, and managers would resist the ability of financial institutions to monitor their control of industry).

368. Scot J. Paltrow, *The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls*, WALL ST. J., Feb. 5, 1998, at A1 (noting concerns about states' ability to regulate insurance).

level. As previously discussed, the Bank Holding Company Act is a piece of this same dynamic.[369]

For example, the United States traditionally has had a dual federal-state system of bank regulation.[370] This system has spawned regulatory permissiveness and competition that has imposed real costs upon the United States taxpayer.[371] During the 1980s, when the savings and loan crisis was brewing, a number of states began to deregulate their savings and loans.[372] California, home of the infamous Lincoln Savings, and Texas were in the vanguard of this movement.[373] California allowed thrifts chartered in that state to operate "virtually free of any constraints."[374] Of course, in light of federal deposit insurance, there were few incentives for states to be concerned about prudential regulation of state-chartered thrifts. As long as the federally backed deposit insurance fund bore responsibility for making good the losses of a failed state-chartered thrift, "there was no great incentive for many state legislators to deny the sweeping demands for additional investment powers made by the thrift industry."[375] California also slashed its regulatory personnel and granted their state-chartered thrifts expansive invest-

369. *See supra* notes 322-31 and accompanying text.

370. *See generally* Howard H. Hackley, *Our Baffling Banking Industry*, 52 VA. L. REV. 565, 568, 597 (1966) (tracing development of the dual banking system and discussing regulatory competition between state and federal systems as well as among federal regulators). There is little logic to the regulatory structure of the banking industry. It has long been recognized that the hodge-podge structure of state and federal regulators has produced inefficiencies and conflict. *See* DE SAINT PHALLE, *supra* note 88, at 39; *see also* Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 30-36 (1977) (demonstrating through an empirical study that regulatory competition exists).

371. As early as 1949, the Hoover Commission sounded the alarm on the deleterious effects of the "crazy quilt of overlapping jurisdictions" among state and federal bank regulators. *See* HOOVER COMMISSION REPORT, *supra* note 64, app. N. at 116. The Hoover Commission stated that this dispersion of regulatory power could well lead to a future banking crisis and recommended that regulatory power be consolidated. *See supra* note 370.

372. *See* Edwin J. Gray, *Warnings Ignored: The Politics of the Crisis*, 2 STAN. L. & POL'Y REV. 138, 139 (1990).

373. *See id.*; *see also* Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1, 45 (1996) (discussing deregulation in Texas).

374. Gray, *supra* note 372, at 139.

375. H.R. REP. NO. 101-54, pt. 1, at 297 (1989).

ment powers.[376] California allowed its thrifts to operate everything from windmill farms to horse-breeding operations.[377] According to Edwin Gray, Chairman of the Federal Home Loan Bank Board (FHLBB), during the early 1980s, such promiscuous lawmaking was the natural cause of the dual-chartering system: "the only motivation for [dual-chartering] seems to have been to provide . . . political contributions from those who are regulated for persons who make and administer state thrift laws."[378] Ultimately, taxpayers from coast to coast paid for this folly. In 1988 alone, state-chartered thrifts in Texas and California accounted for seventy percent of the Federal Savings & Loan Insurance Corporation's expenditures.[379] This sordid episode of regulatory competition occurred even though scholars had long catalogued, and warned of, the problems arising from such competition.[380]

Even beyond regulatory competition, politics was the driving force in the spectacular regulatory failure leading to the savings and loan crisis of the 1980s.[381] Indeed, there is now a growing consensus that that much of the $1 trillion in costs arising from this debacle is attributable to political distortions of regulatory policy.[382] These political distortions have their origins in severe

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376. *See* Gray, *supra* note 372, at 139.

377. *See* H.R. REP. NO. 101-54, pt. 1, at 297; Gray, *supra* note 372, at 140.

378. Gray, *supra* note 372, at 141; *see also* Scott, *supra* note 370, at 1-2 (quoting Fed officials on the dangers of dual banking regulation).

379. *See* H.R. REP. NO. 101-54, pt. 1, at 297.

380. *See* Hackley, *supra* note 370, at 568 (noting that many commentators have voiced concern over competition). Not all commentators accept that regulatory competition is necessarily pernicious. Professors Butler and Macey have shown, however, that in the context of federal deposit insurance, regulatory competition results in "race in laxity." *See, e.g.*, Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 680 (1988). This Article takes the position that at least a number of instances of regulatory dysfunction in the financial arena can be explained best from the perspective of regulatory competition, or a regulatory race to the bottom. *See id.* More recently, one commentator has observed: "With regard to traditional bank activities, the current system fosters competition between regulators." Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 460 n.128 (1998); *see also* Langevoort, *supra* note 8, at 685-87 (discussing regulatory competition in the banking industry and analyzing the race to the bottom by states in eliminating usury protections).

381. *See* Grundfest, *supra* note 299, at 29 ("[O]verall it would be hard to find a better example of the 'capture' hypothesis than the relationship that existed between the [savings and loan industry] and the FHLBB.").

382. *See, e.g.*, Robert E. Litan, *Comment on Political Foundations of the Thrift*

failures by Congress as well as the primary thrift regulator, the FHLBB, to resist the political influence of the savings and loan industry.[383] One of the fundamental reasons why the savings and loan crisis grew into such a large problem was because of political decisions made to deprive regulators of the funding necessary to resolve the crisis, and deregulation initiatives that supposedly would open more opportunities to thrifts but really just exposed them to greater risks.[384] Insolvent depository institutions cannot be closed without adequate funds because depositors must be given the benefit of deposit insurance payments to the extent deposit liabilities exceed assets.

Depriving regulators of the funds needed for the shutdown of insolvent thrifts allows only losses to mount because it is exceedingly difficult for a depository institution to make money when it has more liabilities than assets. Banks survive on the margin by which income on assets exceeds the cost of liabilities,[385] so it helps to have more assets than liabilities. Similarly, allowing an industry that traditionally had made mortgage loans upon the collateral of single-family residential homes to suddenly assume riskier lending that the industry is ill-prepared to underwrite and manage is a certain way to increase losses. Together, deferring the shutdown of ailing thrifts and at the same time expanding the risks they could undertake proved a volatile mix.

The thrift crisis had its genesis in the high interest rates of the late 1970s.[386] Most thrift assets were long-term, low-interest

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Debacle, *in* POLITICS AND ECONOMICS IN THE EIGHTIES 209-14 (Alberto Alesina & Geoffrey Carliner eds., 1991) ("Romer and Weingast are correct when they argue that the fundamental causes of the thrift mess are political rather than economic or criminal."); Romer & Weingast, *supra* note 58, at 178 (arguing that special interests influenced Congress to delay remedial legislation and tolerate assumption of excessive risks by thrifts); *see also* GREIDER, *supra* note 11, at 60 ("Leaving aside the financial and economic complexities, the savings and loan bailout is most disturbing as a story of politics—a grotesque case study of how representative democracy has been deformed.").

383. *See* Grundfest, *supra* note 299, at 26.

384. *See* Romer & Weingast, *supra* note 58, at 186 (noting that the Reagan administration was adverse to additional funding); *see also* H.R. REP. NO. 101-54, pt. 1, at 301, 305 (1989).

385. "Banks buy what they lend and live off the 'interest differential' between the price they pay and the price they charge." MARTIN MAYER, THE BANKERS 553 (1974).

386. *See* NATIONAL COMM'N ON FIN. INSTITUTION REFORM, RECOVERY AND ENFORCE-

rate home mortgages.[387] Most thrift liabilities were short-term deposits.[388] When short-term interest rates soared, thrifts hemorrhaged money; most of their assets were locked in at low rates while the cost of their liabilities soared.[389] By 1981, the industry's net worth had evaporated.[390] In accordance with then prevailing political winds, the initial response to this problem was to deregulate the industry.[391] In 1982 the Garn-St. Germain Depository Institutions Act became law and the scope of thrift activities expanded.[392] This initially caused a huge growth in industry assets. Indeed, while industry assets grew by fifty percent between 1982 and 1984, the staffing of thrift regulatory agencies stagnated in accordance with deregulation vogue.[393] The FHLBB, the primary industry regulator, requested a significantly increased budget for 1985, which the Reagan Administration rejected.[394] Indeed, according to Edwin Gray, he "begged" annually for more supervisory personnel to regulate the burgeoning thrift industry, but the Reagan Administration responded by questioning his loyalty to its deregulation agenda.[395]

The FHLBB certainly did not have clean hands in this fiasco. Instead, the FHLBB was a willing participant in a convoluted scheme to sweep the thrift crisis under the carpet.[396] In the early

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MENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A REPORT TO THE PRESIDENT AND CONGRESS OF THE UNITED STATES 5, 29-32 (1991) [hereinafter NATIONAL COMM'N].

387. *See* LAWRENCE J. WHITE, THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK & THRIFT REGULATION 61-65 (1991).

388. *See id.*

389. *See* H.R. REP. NO. 101-54, pt. 1, at 291.

390. *See* Romer & Weingast, *supra* note 58, at 176.

391. Although deregulation may be appropriate in some arenas, as will be shown, it has not tested well in the financial market regulatory context. *See infra* notes 450-66 and accompanying text. In any event, according to former White House Press Secretary Michael McCurry, industry calls for deregulation are difficult to resist: "If you come back from your fifth fund-raising trip of the year, where you schlepped up and down Wall Street with your tin cup, then you listen [to] . . . their arguments about the efficiency of financial deregulation and so forth, you begin to say, yeah, they've got a point." GREIDER, *supra* note 11, at 259.

392. *See* Romer & Weingast, *supra* note 58, at 177.

393. *See id.* at 187.

394. *See id.*

395. *See* Gray, *supra* note 372, at 141.

396. *See* Grundfest, *supra* note 299, at 29-30.

1980s it was clear that the savings and loan industry was in the midst of a deepening crisis.[397] Still, if the most insolvent thrifts had been closed at this point, tens of billions of dollars could have been saved. Industry lobbying groups persuaded the FHLBB to adopt new accounting standards called "Regulatory Accounting Principles."[398] This accounting approach allowed losses to be transformed into assets by allowing thrifts to spread certain losses over a period of up to forty years.[399] This masked the worsening financial condition of the industry and allowed institutions that should have been shut down to remain in business.[400]

Predictably, this led to disaster. When financial institutions are near insolvency, deposit insurance creates perverse incentives. Naturally, banks are drawn to high-risk ventures because the insurance fund absorbed losses, whereas profits will allow management to continue.[401] Some commentators term this moral hazard "gambling for resurrection."[402] This is not a new concept. The Council of Economic Advisors specifically warned the President of these problems in both 1984 and 1985.[403] When these risks fail to save the bank, but instead plunge it deeper into insolvency, things go from bad to worse. The fact that a bank survives on the extent to which its income on its assets exceed the costs of its liabilities means that when liabilities are greater than assets it is difficult to turn a profit. The thrift industry consequently lost $7.8 billion in 1987 and $12 billion in 1988.[404]

These two factors, gambling for resurrection and the acceleration of negative net worth, meant that it was crucial that fail-

397. *See* NATIONAL COMM'N, *supra* note 386, at 43.

398. *See id.* at 43-55.

399. *See id.*

400. H.R. REP. NO. 101-54, pt. 1, at 297-98 (1989) (summarizing major provisions of regulatory accounting principles and stating that it "played a central role in the thrift crisis").

401. *See* Grundfest, *supra* note 299, at 32 ("[T]he banking industry's insurance fund is not as solvent as it seems, and [analysts] have sounded warnings that 'more than 1,000 banks with about one-half of the nation's banking assets [are] undercapitalized.'").

402. Romer & Weingast, *supra* note 58, at 175, 177-78.

403. *See id.* at 186.

404. *See id.* at 201.

ing banks be closed quickly and the bleeding stanched. In the thrift crisis, politics prevented any quick resolutions of failing thrifts and instead imposed a policy of forbearance.[405] As early as 1985 the Chairman of the FHLBB was pleading for more funds to shut down more failing thrifts.[406] In 1986, bills that would have recapitalized the deposit insurance fund, which in turn would have funded more thrift shutdowns, died, giving thrifts de facto forbearance from regulatory closure.[407] In 1987, a bill that would have allowed an additional $15 billion to be used to close thrifts failed to pass Congress.[408] Econometric studies of the vote on this bill show that legislators' votes were "clearly related" to the thrift constituents within each legislator's district.[409] Finally, in 1987, Congress raised the borrowing limit for the deposit insurance fund to $10.8 billion, but at the time the fund was $6 billion in the red and faced $50 billion in future claims.[410] This was a classic case of too little, too late.

Eventually, Congress fully funded the costs of the savings and loan crisis in 1989, at a total cost to the taxpayer of about $200 billion.[411] The policies of deregulation and forbearance had their source in both Congress and the Reagan Administration.[412] The policy of forbearance responded to two important impulses. First, the savings and loan industry did not want to recognize

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405. *See id.* at 176 ("We argue that Congress was the major source of regulatory forbearance during the crucial period of 1985-1987.").

406. *See id.* at 177.

407. *See id.* at 192-94.

408. *See id.* at 195-96.

409. *Id.* at 195-200; *see also* Steve Blakely, *Panel Approves $5 Billion FSLIC Rescue Plan*, 1987 CONG. Q. WKLY. REP. 635 (reporting lobbying efforts by the savings and loan industry in opposition to FSLIC funding).

410. *See* Romer & Weingast, *supra* note 58, at 200.

411. *See id.* at 201. Actually, this does not include the nearly $500 billion in foregone output that the Congressional Budget Office attributes to the savings and loan mess. Nor does it include the hundreds of billions of dollars that will be paid in interest as a result of the government's decision to finance the cost of the bailout over periods of up to 40 years. *See* Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625, 629 (1996).

412. Representative Jim Leach, a member of the House Banking Committee, remarked that the savings and loan crisis was "a wonderful story about the nature of modern politics. Why is it so hard for the Congress to do something for the public?" GREIDER, *supra* note 11, at 65.

widespread shutdowns.[413] Second, the politicians did not want to explain the crisis in an election year. Indeed, the politicians appear to have worked deliberately to put off any day of reckoning until after the 1988 election.[414] The FHLBB fought this policy. The President's economists warned of the problems inherent in forbearance. The politicians trumped the experts and the American taxpayers suffered greatly. The savings and loan crisis essentially was a politically generated crisis. Certainly, there are important economic factors underlying this crisis, but fundamentally promiscuous congressional attitudes allowed the crisis to transmogrify from an industry crisis to a crisis of government that resulted in hundreds of billions of dollars in losses to the United States Treasury.[415] The thrift crisis is best viewed as a natural consequence of what happens when a major financial services industry controls its regulators[416] and co-opts Congress.[417]

The same issues giving rise to the savings and loan crisis also have coalesced to create a compensation crisis in corporate America and to allow managers of the nation's largest corporations to shirk fiduciary duties. It has been an amazing dynamic: managers have simultaneously redoubled their compensation while striving to constrict their legal duties to almost nothing. The great majority of states now allow managers to contract

413. M. Danny Wall, the Chairman of the FHLBB in 1987, stated: "The industry was saying very uniformly but quietly that we want to wait for the next President." *Id.* at 71.

414. *See id.* at 60-78.

415. One notorious example of politicians exacerbating the crisis is the celebrated Keating Five scandal of 1990. A bipartisan group of five legislators intervened on behalf of Charles Keating, who controlled the poorly operated Lincoln Savings & Loan, in order to seek regulatory forbearance. Ultimately Lincoln failed at a cost to the taxpayers of $1 billion. *See id.* at 27 (noting that no charges were brought against the Senators).

416. "The U. S. League . . . was so mighty that it regularly got its pick of regulators," or, as former Chairman Ed Gray stated: "I was to be their patsy." Brooks Jackson & Paulette Thomas, *Waning Power: As S&L Crisis Grows, U.S. Savings League Loses Lobbying Clout*, WALL ST. J., Mar. 7, 1989, at A1.

417. *See Findings of Booz-Allen and Hamilton Study of FHLBB: Hearings Before the Subcomm. on Gen. Oversight and Investigations of the House Comm. on Banking, Fin. and Urban Affairs*, 100th Cong. 30 (1987) (statement of Henry B. Gonzalez) ("Everything the industry has wanted the Congress has rolled over and given it to them . . . and the results are plain.").

away the duty of care.[418] Duty of loyalty violations typically require a corporate insider to obtain an improper benefit at the expense of the corporation, and therefore usually involve intentional wrongdoing.[419] Short of this, shareholders usually cannot recover against corporate managers for losses incurred.[420] All of this occurred at the state level, and is a direct result of the fact that states have long been in a race to the bottom of corporate standards.[421]

The SEC, even though Congress created it to assure that investors could rely upon "fair and honest markets," has no power to define the rights of investors as shareholders nor the duties of those who manage publicly held companies.[422] Instead, the critical issues of shareholder rights and management duties are left primarily to state law. Theoretically, if securities markets were competitive markets operating efficiently, those corporations choosing inferior state law governance schemes would be punished and their stock price would suffer.[423] Eventually, these firms would face higher costs of capital and would suffer from competitive damage.[424] Thus, over time, markets would assure that corporations with public ownership chose the most efficient

418. *See* James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1209-21 (1988) (analyzing state legislation over a three-year period that allowed restricted officer and director duties in 40 states).

419. *See id.* at 1209-16.

420. *See* 1 AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1994) [hereinafter ALI PRINCIPLES] (imposing liability only for irrational business judgments). Even the ALI is apparently subject to political pressure. *See* Alex Elson & Michael L. Shakman, *The ALI Principles of Corporate Governance: A Tainted Process and a Flawed Product*, 49 BUS. LAW. 1761, 1763-68 (1994).

421. *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (noting that Delaware is in the lead in the race to the bottom); *see also* Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 220 (1996) ("If CEOs are overcompensated it is because of a deficiency in corporate governance, not because of a deficiency in our income tax laws."). Professor Lowenstein criticizes the efforts of the SEC and IRS to deal with excessive compensation, and instead proposes limited federal action to require shareholder approval of CEO compensation. *See id.* at 221-23.

422. 15 U.S.C. § 78b (1994).

423. *See* Ralph K. Winter, *State Law, Shareholders Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977).

424. *See id.* at 257-58.

state of incorporation to take advantage of the best rules of corporate governance.[425]

The reality is that investors neither care about nor have the ability to judge the state of incorporation and the impact that this has either upon their rights or profits. There is therefore little empirical evidence showing that markets integrate a state of incorporation or change in corporate governance into stock prices.[426] One study shows that firms that reincorporated in Delaware showed no statistically significant impact upon their stock prices.[427] Perhaps the most persuasive evidence on this issue, however, is what has occurred in the laboratory of reality. "The most distinctive aspect of the last decade in corporate law was the celerity with which traditional constraints on corporate managers weakened."[428] This rapid change, after decades of stability, on many different fronts, has the look more of politics at work than markets at work.[429] What is theoretically efficient in 1999, was theoretically efficient in 1979.

Nowhere have the results of this regulatory competition been more pronounced than in the area of executive compensation, which in recent years has increased rapidly.[430] The erosion of

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425. *See id. passim* (arguing that market forces do not always result in a race to the bottom).

426. *See* LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS 563 (1996) (summarizing empirical studies and concluding that the studies cast doubt on whether stock prices reflect governance terms); *see also* Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Change" in Corporate Law*, 75 CAL. L. REV. 551, 601 (1987) (showing that "investors do not view the Delaware courts' decisions as events").

427. *See* Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulations*, 53 J. BUS. 259, 281-82 (1980) (finding that such firms also failed to sustain supranormal returns).

428. Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 949 (1990). Professor Seligman notes three legal developments as the source of increasing laxity in manager duties. First, are the recent restrictions in shareholder suffrage. *See id.* at 949-56. Second, is the decline of tender offers as a source of discipline. *See id.* at 956-66. Third, is the decline of shareholder litigation. *See id.* at 966-71. Each of these is consistent with the point here that managers are simply not subject to the same constraints as in the past.

429. *See* Elson & Shakman, *supra* note 420, at 1763-68; *see also* Hanks, *supra* note 418, at 1209 ("[T]he first state to respond to the developments of the mid-1980's was Indiana, in April 1986, followed by Delaware in June. Since then, forty other states have adopted some form of legislation designed to reduce the risk of directors' personal liability for money damages.").

430. *See* Linda J. Barris, *The Overcompensation Problem: A Collective Approach to*

fiduciary duties has given managers and boards greater latitude in setting their compensation.[431] Even respected business journals have raised serious questions about the risks posed by runaway compensation, particularly stock options.[432] These risks can include unwarranted market disruptions and even recession of the general economy.[433] The idea of federal incorporation of

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Controlling Executive Pay, 68 IND. L.J. 59, 100 (1992) (calling for courts to cease using the business judgment rule to shield excess compensation in all cases). Between 1983 and 1993 real annual pay for CEOs increased 70%. *See* MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 9 (1995); *see also* Stacey Tevlin, *CEO Incentive Contracts Monitoring Costs, and Corporate Performance*, NEW ENG. ECON. REV., Jan.-Feb. 1996, at 39 ("The after-tax real wage of the average worker in the United States has fallen 13 percent in the last 20 years, while the average . . . CEO . . . has received a pay raise of over 300 percent."). There is good news on the issue of executive compensation. Specifically, it appears that compensation is positively correlated to the performance of a company. *See* John F. Boschen & Kimberly J. Smith, *You Can Pay Me Now and You Can Pay Me Later: The Dynamic Response of Executive Compensation to Firm Performance*, 68 J. BUS. 577 (1995) (finding pay correlated to performance). Nevertheless, this correlation fails to resolve the question of whether lax fiduciary duties have allowed unnecessarily high compensation, even if correlated to a company's success. If corporate managers can use their newfound advantages to garner higher wages across the board, then positive correlation is meaningless, because such a dynamic will compromise international competitiveness and contribute to domestic inequality.

431. *See* Loewenstein, *supra* note 421, at 202 ("I suggest that no clear answer emerges from empirical work as to whether CEOs are over compensated but that apparent deficiencies in corporate governance support the popular perception that they are."); *see also* 1 ALI PRINCIPLES, *supra* note 420, §§ 5.03, 7.19 (1994) (stating restrictions applicable to compensation challenges).

432. *See* James Champy, *Taking Stock: Management Strategies*, FORBES, Oct. 19, 1998, at 107 (stating that payment through options can encourage unneeded layoffs); Editorial, *Cream: Further Evidence on Incentives and Fat Cats*, ECONOMIST, May 4, 1996, at 12 (criticizing the use of stock options to give excessive compensation to CEOs and citing studies showing that CEOs with small stakes in their firm perform well, but that giving CEOs a large stake can "dampen their entrepreneurial zeal"); *see also* Gretchen Morgenson, *Stock Options Are Not a Free Lunch*, FORBES, May 18, 1998, at 212 (stating that stock options are diluting earnings and are accounted for in ways that overstate earnings).

433. *Cf.* SHELDON DANZIGER & PETER GOTTSCHALTE, AMERICA UNEQUAL 1-14 (1995) (showing that income inequality is greater than any time other than immediately before the Great Depression); SEYMOUR HARRIS, SAVING AMERICAN CAPITALISM (1948) (arguing that disparity in income distribution lowered the average propensity to consume and contributed to the Great Depression). The causes of the Great Depression are complex and controversial. *See generally* MICHAEL A. BERNSTEIN, THE GREAT DEPRESSION 1-20 (1987) (reviewing various theories of the causes of the economic disruptions of the 1930s). Nevertheless, in light of this uncertainty, it would seem

the nation's largest industrial concerns has a long and storied past. The earliest proponents of federal incorporation included John D. Rockefeller and representatives of J.P. Morgan's interests.[434] Although this Article does not necessarily argue for a federal incorporation regime, it does argue that fragmenting regulatory power over corporate governance, for publicly traded corporations, can lead to unhealthy regulatory competition and erodes the ability of the SEC to discharge its basic mission of investor protection. Thus, this is yet another area where regulatory consolidation in an expert agency, like the SEC, can be expected to pay dividends.

The most recent political failures, however, are in many ways the most telling. In the summer of 1999, many observers were hopeful that American financial institutions would finally be subject to a regulatory framework that recognized the modern competitive realities of the financial services industry.[435] A bill that will greatly ease obsolete regulatory restrictions, S. 900,

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most sensible to avoid all of the economic imbalances that accompanied the Great Depression, including severe income inequality. Along these lines, it is interesting to note that those who were charged with resolving the Great Depression, attacked the problem on many fronts, including fighting the maldistribution of income, which they seemed to intuitively understand as one factor leading to the Great Depression. For example, when Senator Wagner introduced the National Labor Relations Act in 1935, he stated:

> When wages sink to low levels, the decline in purchasing power is felt upon the marts of trade. And since collective bargaining is the most powerful single force in maintaining and advancing wage rates, its repudiation is likely to intensify the maldistribution of buying power, thus reducing standards of living, unbalancing the economic structure, and inducing depression with its devastating effect upon the flow of commerce.

79 CONG. REC. S7572 (1935) (address by Sen. Wagner introducing the National Labor Relations Act, May 15, 1935). From the point of view of international competitiveness, American CEOs earn almost twice as much as CEOs in other free-market economies. *See The Need for Greed*, ECONOMIST, May 4, 1996, at 80. This fact also seems to rebut any argument that CEO compensation levels are the result of market pricing. *Cf.* JAMES K. GALBRAITH, CREATED UNEQUAL: THE CRISIS IN AMERICAN PAY 263 (1998) (analyzing the causes and risks of growing income inequality in America and concluding that "we need a rebellion now").

434. *See* KOLKO, *supra* note 169, at 63-64.

435. *See* Michael Schroeder, *Financial Services Bill, Buoyed by Vote in House, May Reach Clinton Before Fall*, WALL. ST. J., July 6, 1999, at A3 (noting the enthusiasm of lawmakers, administrative officials, and others for the possible passage of financial regulation).

wound its way through Congress and competing blocks of special interests.[436] For many decades politics had foiled financial institution regulatory reform.[437] Although the political gridlock preventing financial institution modernization was finally broken, despite a long history suggesting otherwise,[438] regulatory modernization to accommodate these changes appears to have been an afterthought.[439]

The quest for financial institution regulatory modernization aptly illustrates the pernicious effects of regulatory competition. All commentators and regulators agreed that regulatory modernization was needed.[440] Still, it was not clear until the very last minute that the President was going to sign the Act.[441] Although the Treasury Department has sought regulatory reform for decades, it was prepared to recommend to the President that he veto the measure if it concentrated too much regulatory authority in the Fed at the expense of the Department of the Trea-

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436. *See* S. 900, 106th Cong. (1999).

437. *See, e.g.*, Mike McNamee, *The Staring Contest That's Stalling Bank Reform*, BUS. WK., Mar. 1, 1999, at 31 (posing the question whether "after a quarter century, [have] the planets . . . finally aligned for an overhaul of the U.S. financial system?").

438. *See id.* For example, Senator Phil Gramm has used the push for financial institution reform to lead a charge to water down the Community Reinvestment Act (CRA). In late 1998, Gramm killed an earlier version of H.R. 10 because it did not ease CRA restrictions. Again in 1999, Gramm raised the issue, undermining the prospects of any reform, CRA or otherwise. *See* Michael Schroeder, *Financial-Services Overhaul Bill Facing Strong Opposition Clears a Senate Panel*, WALL ST. J., Mar. 5, 1999, at A4. For many years, special interest groups have stifled various proposals for reform. *See, e.g.*, Steve Blakely, *Panel Votes Bare-Bones Bill to Aid FSLIC, Troubled Banks*, 44 CONG. Q. WKLY. REP. 1893, 1894 (1986) (reporting that business interests, including nonbank-banks such as Sears and American Express have successfully blocked financial services reform). In 1991, the securities industry, the insurance industry and small banks allied to deny expanded powers to large banks. *See, e.g.*, John R. Crawford & Alissa J. Rubin, *Panel Members Put Obstacles in Way of Overhaul Bill*, 49 CONG. Q. WKLY. REP. 2608 (1991).

439. *See* Ralph Nader, *Banking Jackpot*, WASH. POST, Nov. 5, 1999, at A33 (noting that the new law fails to adequately address safety and soundness concerns or to address regulatory weaknesses).

440. *See* McNamee, *supra* note 437, at 31 (noting that Republicans, Democrats, banks, insurers and security firms all agreed that the restrictions needed revision).

441. *See* Schroeder, *supra* note 435, at A6 (stating that President Clinton threatened to veto the Senate version of H.R. 10); *see also* Leslie Wayne, *House Acts to Ease 30's Banking Curbs by One Vote Margin*, N.Y. TIMES, May 14, 1998, at 21 (recounting the death of H.R. 10 in 1998).

sury.[442] The Fed regulates bank holding companies.[443] The Fed argued that banks should conduct expanded financial services activities only through affiliates of bank holding companies, thereby vesting regulatory power in the Fed.[444] The Treasury wished to allow banks to conduct such activities through bank subsidiaries.[445] There is limited difference in terms of safety and soundness because each structure creates a corporate veil, or "fire wall" between the bank and the new activity.[446] The Fed claimed that its proposed structure precluded banks from using a safety-net subsidy as a competitive advantage.[447] The Treasury responded that any such subsidy could spread as easily upstream to holding companies and affiliates as downstream to subsidiaries.[448] Given that the safety-net subsidy may not exist and that it does not appear to act only in the context of subsidiaries, the regulators should not threaten to kill financial modernization in the name of regulatory turf.[449] This consideration simply should not be given any weight.[450] The reality is that fragmented regulation, a result directly attributable to the political nature of regulation, long operated to frustrate appropriate modernization.

Even before the passage of S. 900, the regulatory competition between the Fed and the Treasury seemed to be giving rise to

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442. *See* David G. Oedel, *Introduction to a Panel on the Modernization of Financial Regulation: What Is the Governmental Role in Finance, Anyway?*, 49 MERCER L. REV. 771, 772 (1998).

443. *See* John D. Hawke, Jr., *Reflections on the Ongoing Effort to Modernize Financial Services Regulation*, 49 MERCER L. REV. 777, 778-79 (1998) (explaining the Fed's emphasis on holding company subsidiaries rather than bank subsidiaries).

444. *See id.*

445. *See id.*

446. *See id.* at 779. If losses occur in the bank affiliate conducting the expanded activities, the bank's capital is compromised whether the affiliate is a direct subsidiary or a subsidiary of a parent. Either the parent will not be able to contribute as much capital to the bank, or the bank's ability to obtain capital from a subsidiary will be diminished.

447. *See id.* at 778-79.

448. *See id.* at 779.

449. *See id.*

450. For a thorough analysis of the intense regulatory competition presently consuming the Fed and the Department of Treasury, see Carter H. Golembe, *Much More Is Involved in Agency Turf Wars than Meets the Eye*, BANKING POL'Y REP., Sept. 18, 1995, at 2.

excessive risks in the financial system, as both agencies recently have moved to expand the powers of banks and bank holding companies.[451] Both the Fed and the Treasury recently have moved to expand the powers of bank affiliates, and the timing and similarity of these initiatives suggests that they were the result of conscious parallelism.[452] In any event, banks or bank affiliates now may be involved in a wide array of derivatives transactions, futures and options transactions, and securities transactions.[453] The breadth of these transactions has had two profound effects. First, these transactions have increased to such a volume and have become so globalized that the world's financial system has become highly integrated and interconnected. Second, the complexity of these transactions has outstripped the ability of even the most respected regulators and industry professionals to control such risks.[454]

Experience shows that expanded financial institution powers can bring expanded, even catastrophic risks.[455] As demonstrated above, expanded savings and loan powers were a key part of the savings and loan catastrophe.[456] A number of recent experiences

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451. *Compare* 61 Fed. Reg. 68,750 (1996) (Fed initiative to ease revenue restrictions applicable to securities activities of bank affiliates), *and* 62 Fed. Reg. 45,295 (1997) (Fed elimination of restrictions applicable to bank affiliates engaged in securities activities), *with* 61 Fed. Reg. 60,342 (1996) (OCC initiative to relax restrictions on the activities of national banks).

452. *See* Schooner, *supra* note 380, at 446 (stating that OCC adopted controversial rules so as "[n]ot to be outdone by the Fed").

453. Derivative transactions involve instruments that derive their value from the performance of some other asset or financial instrument. *See generally* OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANKING CIRCULAR NO. 277, RISK MANAGEMENT OF FINANCIAL DERIVATIVES (1993) (identifying derivative products to include structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof); Steven McGinity, *Derivatives-Related Bank Activities as Authorized by the Office of the Comptroller of the Currency and the Federal Reserve Board*, 71 CHI.-KENT L. REV. 1195 (1996) (reviewing regulatory standards for derivative transactions).

454. *See supra* notes 6-7 and accompanying text.

455. For example, allowing banks to expand into the securities business may allow them to exploit opportunities beyond their traditional banking business, or it may just lead to losses, as it has for other companies that have so expanded. *See* Leah Nathans Spiro, *Alex. Brown: Handle with Care*, BUS. WK., Apr. 21, 1997, at 116 (recounting problems that General Electric, American Express and Kemper Insurance experienced when expanding into brokerage business).

456. *See supra* notes 372-84 and accompanying text.

serve to highlight the pitfalls of allowing banks, or their affiliates, to expand into the brave new world of globalized derivative and complex financial transactions. A Swiss bank appears to have lost $687 million in loans it made to an international hedge fund.[457] Bankers Trust was required to cover hundreds of millions in losses suffered by customers of its securities subsidiary in complex derivatives actions.[458] Sumitomo Bank, Daiwa Bank, and Barings Bank each suffered astounding losses stemming from international financial trades, often undertaken by single rogue traders.[459] In the case of Barings Bank, the rogue trader literally broke the bank.[460] Given the increased velocity with which the financial system transmits financial shocks, and the inability of the best financial minds to fully comprehend this kind of trading, regulators do not appear to have controlled adequately the risks accompanying this type of complex trading.[461]

Other than general mandates concerning requirements of safety and soundness, the banking regulators have given short shrift to articulating specific standards for conducting such activities. This lack of specificity betrays concerns that are more

457. *See* Lipin et al., *supra* note 7, at A6.

458. *See* Saul Hansell, *Bankers Trust Settles Suit with P. & G.*, N.Y. TIMES, May 10, 1996, at D1 (stating that Bankers Trust agreed to absorb nearly $200 million in losses); *see also* Kelley Holland et al., *The Bankers Trust Tapes*, BUS. WK., Oct. 16, 1995, at 108 (recounting the tactics of a Bankers Trust affiliate, summed up best, by an agent's statement that "what Bankers Trust can do for Sony and IBM is get in the middle and rip them off" and noting that clients sustained over $500 million in losses). Ironically, shortly after this settlement the Fed allowed Bankers Trust to enter the securities business in an even more visible manner, by acquiring a large regional brokerage. *See* Federal Reserve Press Release, *Order Approving Notice to Engage in Nonbanking Activities, In re* Banker's Trust Corp., New York, N.Y. (Apr. 8, 1997); Niamh Ring, *Wedding Announcement for Bankers Trust and Alex. Brown Pleases the Street*, BOND BUYER, Apr. 8, 1997, at 5.

459. *See Former Barings Trader Flies to Singapore*, N.Y. TIMES, Nov. 23, 1995, at D15 (noting that one trader caused $1.4 billion in losses to Barings Bank).

460. *See Former Daiwa Trader Sentenced in Cover-up of $1.1 Billion Loss*, N.Y. TIMES, Dec. 17, 1996, at D12 (reporting sentence of trader who caused losses in government bond trading); *Sumitomo Bank Helps Affiliate*, N.Y. TIMES, July 25, 1996, at D7 (noting that an affiliate of Sumitomo lost $1.8 billion in copper trading).

461. *See* Schooner, *supra* note 380, at 469 ("[T]he current system, however, was established at a time when banks' securities activities were virtually nonexistent. The increase in activity over the last fifteen years calls into consideration the effectiveness of the current model.").

focused upon regulatory turf than regulatory prudence.[462] Certainly, the regulators are aware of the risks and the history of allowing depository institutions to exercise expanded powers in the absence of specific regulatory guidance on managing such risks.[463] Arguably, until they gain more regulatory expertise in this particular area of financial markets, however, the exposure of banks and other financial instruments to this kind of activity should be curtailed sharply.[464] At the very least, the activity must be an activity that is permitted only after thorough analysis by the most expert financial regulators. Whether such analysis has transpired is not presently clear.[465] Given the history of regulatory competition, and accompanying regulatory failures, the public can have only minimal confidence in the adequacy of the current regulatory paradigm. All of this is the backdrop to current initiatives to deregulate the financial services industry. Few discussions have occurred regarding the need to achieve reform accompanied by appropriate regulation because these initiatives are driven by special interests and turf-conscious regulators.[466]

Inappropriate political and special interest influence pervade financial market regulation. The American economy has suffered greatly as a result. The next Part addresses whether depoliticizing regulation in this area, akin to the model of depoliticized regulation of monetary policy, would be appropriate and effective.

IV. SHOULD FINANCIAL REGULATION BE DEPOLITICIZED?

James Madison articulated the dangers of special interests, which he termed "factions," in defending the Constitution over

462. *See* McGinity, *supra* note 453, at 1195.

463. *See supra* notes 55, 299, 317.

464. *See* Greenspan, *supra* note 6.

465. *See supra* notes 452-54 and accompanying text.

466. *See* Stephen Labaton, *House Takes Up Financial Overhaul Measure*, N.Y. TIMES, July 2, 1999, at C1 (summarizing efforts to deregulate financial services but failing to mention expanded regulation to control higher risks arising from increased powers). *See generally* Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 MERCER L. REV. 793 (1998) (discussing emergence of a new consolidated regulatory paradigm to address financial integration and regulatory competition).

two hundred years ago. In *The Federalist No. 10*, Madison argued that a primary benefit of the then proposed constitutional republic was its ability to control factions.[467] Madison argued that factionalism was inherent to democracies and fundamental to their failures prior to the establishment of our constitutional republic.[468] Madison stated that "[a]mong the numerous advantages promised by a well-constructed Union, none deserve[d] to be more accurately developed than its tendency to break and control the violence of faction."[469] Indeed, Madison argued that "any plan which . . . provides a proper cure" for the problems posed by special interests should be given "due value."[470]

Madison could not have foreseen the complexity of our society 200 years hence, nor the concomitant expansion of government regulatory power. Madison's fundamental point, however, regarding the threat posed by special interests to any democracy was prescient. The only change that is required to modernize Madison's analysis is the methods by which factions operate to subvert the commonweal. Today, modern factions can operate successfully beyond the light of public scrutiny because of the sheer number and complexity of issues facing the government. Politics abhors a power vacuum, and special interests move in to fill the void left by a lack of public interest. This regulatory reality can hardly be termed democratic, or consistent with the republican values animating the founders of our constitutional republic.[471] It is axiomatic that the Constitution is fundamentally designed to curb the excesses of democracy and disperse political power.[472] In a more complex society, a more complex govern-

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467. *See* THE FEDERALIST NO. 10 (James Madison).

468. *See id.*

469. *Id.* at 122 (Isaac Kramnick ed., 1987).

470. *Id.*

471. *See id.*

472. In the context of monetary policy, centralizing power in an independent agency is an effective means of assuring that macroeconomic policy is not unduly concentrated in the executive branch. *See* BACH, *supra* note 230, at 210.

> One hardly incites controversy today to say that the Constitution does not envision a pure democracy in which elections serve only to translate popular will into law. Nor could the Constitution envision such a system and still purport to be a written constitution with the object of imposing external constraints on popular sovereignty.

Brown, *supra* note 194, at 555.

ment naturally follows. Along with such complexity comes an inability of the political system to assure that it comprehends all issues and addresses all issues raised by affected interests, particularly the public interest.[473] This Article posits that the Constitution retains sufficient flexibility to address modern challenges to our system of government, so long as the election of politicians charged with regulatory supervision preserves basic political accountability. In that manner, depoliticization can be consistent with our republican tradition.

This raises the issue whether depoliticization makes good sense in a given circumstance or area of regulation. For example, setting up an agency to determine tax policy probably is not consistent with our republican tradition and probably does not make sense from either a policy or a political perspective.[474] Beyond this, the Constitution provides little guidance on when and to what degree depoliticization is appropriate.[475] In addition, historically there has been an incomplete appreciation for the full spectrum of constitutionally permissible independence.[476] Many factors contribute to the degree to which an agency is endowed with real political independence. The correct degree of independence is a complex issue that ultimately turns upon the question of how independent an agency must be to fulfill its mission. So far, independence seems to appear in a chaotic fashion.[477]

Expanded depoliticization in the area of financial market regulation not only makes good political sense, but also makes good policy sense. No modern commentator has seriously suggested that the current regulatory framework is satisfactory.

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473. For example, in 1789 when the Constitution became effective, monetary policy did not exist. The Constitution gave Congress the power to "coin money." U.S. CONST. art I, § 8. Still, it never would have occurred to the Framers that monetary policy would influence the economy and that therefore politicians could manipulate it for political ends. *See* BACH, *supra* note 230, at 211.

474. The Supreme Court has intimated that Congress could not delegate the power to tax. *See* National Cable Television Ass'n v. United States, 415 U.S. 336, 340-42 (1974).

475. *See* Paul R. Verkuil, *The Purposes and Limits of Independent Agencies*, 1988 DUKE L.J. 257, 257-58 (stating that agencies seem to have "random" independence).

476. *See id.* at 259 (defining the characteristics of independent agencies).

477. *See id.* at 258-59.

Financial market regulatory reform is desperately needed and has been for decades.[478] Indeed, there have been numerous proposals for reform, but political gridlock has precluded any.[479] Several concerns have driven the need for reform. First, banks are facing technological obsolescence. Most people no longer maintain large deposits at banks, preferring instead to enjoy higher returns along the spectrum of risk-reward instruments that are now available through the securities markets.[480] Commercial borrowers meanwhile have increased their reliance upon these markets, and borrow less from banks.[481] Even with respect to checking accounts, other financial institutions now offer vehicles that are essentially indistinguishable from demand deposit accounts.[482] Second, with increased internationalization, scholars and policymakers have recognized that American financial institutions are fragmented unnecessarily. With increased economic integration and greater international capital flows,[483] the reality is that American financial institutions must compete internationally and facilitate the ability of the American economy to compete internationally.[484] Regulation should recognize and accommodate this. The current regulatory framework hobbles this goal.[485] Moreover, while allowing financial institutions the powers to compete, regulators must recognize and control the risks implicit in such reforms. Fed Chairman Alan Greenspan recognizes these regulatory risks.[486]

Financial institutions are indispensable to our economic health. They process payments globally so that transactions

478. *See supra* notes 371, 439; *see also* Taylor, *supra* note 466, at 793 ("The regulation of financial services in developed economies has not kept pace with the enormous changes that the industry has experienced over the last two decades.").

479. Professor Bach articulated a compelling case for significant reform nearly thirty years ago. *See generally* BACH, *supra* note 230. Although many of his proposals have been implemented, many of his recommendations have not been enacted.

480. *See* Schooner, *supra* note 380, at 441.

481. *See* Langevoort, *supra* note 8, at 676-80.

482. *See id.*

483. *See* LITAN & RAUCH, *supra* note 17, at 45.

484. *See id.* at 10 (arguing that policy should promote American financial industry's role as leading the world in competitiveness).

485. *See id.* at 5.

486. *See supra* note 6.

need not be settled in cash—a fundamental service to our modern economy.[487] They serve as financial intermediaries so that capital can be aggregated and deployed to its best use which fuels growth.[488] Finally, these financial institutions allow individuals to spread risk (through, insurance companies, for example) or diversify their portfolios (through, for example, mutual funds). This "risk spreading" in turn delivers real benefits to the economy by making business more predictable and decreasing production costs.[489] Consequently, basic elements of regulation are "not negotiable."[490] Taxpayers, who bear ultimate responsibility for deposit insurance, must be protected. Consumers, whose lack of confidence can cause panic, must have faith in the integrity of the financial system. Finally, the soundness of financial institutions must be assured.[491]

There is little doubt that fundamental reform is needed, but these basic regulatory values must be an integral part of any reform.[492] Most reform proposals include the idea that banks should be permitted to exercise expanded powers.[493] The question thus becomes how to restructure financial market regulation in a fashion that balances safety and soundness with competitiveness. The proposal that the framework of this new regulatory structure include expanded depoliticization is fully consistent with the underlying factors creating pressure for reform. Regulators could be given the power to use expertise to determine how restructuring should occur and to break the political gridlock that has set in on this issue. This proposal also increases the soundness of financial market reform by eliminating political and expertising regulation. This is the best means of controlling the new risks being absorbed by financial institutions. Depoliticizing financial regulation would give regulators the

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487. *See* LITAN & RAUCH, *supra* note 17, at 11.
488. *See id.*
489. *See id.* at 12.
490. *Id.* at 7.
491. *See id.*
492. *See id.* at 3 ("Current policy is based on a view of the world developed primarily to prevent another Great Depression; and in doing so it relies on a mix of practices that can and should be improved.").
493. *See supra* notes 8, 16, 17 and accompanying text.

power and flexibility both to accommodate modernization and to control accompanying risks in the public interest.[494]

The foregoing discussion has demonstrated that politics influences financial market regulation in inappropriate ways. The problems of political financial market regulation are transcendent, regardless whether the focus is on financial institution regulation or capital market regulation. These zones of regulation involve transactions and regulated entities that can often be measured in billions of dollars. By necessity, regulation in these areas similarly involves enormous economic stakes. As technology and globalization provide a basis for increased profits, so too do these phenomena create increased risks.[495] Costs of regulatory policies in these areas often are deferred and diffused generally throughout the investing or voting public. All of this adds up to enormous complexity. Under these circumstances, regulation is especially prone to costly, even catastrophic, highjacking in favor of powerful special interests. Depoliticization can stem many of the problems that appear to be inherent in the current system of financial market regulation. Does the evidence justify restructuring the political responsiveness of financial market regulation? Agencies, as presently structured, face grave difficulties acting in the public interest.[496]

Although the empirical evidence available has not supported fully any particular theory of regulation, it does support the notion that under certain circumstances regulatory dysfunction can set in.[497] This Article has marshalled all available evidence to determine if this has occurred in financial market regulation. Lawyers, economists, and political scientists all have concluded that the primary conditions giving rise to regulatory dysfunction

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> [T]he new world of finance . . . is becoming more treacherous for the men and women in Washington . . . who . . . regulate . . . the country's financial system. If they regulate the financial services industry too tightly, they may smother it at a time when innovation is, more than ever, its lifeblood. If they are clumsy in their efforts to stabilize it, they may instead disrupt or undermine it.

LITAN & RAUCH, *supra* note 17, at 2.

495. *See supra* notes 7, 401, 460 and accompanying text.

496. *See supra* notes 1-5, 20 and accompanying text.

497. *See supra* notes 4, 13, 58, 108 and accompanying text.

are prevalent in the regulation of financial markets.[498] Building upon this evidence, the present analysis demonstrates that politics have exerted a pernicious influence upon regulation in this area.

Depoliticization can operate to quell the problems of politicized financial regulation. In regard to the savings and loan crisis, depoliticization could have stemmed the crisis at several crucial points. First, appropriate controls on thrift activities and an appropriate examination of resources could have been deployed based upon expertise instead of politics, and activities that generated losses curtailed.[499] Second, even failing that, if capital standards had been enforced as originally contemplated, without respect to politics, thrifts could have been shuttered before large costs were incurred.[500] After all, there was no nonpolitical basis for the policy of forbearance. This would have avoided the great majority of losses suffered.[501]

The SEC's inability to control the legislative initiatives to curtail investor rights is a classic example of the problems of political regulation.[502] The evidence supporting the PSLRA and the Uniform Act was flimsy at best.[503] The money behind these legislative initiatives was able to distort the legislative process, and to obtain a result that was fundamentally at odds with sound regulation.[504] All sides of the debate recognized the SEC's traditional expertise and discretion in defining investor rights.[505] Nevertheless, SEC expertise ultimately played little role in defining the legislative outcome.[506] Expanded depoliticization could deliver regulation based upon expertise in this area.

Depoliticization can also be of utility in addressing the compensation controversy. Even staunch supporters of free-market resolutions, such as Fed Chairman Alan Greenspan, have ques-

498. *See, e.g.*, Grundfest, *supra* note 299, at 26.
499. *See supra* notes 365-85 and accompanying text.
500. *See supra* notes 386-404 and accompanying text.
501. *See supra* notes 399-404 and accompanying text.
502. *See* Ramirez, *supra* note 344, at 1093.
503. *See id.*
504. *See id.* at 1093.
505. *See id.* at 1115.
506. *See supra* notes 345-56.

tioned the appropriateness of executive compensation.[507] The fragmented regulation of publicly held companies has led states to seek concentrated benefits in exchange for costs imposed upon the economy generally.[508] Only a unified regulatory regime can resolve this issue. By leaving this and other similar corporate governance issues to agency expertise, adjustments to the currently prevailing market resolution can be undertaken based upon the best evidence available.[509]

If depoliticization is deemed an appropriate policy option, however, an important threshold issue should be addressed. Outside of the context of the Fed's administration of monetary policy, can additional depoliticization of financial regulation be achieved? The first step to such depoliticization has been achieved, albeit in a haphazard and chaotic fashion. Congress has created specialized agencies to deal with virtually all aspects of financial market regulation.[510] Moreover, with little apparent forethought, some of these agencies are endowed with a great deal of structural independence. Very few areas of regulation, nevertheless, have been as free of the influences of politics as the Fed.[511] The experience of the Fed provides some insight into how an area of regulation can be depoliticized. Basically, it took two catastrophic economic disruptions—the Panic of 1907 and the Great Depression—for the Fed to achieve the independence it wields today.[512] The Banking Act of 1935 marked the beginning of a truly independent Fed.[513] This act occurred only in the face of the calamity of the Great Depression, and only after the outcry of noted scholars arguing for depoliticization.[514]

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507. *See* Michael M. Phillips, *Greenspan Hits Both Extremes of Wages*, WALL ST. J., Feb. 25, 1999, at A2 ("I find a lot of what is being paid to individual CEOs not directed to the value that they are producing for their shareholders, who are paying the bill . . . .").

508. Delaware, for example, obtained 17.7% of its 1990 revenues from franchise taxes paid by corporations. *See* WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS 125 (7th ed. 1995).

509. *See supra* notes 353-66 and accompanying text.

510. *See supra* notes 25, 85 and accompanying text.

511. *See supra* notes 84-145 and accompanying text.

512. *See supra* notes 85, 98-107 and accompanying text.

513. *See supra* notes 98-103.

514. *See* J. LAURENCE LAUGHLIN, THE FEDERAL RESERVE ACT: ITS ORIGIN AND PROBLEMS 211-17 (1933) (recounting political problems of the Fed and stating "[h]ow

Congress could take a significant step toward depoliticization by consolidating regulatory agencies.[515] For example, if there were only one financial institution regulator, free of monetary policy responsibilities, and one capital market regulator that exclusively regulated publicly held companies, both regulatory competition and regulatory turf battles could be curtailed. The increased gravity, and more diverse regulatory activities of such, would create a significant counterweight to agency capture. In sum, although financial market regulatory power would be divided among these agencies, the regulatory mass of each would be more commensurate with the size of those they regulate. This could further buttress an agency's political independence.

Of course, regulatory consolidation also can eliminate regulatory competition and assure that regulation is based upon expertise; thereby, it is responsive to the public interest instead of special interests. For example, in the context of regulatory modernization, many commentators have stated that the risks of expanded financial institutional powers can be contained through rigid enforcement of capital standards for depository institutions and erecting "fire walls" consisting of corporate veils between affiliates undertaking new activities and depository institutions.[516] Noted economists, however, have shown that taking prompt corrective action in response to eroding capital, as measured by an accounting system that is necessarily a lagging indicator of a bank's health, is likely to be "too little, too late" and is not likely to prevent the next banking crisis.[517] Similarly, relying on fire walls certainly can protect banks from isolated catastrophes that arise from new, riskier activities. Whether

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long, O Lord, how long"). Professor Laughlin was involved intimately in the process of the enactment of the Federal Reserve Act. *See id.* at vii.

515. Professor Bach summarized and rebutted the main policy arguments against regulatory consolidation nearly three decades ago. *See* BACH, *supra* note 230, at 230-33.

516. *See* Hawke, *supra* note 327, at 778.

517. *See* Joe Peek & Eric S. Rosengren, *The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late*, NEW ENG. ECON. REV., Sept.-Oct. 1996, at 49-58 (highlighting problems of relying upon capital ratios for prompt corrective action); *see also* Joe Peek & Eric S. Rosengren, *Will Legislated Early Intervention Prevent the Next Banking Crisis?*, S. ECON. J., July 1997, at 268-80 (stating that new legislation requiring prompt corrective action is not materially different from prior regulatory practice, and is not binding upon regulators).

they will prevent a systemic catastrophe triggered by a general asset value deflation like the Great Depression or the real estate bust of the 1980s is another, unaddressed question.[518] This Article takes no position on these, or similar issues; instead, it attempts to demonstrate that these issues are best resolved by resort to regulatory experts acting in the public interest.

Bipartisan support is a necessary ingredient to the long-term political independence of any administrative agency. The Fed has enjoyed such support for decades. Many administrative agencies, such as the SEC, must have bipartisan representation on its governing body. Although the Fed is subject to no such mandate, it enjoys other sources of bipartisan support. The Hoover Commission was not overly impressed with the bipartisan requirement then prevailing at a number of agencies as a means of assuring appropriate regulatory conduct.[519] Nevertheless, since the time of the Hoover Commission, our government has had extended periods when the presidency has been controlled by one party, while the Congress has been controlled by the other party.[520] Under these circumstances an agency is vulnerable to political pressures if one party dominates its governing body. Thus, a requirement that an agency enjoy bipartisan governance is a means of assuring some degree of long-term bipartisan support.

Another key to depoliticizing a regulatory area is the breadth of delegations to the agency. For example, the Fed enjoys essentially unlimited discretion over monetary policy.[521] Delegations also furnish Congress with the ability to make institutional statements regarding the proper extent of an agency's indepen-

518. *See generally* Hawke, *supra* note 327 (describing a proposal to modernize rules governing financial services without jeopardizing existing federally insured institutions, but failing to address the potential impact of an overall economic decline).

519. *See* HOOVER COMMISSION REPORT, *supra* note 64, at 431.

520. *See, e.g.*, Gerald Ford, *Counting Excesses in D.C.*, SAN DIEGO UNION-TRIB., May 23, 1999, at G4 (noting the presence of a Republican Congress during the Truman Administration and a Democratic Congress during the Eisenhower Administration); David Teich, *Cut the National Debt Before Taxes, Spending*, SEATTLE POST-INTELLIGENCER, Aug. 21, 1999, at A9 (noting the presence of a Republican President and Democratic Congress in the early 1980s).

521. This regulatory monopoly is hardly accidental. Congress has twice affirmatively acted to assure that the Fed does not lose control of monetary policy. *See* WOOLLEY, *supra* note 108, at 41-46.

dence in the context of legislative history. Although such statements certainly are not binding upon a future Congress, they do create risks for legislators who choose to ignore the basis for independence. One example of such legislative history is the Banking Act of 1935.[522]

Funding is key to independence.[523] There is no reason why a unified financial regulator could not assess financial institutions in much the same way as the Fed assesses its member banks.[524] Similarly, the SEC already collects enough in fees to be self-funded.[525] Certainly, a more consolidated agency charged with the regulation of publicly held companies can also achieve self-funding. Although there may be constitutional issues implicated in giving an agency the power of raising its own funds, each of the broad areas discussed in this Article can support agencies that raise sufficient funds to free themselves from the regulatory appropriations process.[526] Certainly, access to public trading markets and the ability to act as a financial intermediary traditionally has been considered a beneficial grant that can be dispensed in exchange for fees or other conditions.[527]

History demonstrates, however, that, unfortunately, such drastic changes in the approach to regulation usually occur only in response to severe economic disruptions.[528] No major overhaul of the fundamental structure of our financial market regulatory structure has occurred in the absence of such a disruption. Nevertheless, the costs of the maladies that inhere in the current regulatory structure have been astounding.[529] Under these circumstances perhaps Congress could restructure financial

522. *See supra* notes 98-107.
523. *See supra* notes 50-57.
524. *See* 12 U.S.C. § 243 (1994).
525. *See Congress Forges SEC Plan, Snubs Self-Funding Idea*, WALL ST. J., Aug. 17, 1994, at A4.
526. *See* National Cable Television Ass'n Inc. v. United States, 415 U.S. 336, 340-42 (1974) (stating that the power to tax is vested in the legislature but that agencies may assess fees to beneficiaries of grants).
527. *See* 12 U.S.C. § 243.
528. *See, e.g.*, WORSHAM, *supra* note 4, at 25 ("Historically, the periods of greatest debate concerning reform of the financial regulatory structure occur during . . . instances of panic and failure . . . .").
529. *See supra* notes 344-64, 411 and accompanying text.

market regulation in accordance with the thesis of this Article before another major regulatory failure. On the other hand, because the nation's economy has grown to be so diverse and the regulatory protections against further depressions seem to work so well, even when such catastrophic disruptions occur, their effects are blunted and no public outcry for substantial reform arises.[530] It may well be that until abuses subvert the regulatory system so deeply that an economic disruption of great proportions results, the reforms discussed herein simply are not possible.

Another possibility is that the next presidentially led effort at regulatory reform recognizes the utility of additional depoliticization.[531] Any such political effort to restructure the financial regulatory structure could benefit from the business interests that operate in the regulated environment of the nation's financial markets. The proposal of this Article should be recognized as a sound component of what Professor Gabriel Kolko has termed "political capitalism."[532] Kolko's definition of political capitalism revolves around the use of governmental power to secure an economic structure providing conditions of stability, predictability, and security—all with the aim of rationalization of the otherwise dangerous vicissitudes inherent in laissez-faire capitalism.[533] Kolko demonstrated that the economic reforms of the Progressive Era, including the Federal Reserve Act of 1913, were the result of the intentions of the business and political class to attain a more stable and secure business environment through government regulation.[534] The costs of the current financial regulatory structure should, by now, be apparent to many key leaders in the industries with stakes in governmental regulatory initiatives. Political capitalism has successfully allowed our nation's economy to function at a high production level, with

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530. Professor Worsham has noted that financial panics or failures provide feedback to key players outside of a regulatory subsystem that something has to be done. *See* WORSHAM, *supra* note 4, at 35. Worsham's observation raises the possibility that the Fed is so adept at managing the economy that fundamental reform is not likely.

531. *See id.* at 46.

532. KOLKO, *supra* note 169, at 3.

533. *See id.* at 1-10.

534. *See id.*

minimal disruption since 1933. Responsible business leaders should recognize the utility of sound governmental regulation and stand ready, to work with politicians, to make appropriate regulatory adjustments.

CONCLUSION

The time has come for an end to depoliticization by accident. Thus far, depoliticization has been underutilized and mentioned rarely in scholarship or political discourse as a solution to the problems of regulation. Depoliticizing regulation is a powerful tool for achieving certain policy objectives. Specifically, in areas of great complexity and little voter interest, depoliticization can be used to resist regulatory domination by narrow special interests. Moreover, it can transfer regulatory power to experts, and allow sophisticated regulation to operate relatively free from immediate political concerns. Thus, depoliticization can help assure that decisions are weighed appropriately in terms of costs and benefits. In light of the advantages of depoliticization, policymakers should begin to consider when the advantages of depoliticization justify its increased use on a more principled basis.

Once the advantages of depoliticization are understood, those areas appropriate for depoliticizing can be identified. Depoliticization may not be tolerable in some areas. In others, Congress may be unwilling to part with power. There can be little doubt, however, that depoliticized regulation can yield significant advantages in financial regulation. Our political system does not function well in the context of financial regulation. The savings and loan crisis of the 1980s, the rampant run of fraud in our securities markets during the same period, and the obsolete regulatory structure hobbling our financial markets all demonstrate the dangers of political influence in the context of financial regulation. Similarly, the "reform" of private securities litigation and the explosion of executive compensation also seem best explained through an analysis of the political context in which each of these phenomena occurred. The costs of these problems are incalculable. The low issue saliency among voters with respect to financial regulation, and the general acceptance of the Fed's authority over monetary policy seem to support the

political viability of insulating financial market regulators from political influence.

Once depoliticization is understood as a tool, policymakers can then address the degree of depoliticization that is desirable. The degree of insulation to be accorded an agency seems to turn upon many factors, but the most important appear to be the funding of the agency and the extent of the political commitment to an agency's independency. The Fed appears to be the most independent agency because of its self-funding mechanism and the reluctance of the political branches to encroach upon its turf. Whether other financial agencies should be as independent as the Fed is an issue beyond the scope of this Article. Perhaps this issue can be addressed best only after further experience is had with more independent agencies. Fundamentally, however, recent history in financial market regulation strongly suggests that agencies operating within this regulatory area, in general, must move towards the Fed in terms of political insulation.

Another question should be considered: Assuming that depoliticization can be a tool for more effective financial market regulation, is it a politically viable option? Severe market disruptions or serious economic dislocation ordinarily has triggered innovative regulation in the area of financial market regulation. Perhaps some future disruption will prompt a reassessment of the role of politics in this vital area of regulation. On the other hand, it is also possible that as specific areas of regulation become more complex, and therefore dangerous, a general political consensus in favor of expert, nonpolitical regulation could emerge. The best option may well be to pursue increased depoliticization for financial markets on a gradual basis. This will occur only if policymakers can be convinced of the long-term stability and advantages of increased political insulation.

Finally, the conclusions of this Article should cause scholars in other intensive areas of regulation to consider further depoliticization as a means of solving common problems of governmental dysfunction. The foregoing discussion has identified a relatively narrow pattern of problems pervading a single regulatory area—the regulation of financial markets. Based upon the conditions spawning these problems, this Article has addressed financial market regulation specifically as an area that would

benefit from further depoliticization. There must be others. The degree of depoliticization advocated herein—specifically, independent commissions governed by commissioners with tenure and insulated from political interloping and the appropriations process—already has attained a high level of constitutional approval. In the one regulatory area where it has been tested—the government's management of monetary policy—it has functioned largely in accordance with expectations. Given the high degree of political cynicism that currently prevails in our political system, any restructuring of regulation that would limit the power of special interests would likely receive a positive political reaction among voters. Consequently, expanded depoliticization should be considered as an option to address the full panoply of systemic problems plaguing the modern regulatory state.