

February 2010

The Illegal Actions of the Federal Reserve: An Analysis of How the Nation's Central Bank Has Acted Outside the Law in Responding to the Current Financial Crisis

Chad Emerson

Follow this and additional works at: <https://scholarship.law.wm.edu/wmblr>



Part of the [Banking and Finance Law Commons](#)

Repository Citation

Chad Emerson, *The Illegal Actions of the Federal Reserve: An Analysis of How the Nation's Central Bank Has Acted Outside the Law in Responding to the Current Financial Crisis*, 1 Wm. & Mary Bus. L. Rev. 109 (2010), <https://scholarship.law.wm.edu/wmblr/vol1/iss1/5>

THE ILLEGAL ACTIONS OF THE FEDERAL RESERVE: AN
ANALYSIS OF HOW THE NATION’S CENTRAL BANK HAS
ACTED OUTSIDE THE LAW IN RESPONDING TO THE CURRENT
FINANCIAL CRISIS

CHAD EMERSON*

TABLE OF CONTENTS

INTRODUCTION	110
I. THE ORIGINS OF THE FEDERAL RESERVE SYSTEM	111
<i>A. Congressional Efforts that Led to the Federal Reserve</i>	111
<i>B. The Adoption of the 1913 Federal Reserve Act</i>	112
<i>C. The Organization of the Federal Reserve</i>	114
II. THE LEGISLATIVE EVOLUTION OF THE FEDERAL RESERVE SYSTEM	115
<i>A. The Banking Act of 1935</i>	116
<i>B. Federal Reserve-Treasury Department Accord of 1951</i>	117
<i>C. The Bank Holding Company Act of 1956</i>	117
<i>D. The International Banking Act of 1978</i>	118
<i>E. The Full Employment and Balanced Growth Act of 1978</i>	118
<i>F. Depository Institutions Deregulation and Monetary Control Act of 1980</i>	119
<i>G. The Federal Deposit Insurance Corporation Improvement Act of 1991</i>	119
<i>H. Gramm-Leach-Bliley Act of 1999</i>	120
<i>I. The Emergency Economic Stabilization Act of 2008</i>	121
III. THE FEDERAL RESERVE’S ROLE IN THE ONGOING ECONOMIC CRISIS.....	122
<i>A. The Adjustment of Existing Programs</i>	123
<i>B. The Creation of New Programs</i>	124
IV. THE FEDERAL RESERVE’S ILLEGAL EXPANSION OF ITS ECONOMIC AUTHORITY	125
<i>A. The Federal Reserve’s Limited Authority to Purchase Private Assets</i>	125
<i>B. The Federal Reserve’s Improper Equity Interests in Private Entities</i>	128

<i>C. The Federal Reserve's Overall Ineffective Response to the Current Crisis</i>	130
V. THE NEED FOR A COMPREHENSIVE AND INDEPENDENT AUDIT OF THE FEDERAL RESERVE	133
CONCLUSION.....	137

INTRODUCTION

In the spring of 2008, the United States Federal Reserve Bank, under the chairmanship of Ben Bernanke, took emergency measures in an attempt to forestall a national, if not international, economic meltdown. The actual effectiveness of these unprecedented measures has been hotly debated. Unfortunately, regardless of their efficacy, the Federal Reserve stepped outside the scope of its legal authority in taking several of these actions.

This Essay will analyze how the Federal Reserve (the Fed) violated the law and, in doing so, will examine how these illegal actions have compromised the authority that Congress has granted to the Fed. In order to place this malfeasance into context, this Essay will examine the origins of the Federal Reserve and how this unique entity has dramatically, and often controversially, expanded the scope of its power.

It will then analyze how the Fed's willful violation of the law has critically undermined the United States' economy in both the short- and long-term. Finally, it will conclude by proposing legislative reform that would begin to resolve this problem by placing the secretive maneuvers of the Fed into the full light of public scrutiny.

Ultimately, when viewed objectively and within its historical context, it is clear that the Fed acted beyond the scope of its legislative authority and, by doing so, harmed the financial interests of the United States, both at home and abroad. This warrants, at the very least, a full and independent audit of the Federal Reserve System to determine its compliance with existing law.

I. THE ORIGINS OF THE FEDERAL RESERVE SYSTEM

A. Congressional Efforts that Led to the Federal Reserve

The Federal Reserve Act of 1913 established the Fed as the central bank for the United States.¹ Prior to that, several attempts to centralize banking efforts had come and gone. For instance, in 1791, Congress chartered the First Bank of the United States.² The Second Bank of the United States was chartered after the first had expired.³ After the Second National Bank charter expired in 1836, the country operated without a central bank.⁴

In 1907, several bank panics renewed the debate regarding the wisdom of establishing a central bank.⁵ Existing law at the time mandated that banks maintain only a small fraction of their overall deposits in reserve.⁶ The remaining reserves could be used to offer loans.⁷ Unfortunately, these low deposit reserve requirements often led to over-lending.⁸ Banks made loans that, in the short run, could only be converted into cash at a fraction of their value.⁹ This resulted in a “race to the bank” when liquidity problems arose.¹⁰

Ultimately, several influential leaders of the nation’s financial community concluded that federal action was needed to remedy a lack of

* Chad Denver Emerson is an Associate Professor of Law at Faulkner University’s Thomas Goode Jones School of Law. He would like to thank his research assistant Robyn Cannon for her excellent and thorough assistance in this matter. He would also like to thank Karl Denninger for his research and attention into this important matter.

1. Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251 (1913); *see also* The Federal Reserve Board, The Structure of the Federal Reserve System, <http://www.federalreserve.gov/pubs/frseries/frseri.htm> (last visited Jan. 26, 2010).

2. Act of Feb. 25, 1791, ch. 10, 1 Stat. 191 (1791).

3. Act of Apr. 10, 1816, ch. 44, 3 Stat. 266 (1816).

4. *See* ROGER T. JOHNSON, HISTORICAL BEGINNINGS: THE FEDERAL RESERVE 10 (Mary Jane Coyle ed., 1999).

5. *See id.* at 16-19; *see also* Michael A. Whitehouse, *Paul Warburg’s Crusade to Establish a Central Bank in the United States*, THE REGION, May 1989, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3815.

6. Act of Feb. 25, 1863, ch. 58, § 41, 12 Stat. 665, 677 (1863); *see also* JOHNSON, *supra* note 4, at 10, 15.

7. Act of Feb. 25, 1863, § 41, 12 Stat. at 677.

8. *See generally* MILTON FRIEDMAN & ANNA J. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960 (1963); Whitehouse, *supra* note 5.

9. *See generally* FRIEDMAN & SCHWARTZ, *supra* note 8.

10. *See generally id.*; Whitehouse, *supra* note 5.

liquidity in the country's economy.¹¹ The Aldrich-Vreeland Act of 1908 created the National Monetary Commission and tasked it with the responsibility of proposing a permanent solution to the problems of illiquidity and bank panics.¹² The work of this Commission ultimately led to the creation of today's Federal Reserve System.

B. The Adoption of the 1913 Federal Reserve Act

Following the adoption of the Aldrich-Vreeland Act in 1908, the National Monetary Commission, headed by Senator Nelson Aldrich, researched different banking and currency schemes¹³ and focused on the European banking system.¹⁴ In particular, Aldrich consulted with influential banking leader Paul Warburg who convinced Aldrich that, in order to avoid future liquidity crises, the United States needed a central bank that was controlled by private bankers and financial experts.¹⁵ This plan could be patterned after the European system and utilize centralized banking as well as currency backed by commercial assets—a combination that the Commission believed would allow for quick liquidity.¹⁶ Aldrich and Warburg also concluded that the mandatory reserve requirement should be increased to force banks to transform a maximum amount of bank assets into cash without disturbing the general condition of the economy.¹⁷

The influential American Bankers Association responded positively to the Aldrich Plan.¹⁸ Doubts, though, remained in Congress, especially after Woodrow Wilson was elected President of the United States.¹⁹ Progressive Democrats, including William Jennings Bryan, strongly opposed Aldrich's plan because it placed the control of a central bank and monetary policy in the hands of private bankers rather than the federal government.²⁰

11. JOHNSON, *supra* note 4, at 16-19.

12. Alrich-Vreeland Act of 1908, ch. 229, §§17-18, 35 Stat. 546, 552-53 (1908); *see also* Whitehouse, *supra* note 5.

13. JOHNSON, *supra* note 4, at 17; *see also* Whitehouse, *supra* note 5.

14. ARTHUR B. SHELTON, NATIONAL MONETARY COMMISSION, S. DOC. NO. 62-243, at 4 (1912); JOHNSON, *supra* note 4, at 19.

15. *See* HARRY SIMONHOFF, SAGA OF AMERICAN JEWRY 1865-1914: LINKS OF AN ENDLESS CHAIN 375, 377-79 (Arco Publishing Co. 1959); Whitehouse, *supra* note 5.

16. *See* S. DOC. NO. 62-243, at 19-20, 27, 36-37; Whitehouse, *supra* note 5.

17. *See* S. DOC. NO. 62-243, at 19-20; *see generally* Whitehouse, *supra* note 5.

18. ARTHUR S. LINK, WOODROW WILSON AND THE PROGRESSIVE ERA 44 (1954).

19. *See id.* at 45-47.

20. JOHNSON, *supra* note 4, at 19-21.

As an alternative to the Aldrich Plan, Representative Carter Glass of Virginia proposed a solution that would add liquidity without utilizing a central bank.²¹ The Glass-Willis Plan called for twelve or more privately owned regional banks that would perform central banking functions, such as holding member banks' reserves and issuing currency backed by commercial assets and gold.²² Basically, this was a decentralized version of the Aldrich Plan.²³

Ultimately, there was a compromise between the Aldrich Plan and the Glass-Willis Plan that included the addition of a central board that coordinated monetary policy through a series of regional reserve banks.²⁴ This compromise plan called for exclusive government control of the Federal Reserve Board and made currency printed by the Federal Reserve an obligation of the United States government.²⁵ Though Representative Glass still opposed a central bank, he agreed to the plan when President Wilson insisted upon centralized public control.²⁶ Key leaders of the powerful banking industry preferred a system that was controlled exclusively by private interests and strongly opposed the compromise plan.²⁷

Despite the banking industry's opposition, President Wilson presented the compromise plan to Congress on June 28, 1913.²⁸ A few days later, Glass sponsored the bill in the House of Representatives, and Senator Robert Owen introduced an identical bill in the Senate.²⁹

Progressive Democrats in the House sought federal supervision of the Federal Reserve and remained skeptical of the bill.³⁰ However, after Representative William Jennings Bryan, a strong advocate of federal control, threw his support behind the bill, the House of Representatives passed the bill on September 18, 1913,³¹ by a vote of 285 to 85, with only three Democrats voting against it.³²

21. *Id.* at 22.

22. *Id.*

23. LINK, *supra* note 18, at 47.

24. JOHNSON, *supra* note 4, at 24-25.

25. *Id.* at 25.

26. *Id.* at 24.

27. *Id.* at 25-26.

28. LINK, *supra* note 18, at 48.

29. *Id.* at 49.

30. *Id.* at 50.

31. *Id.*

32. *Id.* at 50 & n.59; *Money Bill Passes House, 285 to 85*, N.Y. TIMES, Sept. 19, 1913, at 3.

The next hurdle for President Wilson and the Federal Reserve Act was the Senate.³³ The Senate finally voted on the bill after six months of debate, and numerous hearings between September 1, 1913, and October 25, 1913.³⁴

While the Senate debated the bill, Frank Vanderlip, a prominent New York banker, proposed yet another variation of a central banking plan, which consisted of one federally controlled Federal Reserve Bank with twelve branches of reserve banks around the country.³⁵ Though the Vanderlip Plan gained considerable support in the Senate and influenced debate on the issue, in the end it lost out to the amended Federal Reserve Act which did not include final federal government control.³⁶

On December 19, 1913, with full Democratic support, the Senate passed its amended version of the Federal Reserve Act by a vote of fifty-four to thirty-four.³⁷ Since the House's version of the Federal Reserve Act differed slightly from the version passed by the Senate, the bills were submitted to a conference committee composed of members of both chambers.³⁸ The conference committee incorporated various aspects of both bills, and two days after the conference committee concluded its work, both the House and the Senate approved the compromise version.³⁹ On December 23, 1913, Wilson signed the Federal Reserve Act into law.⁴⁰

C. The Organization of the Federal Reserve

The history of the 1913 Federal Reserve Act demonstrates that there was a common belief during that time that a change in the banking and currency system was needed in order to bolster confidence and security in the minds of Americans. It also highlighted the disagreements between conservatives who advocated for as little government interference in the banking system as possible, and progressives who sought a central banking system controlled by the federal government.⁴¹ In the end, the parties compromised and established a system where the federal

33. JOHNSON, *supra* note 4, at 27, 31.

34. *Id.* at 32; LINK, *supra* note 18, at 51.

35. JOHNSON, *supra* note 4, at 32.

36. *Id.* at 33-34.

37. 63 CONG. REC. 1230 (1913); LINK, *supra* note 18, at 52 & n.63.

38. JOHNSON, *supra* note 4, at 34.

39. *Id.*

40. Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251 (1913).

41. JOHNSON, *supra* note 4, at 17-19.

government controlled the central Federal Reserve Board, but private interests influenced the regional reserve banks.⁴² This mix limits both the private bankers' and the federal government's involvement in certain functions and makes the Federal Reserve System "independent ... within the government."⁴³

Today, the Fed "assist[s] in achieving national economic goals" by implementing monetary policy⁴⁴ and is comprised of a seven-member Board of Governors, twelve regional Federal Reserve Banks, the Federal Open Market Committee (FOMC), the Federal Advisory Council, and numerous privately owned commercial banks.⁴⁵ The members of the Board of Governors are appointed by the President with the advice and consent of the Senate.⁴⁶ The FOMC is composed of the seven members of the Board of Governors and five representatives who must be presidents or first vice-presidents of Federal Reserve Banks.⁴⁷ The representatives are elected annually by the banks' Board of Directors.⁴⁸

II. THE LEGISLATIVE EVOLUTION OF THE FEDERAL RESERVE SYSTEM

After its creation, the Fed continued to evolve through a series of congressional acts that altered and, in many cases, expanded the Fed's original scope of authority. Indeed, right up until 2008, the Fed continued to acquire increasingly expansive powers despite the fact that its quasi-private nature allowed it to operate under a veil of opacity.⁴⁹ The

42. See generally Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251 (1913).

43. The Federal Reserve Board, Frequently Asked Questions: Federal Reserve System, <http://www.federalreserve.gov/generalinfo/faq/faqfrs.htm> (last visited Jan. 26, 2010).

44. *Reuss v. Balles*, 584 F.2d 461, 462 (D.C. Cir. 1978).

45. *Id.*; see 12 U.S.C. §§ 221-522 (2006) (code sections pertaining to the Federal Reserve System).

46. 12 U.S.C. § 241 (2006).

47. 12 U.S.C. § 263(a) (2006).

48. *Id.*

49. This is not to say that every congressional act since the 1913 Federal Reserve Act has further expanded the Fed's powers or reduced its transparency. Indeed, though rare, Congress has on occasion passed legislation that did the opposite. Take for instance the Federal Reserve Reform Act of 1977, Pub. L. No. 95-188, 91 Stat. 1387 (1970). The main purpose of this Act was to make the Federal Reserve more accountable for its actions regarding economic and monetary policy. *Id.* With this Act, the Federal Reserve was now required to report its intentions for the future and the current status of the

following examples demonstrate key pieces of legislation that expanded the Fed's power.

A. The Banking Act of 1935

In 1935, Congress passed the Banking Act.⁵⁰ In addition to creating the Federal Deposit Insurance Corporation (FDIC),⁵¹ the Act relocated the Fed's headquarters to Washington, D.C.⁵² Most significantly, however, the Act assigned control of national monetary policy to the Federal Reserve Board of Governors and the FOMC.⁵³

To accomplish this, the Act made several changes. First, it established that the Board of Governors would be comprised of seven members appointed by the President and subject to confirmation by the Senate.⁵⁴ In addition, the Board would no longer include the Comptroller of the Currency or the Secretary of the Treasury as members.⁵⁵ These changes removed control of the banking system and monetary policy from the federal government and concentrated it with the Fed.

The Act also decreased the autonomy of the twelve individual Federal Reserve Banks. Prior to the Act, these banks were given broad discretion over whether to participate in open market activities.⁵⁶ The Act changed this by requiring them to engage in open market activities under the direction of the FOMC.⁵⁷ Ultimately, the Banking Act of 1935 expanded the Fed's role as the central authority for banking industry oversight and established the Fed as the lead monetary policymaker.

economy during monetary policy hearings before Congress. *Id.* § 202. These hearings allowed Congress to have a more cohesive understanding of how the Federal Reserve's monetary policy decisions and forecasts were affecting and would affect the United States' economy. Ultimately, the Federal Reserve Reform Act of 1977 made the Federal Reserve more transparent.

50. Banking Act of 1935, Pub. L. No. 74-305, 49 Stat. 684 (1935).

51. *Id.* § 101; see R. W. HAFER, THE FEDERAL RESERVE SYSTEM: AN ENCYCLOPEDIA 24 (2005).

52. HAFER, *supra* note 51, at 24.

53. See *id.*

54. § 203(b), 49 Stat. at 704; see HAFER, *supra* note 51, at 24.

55. HAFER, *supra* note 51.

56. *Ruess v. Balles*, 584 F.2d 461, 463 (D.C. Cir. 1978).

57. § 205, 49 Stat. at 705.

B. Federal Reserve-Treasury Department Accord of 1951

In 1942, at the request of the Treasury Department, the Fed voluntarily agreed to maintain a low interest rate on government bonds so that the United States could cheaply finance the war debt.⁵⁸ In order to maintain the low interest rate, the Fed gave up control of the size of its portfolio as well as the money supply.⁵⁹

After the war, President Harry Truman and the Treasury Department sought to keep the interest rate low in order to protect the public's investment in wartime bonds, as well as to contain inflationary measures as the Korean War ensued.⁶⁰ This battle over control of interest rates and monetary policy in general led to the 1951 Accord (the Accord).⁶¹ By eliminating the Fed's obligation to monetize Treasury Department debt at a fixed rate,⁶² the Accord restored the Fed's independence⁶³ and expanded the Fed's powers. Yet again, the Fed was further removed from federal control.

C. The Bank Holding Company Act of 1956

Before the Bank Holding Company Act of 1956,⁶⁴ banks formed holding companies in order to own both banking and non-banking businesses and geographically, to expand into areas where branch banking was otherwise restricted.⁶⁵ The 1956 Act ended this practice by

58. Allan Sproul, "The Accord"—*A Landmark in the First Fifty Years of the Federal Reserve System*, 46 FED. RES. BANK OF N.Y. MONTHLY REV. 227, 228 (Nov. 1964); The Federal Reserve Bank of Richmond, The 50th Anniversary of the Treasury—Federal Reserve Accord 1951-2001: Background, http://richmondfed.org/publications/research/special_reports/treasury_fed_accord/background/ (last visited Jan. 26, 2010).

59. Sproul, *supra* note 58, at 228; The Federal Reserve Bank of Richmond, *supra* note 58.

60. Sproul, *supra* note 58, at 229-30; The Federal Reserve Bank of Richmond, *supra* note 58.

61. Sproul, *supra* note 58, at 230-33.

62. Press Release, Joint Announcement by the Sec'y of the Treasury and the Chairman of the Board of Governors, and of the Fed. Open Market Comm., of the Fed. Reserve Sys. (Mar. 4, 1951), http://www.richmondfed.org/publications/research/special_reports/treasury_fed_accord/historical_documents/pdf/accord_announcement_03_04_1951.pdf.

63. Sproul, *supra* note 58, at 233.

64. Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (1956).

65. Sproul, *supra* note 58, at 280; *see also* J. Nellie Liang & Donald T. Savage, *The Nonbank Activities of Bank Holding Companies*, 76 FED. RESERVE BULL. 280, 280-81

prohibiting bank holding companies from engaging in most non-banking activities or acquiring voting securities of certain non-banking companies.⁶⁶

The Act also increased the Fed's power: by requiring each bank holding company to register with the Board of Governors of the Federal Reserve,⁶⁷ the Act granted to the Fed's Board of Governors the responsibility of regulating and supervising bank holding company activities.⁶⁸ In particular, the Board of Governors was given the power to regulate activities in the areas of banking, finance, or insurance as long as they were closely related to the business of banking or the management or control of banks.⁶⁹ Ultimately, the 1956 Act afforded the Fed broad power and discretion over all institutions that have any control over or influence in the banking system, not just banks themselves.

D. The International Banking Act of 1978

The International Banking Act of 1978⁷⁰ was passed in order to promote competitive equality between foreign and domestic banks, improve federal control over monetary policy, and provide a federal presence in the regulation and supervision of foreign bank activities inside the United States.⁷¹ In order to achieve these goals, the Act placed foreign banks and domestic corporations that conduct business with foreign financial operations under the supervision of the Fed;⁷² the Fed's scope of authority was again expanded.

E. The Full Employment and Balanced Growth Act of 1978

Congress passed the Full Employment and Balanced Growth Act of 1978⁷³ in response to America's fear of a recession in light of high

(Jan. 1990).

66. §§ 3-4, 70 Stat. at 134-37; Liang & Savage, *supra* note 65, at 281.

67. §§ 3-4, 70 Stat. at 134-37; Liang & Savage, *supra* note 65, at 201.

68. *See* Liang & Savage, *supra* note 65, at 281.

69. § 4(c)(6), 70 Stat. at 137.

70. *See* International Banking Act of 1978, Pub. L. No. 95-369, 92 Stat. 607 (1978).

71. John P. Segala, *A Summary of the International Banking Act of 1978*, 5 FED. RES. BANK OF RICHMOND ECON. REV., Jan.-Feb. 1979, at 16, 18-19.

72. § 4, 92 Stat. at 610-13; Segala, *supra* note 71, at 19.

73. Full Employment and Balanced Growth Act of 1978, Pub. L. No. 95-523, 92 Stat. 1887 (1978).

inflation and unemployment rates.⁷⁴ Instead of the singular goal of full employment, as set forth in the Employment Act of 1946, the 1978 Act set forth several economic goals, including full employment, production growth, price stability, trade balance, and a balanced budget.⁷⁵ Specifically, the Act required the Fed to establish a monetary policy that encouraged long-run growth, minimized inflation, and promoted price stability.⁷⁶ It also integrated the monetary policy of the Fed with the economic policy of the President.⁷⁷ Through these changes, Congress created a situation in which the Fed exercised a more direct presence in and greater influence over the national economy and its long-term goals.

F. Depository Institutions Deregulation and Monetary Control Act of 1980

The Depository Institutions Deregulation and Monetary Control Act of 1980⁷⁸ changed the country's monetary policy and deregulated the banking system. Under the Act, all banks, including credit unions and savings and loan companies, were allowed to access the Federal Reserve Discount Window⁷⁹ in order to obtain credit advances.⁸⁰ In return, all banking institutions in the United States were essentially required to abide by the Fed's rules and policies.⁸¹ The end result was to expand the Fed's power over both America's banking industry and the economy in general.

G. The Federal Deposit Insurance Corporation Improvement Act of 1991

The Federal Deposit Insurance Corporation Improvement Act of 1991⁸² was passed in response to the thrift industry crisis. It significantly

74. See COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 201-03 (1984), available at <http://fraser.stlouisfed.org/publications/ERP/issue/1387/>.

75. § 102, 92 Stat. at 1890-92.

76. *Id.* § 2(c), 92 Stat. at 1889.

77. *Id.*

78. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980).

79. For a description of the Federal Reserve Discount Window, see BOARD OF GOVERNORS OF THE FEDERAL RESERVE, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 45-46 (2005).

80. § 103(b)(7), 94 Stat. at 136.

81. *Id.* §§ 102-03, 94 Stat. at 132-38.

82. See Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

increased the powers and authority of the FDIC.⁸³ In addition, the Act included a subsection known as the Foreign Bank Supervision Enhancement Act of 1991.⁸⁴ This provision enhanced the Fed's authority to supervise foreign banks entering the United States banking system.⁸⁵ Foreign banks could no longer establish a branch or agency in the United States without first being approved by the Federal Reserve Board of Governors.⁸⁶ By requiring this approval, the Act strengthened the Fed's ability to examine and supervise foreign banking and further expanded the Fed's influence over the American banking industry and economy.

H. Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Act of 1999 is a far-reaching, complex law that covers many aspects of the banking industry, from mergers of institutions, to protection of private consumer information.⁸⁷ It was passed under the auspices of modernizing the United States financial services industry.⁸⁸ It removed the prohibitions on cross ownership of banks, securities firms, and insurance companies that were established by the Banking Act of 1933,⁸⁹ and it permitted commercial banks to underwrite securities and own insurance companies through federally regulated subsidiaries.⁹⁰

The Act also established the Fed as the regulator of these banks and their subsidiaries, known as financial holding institutions.⁹¹ It gave the Fed and the Treasury Department the right to veto each other's decisions on newly acquired financial powers.⁹² However, more than anything else, the Gramm-Leach-Bliley Act of 1999 significantly expanded the Fed's power—the Fed's authority grew to include the broad category of financial holding institutions, which included banks, securities firms, and insurance companies.

83. Federal Deposit Insurance Corporation, Important Banking Legislation, <http://www.fdic.gov/regulations/laws/important/index.html> (last visited Jan. 26, 2010).

84. Foreign Bank Supervision Enhancement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2286 (1991).

85. *See id.*

86. *Id.*

87. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

88. *See generally id.*

89. *Id.*

90. *Id.* § 121, 113 Stat. at 1373.

91. *Id.*

92. *Id.* § 103(a), 113 Stat. at 1342.

I. The Emergency Economic Stabilization Act of 2008

Congress passed the Emergency Economic Stabilization Act of 2008 as a response to the subprime mortgage crisis in an effort to bail out the United States financial system.⁹³ The Act allowed the federal government to purchase and insure certain types of troubled assets for the purpose of providing stability and preventing disruption to the country's economic growth.⁹⁴ It authorized the Secretary of the Treasury to establish the Troubled Assets Relief Program (TARP) in order to purchase troubled assets from any financial institution.⁹⁵ In addition, the Act directed the Federal Reserve Board and other housing and finance agencies to take a variety of actions, including modifying the terms of mortgage loans and reducing the number of foreclosures.⁹⁶

The Act also allowed the Fed to pay banks a high rate of interest on deposits held as reserve beginning October 1, 2008,⁹⁷ instead of 2011, as specified by prior law.⁹⁸ The Congressional Budget Office estimated that over the next three years, the exercise of this provision will reduce the Fed's payments of its profits, which are considered revenue to the Treasury Department in the federal budget.⁹⁹ Through the Emergency Economic Stabilization Act of 2008, the Fed has become an integral part of rescuing the United States economy from both current and future instability.

With the passage of this Act, the Fed's power was at an apex in terms of scope and authority. From its original role as a central bank primarily focused on monetary policy, the Fed became a gatekeeper over much of the nation's financial system and one of the nation's most expansive economic regulators. Yet, even with these broad powers, the Fed did not possess unlimited authority. As the current economic crisis began to unfold, it became clear that the Fed did not understand these limitations.

93. *See generally* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

94. *Id.* §§ 101-02.

95. *Id.* § 101.

96. *Id.* §§ 102, 109.

97. *Id.* § 128; Letter from Peter R. Orszag, Director, Congressional Budget Office, to the Honorable Barney Frank, Chairman, Committee on Financial Services, U.S. House of Representatives (Sept. 28, 2008), *available at* <http://cboblog.cbo.gov/?p=173>.

98. Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, § 203, 120 Stat. 1969 (2006).

99. Orszag, *supra* note 97.

Rather than operating within its legislative bounds, the Fed soon commenced a series of initiatives that fell squarely outside of its regulatory authority.

III. THE FEDERAL RESERVE'S ROLE IN THE ONGOING ECONOMIC CRISIS

On February 1, 2006, Ben Bernanke was sworn in as chairman of the Fed to replace the retiring Alan Greenspan.¹⁰⁰ Prior to becoming Chairman, Bernanke held a variety of academic positions and served as a member of the Fed's Board of Governors from 2002 to 2005.¹⁰¹ Widely considered a surprise choice by President George W. Bush, Bernanke was nevertheless expected to continue many of the laissez-faire, free-market policies that defined much of Alan Greenspan's terms as Fed Chairman.¹⁰² This expectation, however, should have been balanced with the fact that one of Bernanke's most renowned areas of study and analysis is the Great Depression.¹⁰³ Based on his research, Bernanke concluded that the Great Depression had been exacerbated by the Fed's adherence to orthodox policy.¹⁰⁴ More than anything else, Bernanke's belief that extraordinary measures could have mitigated the Great Depression foreshadowed the extremely market-intrusive measures that the Fed would take as the current crisis unfolded. In response to the crisis, the Bernanke-led Fed engaged in a series of unprecedented regulatory maneuvers. These ranged from an adjustment of existing Fed programs to the creation of entirely new ones.

100. Press Release, Board of Governors of the Federal Reserve System (Feb. 1, 2006), <http://www.federalreserve.gov/newsevents/press/other/20060201a.htm> (last visited Jan. 26, 2010).

101. Board of Governors of the Federal Reserve Board, Biography of Ben S. Bernanke, Chairman, <http://www.federalreserve.gov/aboutthefed/bios/board/bernanke.htm> (last visited Jan. 26, 2010).

102. Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and Into the Future*, 81 AM. BANK. L.J. 375, 400 (2007); Edmund L. Andrews et al., *At the Fed, an Unknown Became a Safe Choice*, N.Y. TIMES, Oct. 26, 2005, <http://www.nytimes.com/2005/10/26/business/26fed.html> (last visited Jan. 26, 2010).

103. For an example of Bernanke's work, see Ben S. Bernanke, *The Macroeconomics of the Great Depression: A Comparative Approach*, 27 J. MONEY, CREDIT & BANK. 1 (1995).

104. *Id.* at 4; Andrews et al., *supra* note 102.

A. *The Adjustment of Existing Programs*

In the beginning of 2007, early indications of a subprime mortgage crisis began to percolate to the surface.¹⁰⁵ One of the key problems was the unanticipated increase of delinquencies in this segment of the mortgage industry.¹⁰⁶ Despite the growing number of failed subprime mortgages and the May 2007 bankruptcy of New Century Financial Corp., a major subprime lender, Bernanke continued to argue that the problem of subprime mortgages did not represent a risk to the financial system as a whole: “We believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.”¹⁰⁷ Even as late as August 7, 2007, the Fed refused to reduce its federal funds rate—a key Fed program that promotes market liquidity through overnight inter-bank lending.¹⁰⁸ By refusing to reduce the federal funds rate, the Fed signaled that no change in market liquidity was necessary.

The Fed’s refusal to act, however, was short-lived. Indeed, only ten days later, the Fed reversed course and cut the Primary Credit Rate—another key interest rate—by one half of 1 percent.¹⁰⁹ Throughout the fall of 2007, the Fed continued to reduce these rates, eventually cutting the federal funds rate to 4.25 percent by December 2007.¹¹⁰

Despite these rapid interest rate cuts, the threats facing the economy continued to grow rather than contract. It became clear that the Fed would have to take more dramatic steps to increase liquidity in the financial system.¹¹¹ The Fed’s next step would be to establish a series of new liquidity programs.

105. Federal Reserve Bank of San Francisco, *The Subprime Mortgage Market National and Twelfth District Developments*, in 2007 ANNUAL REPORT 6, 6 (2009), <http://www.frbsf.org/publications/federalreserve/annual/2007/2007annualreport.pdf>.

106. *Id.*

107. Daniel Wagner, *Key Moments During Bernanke’s First Term as Fed Chairman Show Evolution, Bold Action*, THE WASH. EXAMINER, Aug. 26, 2009, <http://www.washingtonexaminer.com/politics/ap/54944392.html>.

108. Alister Bull, *Timeline: Fed Actions to Boost Activity*, REUTERS, Mar. 17, 2008, <http://www.reuters.com/article/idUSN1755626820080317?virtualBrandChannel=1011&pageNumber=2>. The federal fund rate was 5.25 percent at the time. *Id.*

109. *See id.*

110. *Id.*

111. At the same time, the federal government, through both the Treasury Department and Congress, was implementing a variety of relief programs aimed at addressing the

B. The Creation of New Programs

In December 2007, the Fed created the Term Auction Facility—one of its first new programs aimed at addressing the economic challenges.¹¹² This program was designed to inject liquidity into the financial system; the Fed would auction funds to qualified depository institutions, and a broad array of assets would be eligible to serve as collateral for these auctioned loans.¹¹³ At the same time, the FOMC announced plans to increase liquidity on an international scale through currency swap arrangements with the Swiss National Bank and European Central Bank.¹¹⁴

These dramatic measures still failed to slow down the growing crisis, so, on March 11, 2008, the Fed created another new program—the Term Securities Lending Facility. The program would lend up to \$200 billion worth of liquidity to approved recipients, with a broad array of public and private securities qualifying as collateral.¹¹⁵ During this time, the Fed continued to reduce its interest rates to promote lending and liquidity.¹¹⁶

Even with these measures, the pervasive nature of the crisis was unrelenting. The scope of the problem continued to grow during March 2008, and the Fed was forced to intercede to prevent the failure of Bear Stearns—a move that would ultimately serve as one of the clearest examples of the Fed acting outside the scope of its legislative authority.¹¹⁷

Going forward, the Fed continued to announce new and expanded programs that were designed to increase liquidity in the financial system. The Fed lowered interest rates to essentially zero percent,¹¹⁸ accepted even

growing amount of mortgage defaults and the overall financial problems that they were causing. For more information on these programs, see Chad D. Emerson, *A Troubled House of Cards: Examining How the Housing and Economic Recovery Act of 2008 Fails to Resolve the Foreclosure Crisis*, 61 OKLA. L. REV. 561, 569-84 (2008).

112. Federal Reserve Bank of St. Louis, *The Financial Crisis: A Timeline of Events and Policy Actions*, <http://timeline.stlouisfed.org/index.cfm?p=timeline> (last visited Jan. 26, 2010).

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. For a discussion of the Fed's role in the Bear Stearns matter, see *infra* Part IV.B.

118. Board of Governors of the Federal Reserve System, *Credit and Liquidity Programs and the Balance Sheet*, *The Federal Reserve's Response to the Crisis*, http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm (last visited Jan. 26, 2010).

more types of loan collateral,¹¹⁹ and ultimately provided a bailout for American International Group (AIG).¹²⁰ Many of these actions, while unprecedented in nature, were within the expanded authority that Congress had given the Fed over the last half-century. This, however, was not uniformly the case.

IV. THE FEDERAL RESERVE'S ILLEGAL EXPANSION OF ITS ECONOMIC AUTHORITY

With these new and expanded programs, the Fed unquestionably implemented an aggressive series of actions in response to the current economic crisis. While the effectiveness of these programs is subject to great debate, in many cases their actual legality is not. Although the Fed has a broad array of powers, including a set of emergency powers that further increase its ability to expand existing programs and develop new ones in certain situations, the powers of the Fed are not unlimited.

In responding to the current crisis, the Fed exceeded its statutory limitations. The Fed initiated several programs that fall outside the broad scope of authority that Congress granted to it. It engaged in activities which are impermissible under the 1913 enabling act and subsequent amendments.¹²¹ It has broken the law.

A. The Federal Reserve's Limited Authority to Purchase Private Assets

To fully understand how the Fed exceeded its authority in responding to the current financial crisis, one must make a distinction between two types of assets: public assets and private assets. Public assets are those either originating from or fully guaranteed by the government. They may come in the form of bonds issued by the government itself or through bonds or other obligations issued by a third-party, but fully backed by the government. All other assets are private.

In addition, one must also distinguish between two types of transactions: loans and purchases. The Federal Reserve Act gives the Fed

119. Press Release, Board of Governors of the Federal Reserve System, (Oct. 25, 2008), <http://federalreserve.gov/newsevents/press/monetary/20080914a.htm> (last visited Jan. 26, 2010).

120. Board of Governors of the Federal Reserve System, Credit and Liquidity Programs and the Balance Sheet, Support for Specific Institutions, http://www.federalreserve.gov/monetarypolicy/bst_supportspecific.htm (last visited Jan. 26, 2010).

121. *See supra* Part I.

the power to engage in both loans and purchases, but does so in significantly different ways. For instance, the Fed has the power to provide loans to private parties when those loans are backed by collateral.¹²² In particular, the Fed may regularly provide loans to commercial banks (also known as depository institutions),¹²³ and it may provide loans to non-commercial banks in limited emergency situations.¹²⁴

Although the Fed may purchase certain obligations outright,¹²⁵ the power to purchase assets is much more limited in scope than the power to provide loans. In particular, section 14 of the Federal Reserve Act outlines the narrow scope of the Fed's authority to make purchases. Section 14(b)(1) provides:

Notwithstanding any other provision of this chapter, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities but only in the open market.¹²⁶

In addition, section 14(b)(2) permits the Fed to purchase assets not only backed by the United States directly, but also those guaranteed by a United States government agency.¹²⁷ This means that all purchases made by the Fed, as opposed to loans issued by the Fed, are limited to those obligations in which principal and interest are either owned by the United States or fully guaranteed by it or one of its agencies. Noticeably missing from this authority is the power of the Fed to purchase privately owned assets outright.¹²⁸

The Act does provide the Fed with more expansive powers in certain emergency situations:

122. For a detailed discussion of the scope and history of the Fed's lending powers, see David H. Small & James A. Clouse, *The Scope of Monetary Policy Actions Authorized under the Federal Reserve Act*, <http://www.federalreserve.gov/pubs/feds/2004/200440/200440pap.pdf> (last visited Jan. 26, 2010).

123. *Id.* at 10.

124. MARC LABONTE, CONGRESSIONAL RESEARCH SERVICE, FINANCIAL TURMOIL: COMPARING THE TROUBLED ASSET RELIEF PROGRAM TO THE FEDERAL RESERVE'S RESPONSE 1 (2008), available at <http://www.fas.org/sgp/crs/misc/RS22966.pdf>.

125. *Id.* at 17.

126. Federal Reserve Act § 14(b)(1), 12 U.S.C. § 355(1) (2006).

127. Federal Reserve Act § 14(b)(2), 12 U.S.C. § 355(2) (2006) ("[The Fed may also purchase] any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States.").

128. Privately owned assets are neither issued by the federal government nor generally guaranteed by the government.

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this Title, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are endorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual or partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.¹²⁹

A careful review of these emergency powers reveals that the Fed exceeded even this increased authority with its recent actions. For instance, the emergency section applies only to the *discounting* of notes, drafts, and bills of exchange in unusual and exigent circumstances. Nowhere does the section provide the Fed with authority to purchase private assets. As a result, under the Federal Reserve Act, the Fed cannot purchase notes or drafts that do not comport with section 14.¹³⁰ Significantly, the section 14 authority to purchase private bills of exchange is significantly limited in scope and duration—generally less than ninety days.¹³¹

These clear limits on the Fed's purchasing powers were succinctly stated by two members of the Board of Governors: "There is no express provision in the Federal Reserve Act for the Federal Reserve to use its open-market authority to purchase private-sector promissory notes such as mortgages or corporate bonds or to purchase equities."¹³² Nevertheless, as the current economic crisis grew, the Fed decided that the danger posed to the financial system as a whole warranted actions that were beyond the Fed's actual authority. The clearest examples of this extra-legal conduct are the Fed's actions in response to the looming failures of investment bank Bear Stearns and worldwide financial company AIG.

129. Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006).

130. LABONTE, *supra* note 124, at 1; *see generally* David Small & James Clouse, *The Limits the Federal Reserve Act Places on the Monetary Policy Actions of the Federal Reserve*, 19 ANN. REV. BANKING L. 553, 574 (2000).

131. *See* 12 U.S.C. § 344 (2006).

132. Small & Clouse, *supra* note 122, at 4.

B. The Federal Reserve's Improper Equity Interests in Private Entities

In the cases of Bear Stearns and AIG, the Fed acted outside the scope of its statutory authority by effectively purchasing assets that did not fall within the narrow purchase authority provided by the Federal Reserve Act.¹³³ Essentially, the Fed attempted to use legal trickery to disguise its illegal purchases of private assets from these companies. As one commentator described the situation:

[T]he Fed's assistance in the Bear Stearns merger with JPMorgan Chase took a form that has some similarities to the TARP proposal. In the case of Bear Stearns, the Fed created a limited liability corporation called Maiden Lane, and lent Maiden Lane \$28.82 billion. Maiden Lane used the proceeds of that loan and another loan from JPMorgan Chase to purchase mortgage-related assets from Bear Stearns. Thus, although the Fed created and controlled Maiden Lane, the assets were purchased and held by Maiden Lane, not the Fed. Similar to TARP, Maiden Lane plans to hold the assets until markets recover, and then sell the assets to repay its loans to the Fed and JPMorgan Chase.¹³⁴

The Fed created a wholly-controlled limited liability company (LLC) to engage in purchase activities that the Fed was barred from doing itself by the Federal Reserve Act.¹³⁵ In fact, the Fed implicitly admitted as much in later disclosures: "Maiden Lane LLC (ML LLC) was formed to facilitate the merger of the Bear Stearns Companies, Inc. and JPMorgan Chase & Co. The New York Fed extended credit to ML LLC to acquire certain assets of Bear Stearns."¹³⁶

Despite this statement, the Fed went on to claim that by "loaning" money to Maiden Lane to purchase Bear assets, rather than purchasing the assets directly from Bear Stearns, it somehow complied with the Federal Reserve Act: the transaction constituted a lending activity for which the Fed has broad rights, rather than a purchasing activity.¹³⁷ As one

133. See generally LABONTE, *supra* note 124 (discussing the purchases); see also *supra* notes 122-32 and accompanying text.

134. LABONTE, *supra* note 124, at 4.

135. Federal Reserve Act, §§ 13(3), 14(b)(2), 12 U.S.C. §§ 343, 355(2) (2006). Technically, the owner of the Maiden Lane entities was the New York Federal Reserve Bank rather than the Fed itself. However, that is a distinction without significance, since both entities are subject to the private purchase restrictions of the Federal Reserve Act. See Federal Reserve Act § 14(b)(2), 12 U.S.C. § 355(2) (2006).

136. Federal Reserve Bank of New York, Maiden Lane Transactions, <http://www.newyorkfed.org/markets/maidenlane.html> (last visited Jan. 26, 2010).

137. See generally *id.*

commentator noted, this is not an accurate description of the actual transaction: “From an economic perspective, this complex arrangement is functionally identical to a purchase of the Bear portfolio by the Fed—one that’s financed in small part by the subordinated \$1 billion loan from JPMorgan.”¹³⁸

Another problem with this scheme is that nowhere in the Federal Reserve Act did Congress provide authority for the Fed to create subsidiary corporate entities as it did with Maiden Lane.¹³⁹ The Fed cannot simply establish off-the-books shadow companies to avoid its restrictions under the Act. The legislative power of Congress cannot be circumvented by merely creating a LLC.

The Fed used two other Maiden Lane LLCs¹⁴⁰ to divert Fed funds into impermissible AIG equity investments. Known as Maiden Lane II and Maiden Lane III,¹⁴¹ these LLCs were created by the Fed to purchase credit default swaps and mortgage securities from AIG; the diminished value of these assets was burdening the company to the point that its continued ability to operate was in question.¹⁴² While the Fed did not pay AIG directly, it essentially purchased assets from AIG—the Fed system was the true owner of the Maiden Lane entities.¹⁴³ As with the Bear Stearns transaction, the Fed’s attempt to conceal an illegal purchase of AIG assets through the use of a wholly-controlled LLC is, at best, a surreptitious attempt to circumvent the meaning of the Federal Reserve Act and, at worst, an intentional and purposeful violation of the law.

138. Peter Coy, *Where No Fed Has Gone Before*, BUS. WEEK, Mar. 26, 2008, http://www.businessweek.com/magazine/content/08_14/b4078000069548.htm (last visited Jan. 26, 2010).

139. *Id.*; see also Federal Reserve Act §§ 13(3), 14(b)(2), 12 U.S.C. §§ 343, 355(2) (2006).

140. Whatever the Fed possesses in brazenness it apparently lacks in naming creativity—the term “Maiden Lane” appears to have been selected because it is the name of the street on which the New York Federal Reserve Bank is located. Mark Pittman, *Bear, AIG Dumped \$74 Billion in Subprime, CDOs on Fed (Update I)*, BLOOMBERG, Apr. 24, 2009, <http://www.bloomberg.com/apps/news?pid=20601109&sid=aP2XyOHIRSGI>.

141. See generally Federal Reserve Bank of New York, *supra* note 136.

142. *Id.*; see also Posting of Andrew Ross Sorkin to Dealbook Blog, <http://dealbook.blogs.nytimes.com/2008/12/03/aig-and-us-in-deal-to-terminate-some-debt-obligations/> (Dec. 3, 2008, 7:22 EST).

143. Federal Reserve Bank of New York, *supra* note 136. (“The New York Fed has all material control rights over the Asset Portfolio and is the sole and managing member of ML LLC.”).

C. The Federal Reserve's Overall Ineffective Response to the Current Crisis

The impropriety of the Fed's response to the current economic crisis is paralleled only by the Fed's ineffective work leading up to the crisis. Indeed, the Fed's decision to exceed its legislative authority was, in large part, the result of its failure to act proactively in preventing, or at least mitigating, the crisis in the first place. The scope of the Fed's failure to comprehend the extent of the looming economic crisis is evidenced by a review of the actual public statements made by the Fed leading up to the crisis, especially those made by Chairman Bernanke.

Considering the great amount of power that his office possesses, Chairman Bernanke is in a special position to inform the public as to the state of the economy.¹⁴⁴ Moreover, when he addresses the public, his statements typically represent the official views of the Fed.¹⁴⁵ In the present crisis, this has been problematic, because he has repeatedly failed to comprehend the scope and extent of the crisis.

Consider the following statements made by Mr. Bernanke as the crisis unfolded:

July 2005

INTERVIEWER: Ben, there's been a lot of talk about a housing bubble, particularly, you know [inaudible] from all sorts of places. Can you give us your view as to whether or not there is a housing bubble out there?

BERNANKE: Well, unquestionably, housing prices are up quite a bit; I think it's important to note that fundamentals are also very strong. We've got a growing economy, jobs, incomes. We've got very low mortgage rates. We've got demographics supporting housing growth. We've got restricted supply in some places. So it's certainly understandable that prices would go up some. I don't know whether prices are exactly where they should be, but I think it's fair to say that much of what's happened is supported by the strength of the economy.

July 2005

INTERVIEWER: Tell me, what is the worst-case scenario? Sir, we have so many economists coming on our air and saying, "Oh, this is a bubble, and it's going to burst, and this is going to be a real issue for the economy." Some say it could even cause a recession at some point. What is the worst-case scenario, if in fact we were to see prices come down substantially across the country?

144. See generally 12 U.S.C. § 225(b) (2006).

145. See generally *id.*

BERNANKE: Well, I guess I don't buy your premise. It's a pretty unlikely possibility. We've never had a decline in house prices on a nationwide basis. So what I think is more likely is that house prices will slow, maybe stabilize: might slow consumption spending a bit. I don't think it's going to drive the economy too far from its full employment path, though.

INTERVIEWER: So would you agree with Alan Greenspan's comments recently that we've got some areas of the country that are seeing froth, not necessarily a national situation, but certainly froth in some areas?

BERNANKE: You can see some types of speculation: investors turning over condos quickly. Those sorts of things you see in some local areas. I'm hopeful—I'm confident, in fact, that the bank regulators will pay close attention to the kinds of loans that are being made, and make sure that underwriting is done right. But I do think this is mostly a localized problem, and not something that's going to affect the national economy.

November 2006

BERNANKE: This scenario envisions that consumer spending, supported by rising incomes and the recent decline in energy prices, will continue to grow near its trend rate and that the drag on the economy from the [inaudible] housing sector will gradually diminish. The motor vehicles sector may already be showing signs of strengthening. After having cut production significantly in recent months, in response to the rise in inventory of unsold vehicles, automakers appear to have boosted the assembly rate a bit in November, and they have scheduled further increases for December. The effects of the housing correction on real economic activity are likely to persist into next year, as I've already noted. But the rate of decline in home construction should slow as the inventory of unsold new homes is gradually worked down.

February 2007

BERNANKE: We expect moderate growth going forward. We believe that if the housing sector begins to stabilize, and if some of the inventory corrections still going on in manufacturing begin to be completed, that there's a reasonable possibility that we'll see some strengthening in the economy sometime during the middle of the new year. Our assessment is that there's not much indication at this point that subprime mortgage issues have spread into the broader mortgage market, which still seems to be healthy. And the lending side of that still seems to be healthy.

July 2007

BERNANKE: The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending

standards, and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment, as well as by mortgage rates that, despite the recent increase, remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further, as builders work down the stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth in coming quarters, although the magnitude of the drag on growth should diminish over time. The global economy continues to be strong, supported by solid economic growth abroad. U.S. exports should expand further in coming quarters. Overall, the U.S. economy seems likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend.¹⁴⁶

Clearly, the Bernanke-led Fed repeatedly failed to recognize the severity and scope of the current economic crisis. This failure indicates a lack of overall competence in the execution of its legislative authority—something that impugns any deference it might receive in expansively interpreting its regulatory powers.

In no uncertain terms, the Fed failed in its efforts to recognize and measure the crisis in advance, as well as implement effective policy and programmatic responses. Individually, these failures damage the Fed's efficacy. Taken together, they evidence a systemic failure of the central bank. At the very least, this should provoke Congress to vigorously investigate the extent to which the Fed itself was a contributor to the severity of this crisis.

Unfortunately, the opacity of the Fed's actions is so cloudy that it is able to prevent a comprehensive examination of these practices. The Fed's ability to obscure an in-depth review of its illegal equity purchase activities provides the most convincing evidence in support of an initial, but significant step toward resolving this obfuscation: a comprehensive Congressional audit of the Federal Reserve System.¹⁴⁷

146. These quotes are taken from a transcript of a video compilation of statements by Ben Bernanke. The transcript can be found at Mises Daily, *Ben Bernanke Was Incredibly, Uncannily Wrong*, <http://mises.org/story/3588> (last visited Jan. 26, 2010). The original video can be found at <http://www.youtube.com/watch?v=HQ79Pt2GNJo>.

147. Recently, Chairman Bernanke publicly called for the Government Accountability Office to conduct a "full review" of the Fed's activities related to the AIG bailout. See *Bernanke Asks GAO to Review Fed's AIG Bailout*, MSNBC, Jan. 29, 2010, http://www.msnbc.msn.com/id/34939495/ns/business-us_business/. While this may constitute some step towards transparency, it falls woefully short. Not only is the review limited to a single transaction, Chairman Bernanke fails to define what constitutes a "full review." Whatever Chairman Bernanke's motives, this development is at best a piecemeal step

V. THE NEED FOR A COMPREHENSIVE AND INDEPENDENT AUDIT OF THE FEDERAL RESERVE

Though the Fed's illegal equity purchase activities are evident in a macro sense, the precise details of this malfeasance is difficult to expose, especially because Congress currently does not possess the power to comprehensively audit the Fed.¹⁴⁸ This is true despite the fact that the Fed has the ability to control the monetary policy of the United States. The Fed can essentially make the federal government responsible for unlimited financial obligations through its loan and purchase powers.¹⁴⁹ At the same time, the Fed has historically been able to shield itself from complete and independent audits of its activities.

From the Federal Reserve Board's inception in 1913 until 1933, the federal government maintained a limited authority to audit some of its functions.¹⁵⁰ The 1933 Banking Act eliminated most of this authority leaving only a very narrow swath of audit authority.¹⁵¹

It was not until the late 1970s that Congress restored the federal government's ability to engage in broader audits of the Fed's activities. This renewed authority arose out of the Federal Banking Agency Audit (FBAA) Act, which Congress passed in 1978.¹⁵² One of the main purposes of the FBAA Act was to expand congressional oversight over the Fed.¹⁵³ The Act empowered the Government Accounting Office (GAO) with "authority to audit the Board of Governors [and] Reserve Banks"¹⁵⁴

However, the Act was not as effective as it could have been—it specifically prohibited the GAO or any other independent entity from

that is too narrowly crafted to effectively address the underlying issues discussed in the following section.

148. See PAULINE SMALE, CONGRESSIONAL RESEARCH SERVICE, STRUCTURE AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM 6 (2005), available at http://www.policyarchive.org/bitstream/handle/10207/3436/RS20826_20050615.pdf?sequence=1.

149. See generally 12 U.S.C. §§ 343, 355(2); *supra* Part IV.A.

150. H.R. 2176, *A Bill to Amend the Accounting and Auditing Act of 1950: Hearing Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the H. Comm. On Government Operations*, 95th Cong. 3 (1977) (statement of Ellsworth H. Morse, Jr., Asst. Comptroller of the United States), available at <http://archive.gao.gov/f1102a/100319.pdf>.

151. *Id.*

152. Federal Banking Agency Audit Act of 1978, Pub. L. No 95-320, 92 Stat. 391 (1978) (codified as amended at 31 U.S.C. § 714 (2006)).

153. SMALE, *supra* note 148, at 6.

154. *Id.*

auditing several other critical areas of Fed activity. The FBAA Act, as currently codified, provides that:

Audits of the Federal Reserve Board and Federal reserve banks may not include--

- (1) transactions for or with a foreign central bank, government of a foreign country, or nonprivate international financing organization
- (2) deliberations, decisions, or actions on monetary policy matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;
- (3) transactions made under the direction of the Federal Open Market Committee; or
- (4) a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to clauses (1)-(3) of this subsection.¹⁵⁵

These exceptions are problematic, because they include the sources of the Fed's faulty decisions, including the illegal equity purchases, made in response to the present economic crisis. The inability of any independent agency to audit the Fed's monetary actions and transactions with most foreign entities, as well as the activities of the FOMC, prevents a detailed review of the Fed's unprecedented actions in this matter. The result is a glaring "blind spot" in the government's ability to audit the agency that has the ability to bind it to near unlimited financial obligations.

In response to the argument that the Fed faces little to no oversight, the Fed points to the Inspector General Act of 1978, which authorizes the Inspector General of the Federal Reserve System to engage in reviews of the areas that the FBAA Act prevents the GAO from auditing.¹⁵⁶ However, this authority is insufficient for two reasons. First, the Fed's Inspector General, while certainly professing independence, is nevertheless still a part of the Federal Reserve System. As such, no matter how it is conducted, any audit by the Fed's Inspector General is simply a self-audit by the Fed. This in no way equates to an independent audit.

Worse still, by the Inspector General's own admission, the power of the office to review the areas excluded from the GAO's audit jurisdiction is limited and subject to the final authority of the Fed itself:

The Board's OIG is also authorized to audit and investigate the monetary policy programs and operations of the Board. However, this

¹⁵⁵ 31 U.S.C. § 714 (2006).

¹⁵⁶ Inspector General Act of 1978, Pub. L. No. 95-452, 92 Stat. 1101 (1978).

access can be limited, in part, by section 8G(g)(3) of the IG Act. *These provisions state that the Board's IG may be placed under the direction and control of the Chairman of the Federal Reserve Board, if such control is necessary to prevent the disclosure of any information concerning decisions or deliberations on policy matters, the disclosure of which could reasonably be expected to have a significant influence on the economy or market behavior, or if such disclosure would constitute a serious threat to national security. In these cases, the agency head has the ability to prohibit such an audit or investigation, if the agency head determines that such prohibition is necessary to prevent significant impairment to the national interests of the United States.*¹⁵⁷

The acknowledgment that the Fed has final discretion over the auditing power given to the Inspector General evidences the true inability for any entity—internal or external—to engage in an independent and comprehensive audit of the Fed's full range of activities. The GAO has some limited authority, and the Fed's Inspector General also has some limited authority. Neither entity, though, has absolute auditing power. This gap in auditing coverage allows the Fed to ultimately prevent a full review of the complete details behind its response to the current financial crisis.

Ultimately, because of the Fed's conduct, the federal government finds itself obligated on purchases for which Congress did not provide any budgetary appropriation. As one commentator described the situation:

If this case proves anything, it's that the Fed is ready to press the limits of its charter to keep the financial system afloat. Effectively acquiring the Bear [Stearns] assets at a bargain price and then liquidating them is similar to what Resolution Trust Corp. did when it shut down savings and loans and auctioned off their loan portfolios in the 1990s. The difference is that Congress set up the RTC but had nothing to do with the Fed's moves.¹⁵⁸

In response to this untenable situation, Representative Ron Paul of Texas introduced the Federal Reserve Transparency Act,¹⁵⁹ and Senator Bernie Sanders of Vermont introduced the Federal Reserve Sunshine Act of 2009.¹⁶⁰ Both acts would provide the federal government with the

157. *The Role of Inspectors General: Minimizing and Mitigating Waste, Fraud, and Abuse: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 111th Cong. 11 (2009) (statement of Elizabeth A. Coleman, Inspector General, Board of Governors of the Federal Reserve System) (emphasis added), http://www.house.gov/apps/list/hearing/financialsvcs_dem/coleman_testimony.pdf.

158. Coy, *supra* note 138.

159. Federal Reserve Transparency Act of 2009, H.R. 1207, 111th Cong. (2009).

160. Federal Reserve Sunshine Act of 2009, S. 604, 111th Cong. (2009).

authority to engage in a comprehensive and independent audit of the Fed's activities, including those related to the current financial crisis.

The importance of this authority is evidenced by the strong bi-congressional support that both bills have received. Indeed, as of September 2009, Representative Paul's bill had 290 co-sponsors—more than enough to secure a vote before the full 435-member House of Representatives.¹⁶¹ In addition, the legislation is largely bi-partisan—over 100 of the co-sponsors of Republican Paul's bill are Democrats.¹⁶² Senator Sanders' bill has likewise generated bi-partisan support, with 27 sponsors as of September 2009.¹⁶³

If Congress were to pass these bills, the GAO could engage in a complete and independent audit of the Fed's activities, both generally and specifically related to its current, unprecedented programs. The audit would include a comprehensive review of the details related to the Fed's illegal equity purchases in the transactions involving Bear Stearns and AIG.¹⁶⁴ The usefulness of such a review was succinctly explained by one commentator: The "particular confluence of the ugly and the unknown [the Maiden Lane LLCs], is exactly why we need an outside, independent audit of the Federal Reserve."¹⁶⁵

Protests by the Fed and its supporters that such authority would infringe upon the Fed's independence are unfounded, as the audits could be structured to narrowly review whether the Fed's activities fall within the scope of its statutory authority.¹⁶⁶ There is simply no reasonable basis to argue that an investigation into the legality of specific Fed programs would compromise the central bank's independence. Rather than serve as a threat, an audit would force the Fed to more stridently act to conform to the law—appropriate behavior for an entity created by Congress with the ability to bind the federal government and United States citizens to a wide array of near unlimited financial obligations.

161. H.R. 1207.

162. Steve Cauley, *Audit of Federal Reserve Gains Momentum*, EXAMINER.COM, Aug. 6, 2009, <http://www.examiner.com/x-19241-Austin-Libertarian-Examiner~y2009m8d6-Audit-of-Federal-Reserve-gains-momentum>.

163. S. 604.

164. *See supra* Part IV.B.

165. The Daily Bail, *JPM and Maiden Lane: What the Fed Doesn't Want Us to Know*, <http://seekingalpha.com/article/149488-jpm-and-maiden-lane-what-the-fed-doesn-t-want-us-to-know> (last visited Jan. 26, 2010) (emphasis omitted).

166. Posting of Declan McCullagh to Econwatch, <http://www.cbsnews.com/blogs/2009/07/28/business/econwatch/entry5193539.shtml> (July 28, 2009, 12:32 EST).

A concern by the Fed that a review of the details of this now-hidden activity would result in political gamesmanship, if proven valid, could be accommodated by limiting the disclosure of this information, as is done for disclosures of national security information to Congress for its oversight of military and intelligence agencies.¹⁶⁷ At the very least, elected members of Congress should be afforded the power to see the full details of the Fed's transactions.

Ultimately, the Fed's illegal purchases of private assets from private companies provide the most striking rationale to date for Congress to authorize a comprehensive and independent audit into the central bank's lending and purchasing activities.

CONCLUSION

The Federal Reserve Act of 1913 established a central banking system that was part private and part public. Unfortunately, the Fed has used its partially private nature to circumvent the scope of its statutory authority under the 1913 Act. The lack of transparency in the Fed's behavior has enabled the Fed to engage in purchases of private assets that are impermissible under the law. As a result, Congress should authorize a comprehensive and independent audit of the Fed's purchasing and lending activities. Only through exposure can the negative effects of the Fed's opaque actions be resolved and the current financial crisis addressed in a productive way.

167. *See, e.g.*, National Security Act, 50 U.S.C. §§ 413, 413a (2006).