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Are We Ready for the Next Financial Crisis?

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SYMPOSIUM

ARE WE READY FOR THE NEXT FINANCIAL CRISIS?[†]

WELCOME AND INTRODUCTORY REMARKS

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WELCOME AND INTRODUCTORY REMARKS

MATTHEW DILLER: Good afternoon. My name is Matthew Diller. I have the honor of being the Dean of Fordham University School of Law. It is a pleasure to see you all here this afternoon.

Thank you for joining us for the Symposium of the *Fordham Journal of Corporate & Financial Law*, which was founded twenty years ago. This is an anniversary event for us. Let me just say that we are so proud of the success the *Journal* has had and the impact that it has had over the twenty years of its existence. In fact, it is remarkable that the *Journal* is only twenty years old and is already the most cited student-edited journal in banking and finance law.[1] It shows how quickly the *Journal* has had an impact. That is really what we aim to do here. We aim to put forward considered, thoughtful, yet often provocative ideas that meet a need in the marketplace and help us think more clearly and more deeply about problems that we are facing in moving forward through corporate leadership in our society.

Before I talk about today's program, let me thank a few people. I want to thank, in particular, Caitlin Fahey, the *Journal*'s Symposium Editor, who put together today's program. Thank you, Caitlin. I want to thank two of our wonderful faculty members, Professor Caroline Gentile and Professor Sean Griffith, for their leadership and their contributions in guiding the *Journal*. I also want to thank Sean for his leadership of the Corporate Law Center here at Fordham, which is one of our jewels as well. The fact of the matter is that we really rock in the field of business law. When you look at our course catalogue, we have an amazing range of courses that our students really flock to. We also have both the Corporate Law Center and the *Journal* as focal points for activity, and as a way of getting our message out to the world. When you add that all up, it is really remarkable. It is all supported by a superb and extremely deep faculty.

I want to also thank our panelists for joining us, Richard Kim, Fordham Law alumnus Eric Grossman, and our keynote speaker, Dan

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1. According to the ranking system maintained by the Law Library at Washington & Lee University School of Law. *See Law Journals: Submissions and Ranking, 2007 – 2014*, WASH. & LEE UNIV. SCH. LAW, http://lawlib.wlu.edu/LJ/index2014.aspx?mainid=554 [perma.cc/Z6GZ-LABF] (to replicate the search results, search "Subject: Banking and finance;" then "Edit type: Student-edited;" and "Ranking Criteria: Case cites").

Gallagher. It is a pleasure to have you back at Fordham. There is one more thank-you that I need to do by way of introduction, which is to Professor Richard Squire, whom I have left for last, and whose work is really the inspiration for today's program. There has been a lot of talk and discussion and back-and-forth on Dodd-Frank. There is a certain book coming out in 2016 through the Columbia University Press that you must read, *Getting Ready for the Next Bailouts* by Professor Richard Squire,[2] which is the inspiration for today's program. Let me tell you a little bit more about Richard. He has been a member of the Fordham faculty since 2006. He teaches corporations and corporate reorganization in bankruptcy. He has twice been elected Fordham Law School's Teacher of the Year in 2010 and 2011. His scholarly articles have appeared in the *Harvard Law Review*,[3] the *Yale Law Journal*,[4] and the *Stanford Law Review*,[5] among other journals. That is really quite an arsenal of accomplishments. So, we are all very glad to be here today.

I will now turn it over to you, Richard.

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2. RICHARD SQUIRE, GETTING READY FOR THE NEXT BAILOUTS (forthcoming 2016).

3. Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151 (2010).

4. Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L. J. 806 (2009).

5. Richard Squire, *Antitrust and the Supremacy Clause*, 59 STAN. L. REV. 77 (2006).

PANEL

RICHARD SQUIRE: Thank you very much for that introduction, Dean Diller.

Our program today consists of two main events. First, we are going to have this panel discussion. Each of the panelists is going to speak for about fifteen to twenty minutes on the subject of the conference. The title of the conference is *Are We Ready for the Next Financial Crisis?* We will have time to take about thirty-five minutes of questions from you all. We are looking forward to those questions. We will have a break for about fifteen minutes, and then we will have a very special second half of the event, which is the keynote address from former Commissioner Gallagher. Since I am the host of the panel, it is my responsibility to get the conversation going by speaking first. But before I give my comments, I would like to introduce my co-panelists. We are very lucky to have both of these gentlemen here.

Eric F. Grossman is the Chief Legal Officer at Morgan Stanley, a position he has held since 2012. He previously was Morgan Stanley's head of litigation and the General Counsel of the Americas. Before he joined Morgan Stanley in January of 2006, he was a partner in the litigation department of Davis Polk & Wardwell, where he started working in 1994. He became a partner there in 2001. He graduated from Hamilton College in 1988, and—the most distinguished accomplishment on his résumé—he graduated from the Fordham Law School with a degree magna cum laude in 1993, where he was a member of the Order of the Coif and part of the *Fordham Law Review*. He also clerked for the Honorable Richard J. Cardamone for U.S. Court of Appeals for the Second Circuit after leaving Fordham. We are very excited to have you here, Mr. Grossman.

After Mr. Grossman speaks, Richard Kim will speak. Mr. Kim is a partner at the New York law firm of Wachtell, Lipton, Rosen & Katz. He specializes in representing financial institutions in a broad range of regulatory matters, including in connection with mergers and acquisitions, enforcement actions, compliance, and related matters. He was previously an attorney with the Board of Governors of the Federal Reserve System—the Federal Reserve is going to play prominently in my comments—where he worked on a wide range of bank supervisory matters. He was also Assistant General Counsel with NationsBank Corporation. He graduated from Stanford in 1983, and his law degree is from Columbia in 1986. He is also a member of the Board of Directors of the Asian American Legal Defense and Education Fund.

I would like to thank both of my co-panelists for joining me today. I am speaking first, and I feel like I should start by giving you what I think is the answer to the question: Are we ready for the next financial crisis? My answer is going to be no, I do not think we are. In a certain, important way, I think we are less ready than we were in 2007 and 2008 during the last crisis. I am going to tell you about why I think that is and maybe what we need to do about it in the future.

I will discuss just a little bit of information to refresh our memories, because it has been almost ten years. Back in 2006, housing prices did something that they are not supposed to do ever—they fell. They started falling in 2006 and continued falling in 2007.[6] People started defaulting on their mortgages at rates that were unprecedented.[7] This created risk for banks because banks and other financial institutions held much of either the original loans or the repackaged loans in mortgage-backed securities and other instruments. So, in 2007, financial institutions started having difficulty in terms of their liquidity.[8] They were running short on cash. Depositors were taking their money away. Other short-term creditors were not rolling over the debt. So, we had a financial crisis—or at least a liquidity crisis initially—in the making.

In December 2007, the Federal Reserve created the first of several emergency liquidity mechanisms to provide cash to the financial sector pursuant to its power to do so as the lender of last resort as the central bank in the United States. The general public started paying attention. I started paying attention—I count myself as a member of the general public, certainly at this point. In March 2008, Bear Stearns, the big investment bank, looked like it was going to file for bankruptcy.[9] Nobody thought this could happen. The federal government, in the first of what I think of as the "notorious bailouts," backed an acquisition and

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6. *See* RICHARD SCOTT CARNELL ET AL., THE LAW OF FINANCIAL INSTITUTIONS 31-32 (5th ed. 2013).

7. *See id.*

8. For a discussion of these liquidity problems, see generally Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 23 J. ECON. PERSP., no. 1, 2009, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.1.77 [http://perma.cc/CU4N-NHGN].

9. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 280-91 (2011).

put some taxpayer money at risk so that Bear Stearns would not file for bankruptcy. Instead, it would be acquired by J.P. Morgan.[10] Things reached a boiling point, both politically and financially, in September 2008. Lehman Brothers filed for bankruptcy.[11] Simultaneously, the most notorious of all the bailouts occurred. You may remember that a large amount of money was made available, initially by the Federal Reserve, and that would eventually be worth $180 billion, to the international insurance company, AIG, that got involved in mortgage assets by writing certain derivatives that ensured the performance of certain mortgage-backed securities.[12]

There was outrage at this point. This was seen as something that was necessary, but it was a necessary evil. AIG did not help matters for itself. You might remember, in early 2009, AIG announced that it was going to pay some bonuses to the people who were in the same department—it was actually in London—that had been selling these credit default swaps that had gotten in trouble.[13] There was this outrage that taxpayer money was going to be used to pay expensive bonuses to rich bankers. President Obama actually directed Timothy Geithner, the Treasury Secretary, to pursue every legal avenue possible to block these bonuses and to make the American taxpayers whole.[14]

People were outraged across the political spectrum at what was happening. I was among the people who were outraged. Occupy Wall Street, that movement of ongoing outrage, would be an outgrowth of all of this. I think there were two main reasons for the outrage. One had to

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10. *See id.* J.P. Morgan initially offered to buy Bear Stearns for $2 per share, but later increased the offer to $10 per share. *See id.* at 290; Andrew Ross Sorkin, *JPMorgan Raises Bid for Bear Stearns to $10 a Share*, N.Y. TIMES (March 24, 2008), http://www.nytimes.com/2008/03/24/business/24deal-web.html [http://perma.cc/EYD8-75CD].

11. Carrick Mollenkamp et al., *Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash*, WALL. ST. J. (Sept. 16, 2008, 6:52 PM), http://www.wsj.com/articles/SB122145492097035549 [http://perma.cc/BJP6-UPWQ].

12. *See generally* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009).

13. Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES (Mar. 14, 2009), http://www.nytimes.com/2009/03/15/business/15AIG.html [http://perma.cc/6BA4-97CY].

14. *Obama's Statement on A.I.G.*, N.Y. TIMES: THE CAUCUS (Mar. 16, 2009, 12:45 PM), http://thecaucus.blogs.nytimes.com/2009/03/16/obamas-statement-on-aig/ [http://perma.cc/KV93-8J75].

do with a sense of an injustice being done: that money was being transferred from the average American, or at least the average American taxpayer, to very wealthy Wall Street bankers. So, this seemingly regressive wealth transfer was occurring. The other had to do with whether you are someone who generally believes in free markets—and I put myself in that category—then you thought that something else perverse was happening, which was that the government was getting involved in the economy, and that moral hazard was being created. We were taking losses and transferring the burden of them from the people who were responsible to people who were not responsible, to innocent people, to the taxpayers. If you have that kind of transfer of loss, then it just encourages more irresponsible behavior.

We had the main political response, but we also had the main regulatory and statutory response, which was the Dodd-Frank Act enacted in 2010.[15] There is no doubt about it that this was an "anti-bailout" bill. It actually says in the preface that the promise was to end "too big to fail" and "to protect the American taxpayer by ending bailouts."[16] The statute imposes a slew of new regulations on banks and financial institutions. They are supposed to make these institutions more sound and less risky. There are also many regulations that were political priorities for Congress at the time, but were not related to the financial crisis. I am not going to address those now. It is a very large bill and it tries to do many things.

One of the things that it does as part of its anti-bailout agenda is to clip the wings of the Federal Reserve.[17] The Federal Reserve has an emergency lending power as part of its lender-of-last-resort function, but the statute amended the Federal Reserve's power, and it said that in the future the Federal Reserve would no longer be able to lend to just one particular financial institution.[18] What the Federal Reserve would have to do instead is to lend based on broad-based eligibility criteria established beforehand.[19] This is the "anti-AIG" bailout provision. There is no doubt that Congress had it in mind that we never want that to happen again; we never want a one-off type of bailout where the Federal

15. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered titles of U.S.C. (2012)).

16. *Id.*

17. *Id.* § 1101, 124 Stat. at 2113-15.

18. *Id.*

19. *Id.*

Reserve uses its statutory power to bail out one particular institution. President Obama, when he signed the bill, said "the American people will never again be asked to foot the bill for Wall Street's mistakes."[20]

That is about where we were in 2010. We had this narrative that Wall Street had fleeced Main Street, and therefore, we had a statute that would make sure that did not happen again. But, we need to update the narrative. We need to look at what happened in the subsequent years. A funny thing happened on the way to the fleecing of the American taxpayer, which is that Wall Street paid all of the money back, with interest. I will give you some specific examples of this. Some of you may know this, and some of you may be surprised by this. This certainly was not emphasized nearly as much in the press as the original bailouts were.

Let me start with the Troubled Asset Relief Program ("TARP"). TARP was the bailout fund that was authorized by Congress in October 2008.[21] At this point, back in October 2008, there was so much flak being received by the Federal Reserve for its liquidity measures that it felt that it simply could not go on without some kind of political cover. It went to Congress and said, "We want you to authorize money to be given," and Congress did that. TARP was originally authorized for $700 billion.[22] Not all of that was ever disbursed. $313 billion was disbursed to the financial sector.[23] The financial sector paid back $321 billion. It is not a great return on your investment, but when you are expecting to lose hundreds of billions of dollars, and it turns out that the taxpayer actually makes money, then it turns out to be a successful program.

TARP is not the biggest story in terms of the bailouts of the time, but it was the most famous. The Federal Reserve created several other liquidity mechanisms. I will mention one: the Term Auction Facility

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20. Barack Obama, President, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010), http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act [http://perma.cc/NM8Y-HD3F].

21. Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, tit. I, 122 Stat. 3765, 3767-800.

22. Emergency Economic Stabilization Act § 115.

23. *Report on the Troubled Asset Relief Program−March 2015*, Cong. Budgeting Office, at 3 (2015), http://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/50034-TARP.pdf [http://perma.cc/88UQ-WQTW].

("TAF").[24] There is a good chance you have not heard of this or do not know much about it. From December 2007 to March 2010, the Federal Reserve made liquidity loans to banks. The largest amount outstanding was $493 billion at one point, so this was actually bigger than TARP.[25] That was all repaid in full with interest.

In addition, the Treasury guaranteed for one year all investors in money market mutual funds.[26] This was after one money market mutual fund, Reserve Primary Fund, broke the buck.[27] This means that it became slightly insolvent. There was then a general run by investors in other money market mutual funds. To put an end to this, the Treasury guaranteed the investments for a year. The number of claims made to the Treasury on these guarantees for that one year was zero. No claims were made.[28] We never had to pay out—by "we," I mean the taxpayer—on these guarantees. In fact, we made money because $1.2 billion was charged in fees to the funds that received the guarantees.[29]

So far, so good, in terms of these bailouts. They are not fleecing the taxpayer. Now, let us go to the most notorious bailout, AIG. AIG was given $182 billion at various points.[30] In the end, the government received that amount in full, plus an additional profit of $23 billion.[31] This was a very high rate of return on a government-based loan

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24. For more information about the TAF, see *Term Auction Facility*, BD. OF GOVERNORS OF THE FED. RES. SYS., http://www.federalreserve.gov/monetarypolicy/taf.htm [http://perma.cc/G8YN-ZCUL] (last updated Nov. 24, 2015).

25. *See* Bradley Keoun, *Fed's $1.2 Trillion Loan Lifelines Dwarfed TARP: Glossary*, BLOOMBERGBUSINESS (Aug. 21, 2011, 7:01 PM), http://www.bloomberg.com/news/articles/2011-08-21/fed-s-1-2-trillion-liquidity-lifelines-dwarfed-tarp-glossary [http://perma.cc/L646-TTME].

26. *See Press Center: Treasury Announces Temporary Guarantee Program for Money Market Funds*, U.S. DEP'T TREASURY (Sept. 29, 2008), http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx [http://perma.cc/BET7-Y2PP].

27. *See* Diya Gullapalli, Shefali Anand & Daisy Maxey, *Money Fund, Hurt by Debt Tied to Lehman, Breaks the Buck*, WALL ST. J. (Sept. 17, 2008, 12:01 AM), http://www.wsj.com/articles/SB122160102128644897 [http://perma.cc/J663-UCGQ].

28. *See Press Center: Treasury Announces Expiration of Guarantee Program for Money Market Funds*, U.S. DEP'T TREASURY (Sept. 18, 2009), http://www.treasury.gov/press-center/press-releases/Pages/tg293.aspx [http://perma.cc/SX5P-PWBD].

29. *See id.*

30. *See Press Center: Treasury Sells Final Shares of AIG Common Stock, Positive Return on Overall AIG Commitment Reaches $22.7 billion*, U.S. DEP'T TREASURY (Dec. 11, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx [http://perma.cc/7GF3-P67U].

31. *See id.*

investment that was ultimately in one financial institution. There is a certain irony here. AIG was the most notorious of the bailouts, and yet it was the most successful according to a set of criteria set out by Walter Bagehot, an English economist in the nineteenth century who wrote about the proper role of a central bank in a liquidity crisis.[32] He wrote that in a financial crisis, the central bank provides a valuable service by lending freely to solvent financial institutions at penalty rates against good collateral. Penalty rates mean a high rate of interest, which is certainly what AIG paid.

Why is that a good idea? Well, that means that we do not have moral hazard. The private investors, the shareholders who are borrowing the money, are the ones that are bearing the costs. The taxpayer does not bear the cost, and so we do not have moral hazard. AIG's shareholders paid through the nose for that bailout money, so much so that one of them sued the federal government. That shareholder was Hank Greenberg, the former CEO of AIG. He was pushed out by Eliot Spitzer before any of this happened. He sued the federal government claiming that the bailout money was so expensive that it amounted to a taking of private property for public use without compensation, and thus was a Fifth Amendment violation.[33] Regardless of what we think of the constitutional argument, it certainly shows that this was not free money being given away.

What we have in Dodd-Frank, once we update the story, and once we look at the fact that the bailout money was all paid back with interest—with an exception that I am going to talk about in a moment—we see that Dodd-Frank reflects a misdiagnosis. Wall Street, or the financial sector generally, was not insolvent in 2007 or 2008. A few firms were slightly insolvent and what we had was a liquidity problem. This was not a surprise. Financial institutions often get into liquidity difficulties. Their job is to take short-term liquid loans, deposits, and so on, and invest them in illiquid assets, which are mainly but not exclusively mortgage-based assets. Sometimes when there is a drop in the value of those assets, which is what we had, there is a concern in the market that some of these financial institutions may be insolvent and will not repay either in full or on time, so investors and depositors

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32. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (1873).

33. *See* Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 431 (2015).

rationally want to pull their money out. However, they do not know which ones are insolvent, so they pull their money out of all of them. There is a lack of transparency about who is going to fail, who may be in trouble, and who is not. As a result, the financial sector as a whole no longer can tap private sources of cash. This is where the lender of last resort, serving a valuable function, steps in. You do not have to be someone on the left wing politically to believe that the lender of last resort is a good idea. These are not Keynesian stimulus packages, which are controversial. Bagehot was a very conservative economist. This is a valuable public service, especially when the government has a fiat currency. It can provide liquidity more cheaply than others.

By the way, we should not have been surprised that most firms in the financial sector never became insolvent. A couple of numbers put this in perspective. At the end of 2006, there were $1.3 trillion of subprime mortgages outstanding. It sounds like a lot, but if we look at that same point and add up the equity value—not the value of the assets, but the shareholder equity—of all the financial institutions plus Wall Street institutions, it exceeded $1.3 trillion. Even if those subprime mortgages had turned out to be worth zero, it would not have rendered the whole financial sector insolvent. Actually, the losses, which were much greater than anybody expected, were only a fraction of that $1.3 trillion—about a fifth.

There was no doubt that we were not going to be facing widespread insolvency. What we had was widespread illiquidity. The Federal Reserve did what it was supposed to do. It was flexible at this period. It was nimble in its responses. The bailouts overall did a pretty good job. Now, there is an exception here. I do not want to say the bailouts were perfect. I am going to criticize TARP in particular. Remember, this is where Congress got into the act, and then the Treasury Department got into the act and made two mistakes. I keep saying the money was paid back. It was paid back if we are talking about financial institutions.

The Secretary of the Treasury Department also authorized loans for GM and Chrysler.[34] You have probably heard of them. They are not banks; they are manufacturers of automobiles. They do not face liquidity crises; they face solvency problems. Eighty billion dollars was given to

34. *Financial Stability: Auto Industry*, U.S. DEP'T OF THE TREASURY (last updated Dec. 22, 2014), http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/automotive-programs/Pages/overview.aspx [http://perma.cc/MHU5-M289].

Detroit, and Detroit did not give anywhere close to that back. Most of the losses on TARP, about $15 billion, are from the bailouts to the automakers.[35]

You may think that it was a good idea for other reasons, maybe for political reasons or for general economic stimulus, but it certainly does not fit the textbook of the lender-of-last-resort function of the central bank. My view is that it had a political motivation. In addition, TARP created more risk for the taxpayer because, unlike the Federal Reserve, Congress did not lend money precisely. What Congress did was give investments in exchange for preferred stock, which put the taxpayer lower down in the pecking order in case the entity failed. It did not end up failing, but if it had, there would have been greater losses for the taxpayer, and therefore, more risk. Certain mistakes are made when this function is transferred from the central bank to the political branches. Here, it transferred from the Federal Reserve to Congress, and then to the Treasury Department and the executive branch.

Are we going to have another crisis? Every major banking crisis in developed economies since 1945 has followed a drop in housing prices. This is well established now. If you want to read the book on this, it is *This Time Is Different* by economists Carmen Reinhart and Kenneth Rogoff.[36] This is always and everywhere, since 1945, in Europe, Japan, and the United States. After a housing crisis, prices fall and then we have a banking crisis. If we were really worried about banking crises, the best response would have been to change our housing policy. For reasons that I do not completely understand, there is a view that you are simply an irresponsible person, and that you are not really grown up and mature, if you do not own your house. I am a renter, but for some reason, the federal government thinks that I am irresponsible. We have a policy in the United States in which we subsidize through the tax code, and through other government agencies, programs that are designed to put people into houses that they own through mortgages, even if their credit would not enable them to get a loan otherwise.[37] As long as we

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35. Brent Snavely, *Final Tally: Taxpayers Auto Bailout Loss $9.3B*, USA TODAY (Dec. 30, 2014, 5:54 PM), http://www.usatoday.com/story/money/cars/2014/12/30/auto-bailout-tarp-gm-chrysler/21061251/ [http://perma.cc/3BNT-96FA].

36. CARMEN M. REINHART & KENNETH ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009).

37. James Surowiecki, *The Mortgage Mistake,* NEW YORKER (Jan. 12, 2015), http://www.newyorker.com/magazine/2015/01/12/mortgage-mistake [http://perma.cc/9

have that subsidy for the housing market, we are going to have a risk of a financial crisis.

Given that, are we in a better position than we were before? I say no. The reason is that Dodd-Frank, for one, clipped the wings of the Federal Reserve to provide this lender-of-last-resort function and to provide liquidity. I think when a crisis happens again, it is going to have to go to Congress for authorization for more money earlier than it even did in 2008. This introduces a political variable, which can create uncertainty and other associated risks. The problem here is not just in terms of regulatory awareness. There is, I think, a mentality, and there is a political problem as well. Bailouts have a really bad name. It is like the Rodney Dangerfield of economic policy. I think the government actually did a great job, and this is coming from someone who is generally a free-market type of person. In particular, the Federal Reserve did a very good job, but the view is that they are so bad that now it is going to be even more politically damaging to try to do anything like that again. Right now, Congress—which is mainly Republican—is proposing legislation that would further roll back the ability of the Federal Reserve, and secondarily, the Treasury, to provide liquidity to struggling financial institutions in a crisis.[38] I think bailouts have an undeserved bad name. Properly structured, they work well.

What do I think academics like me should do? I think to better prepare us for the next crisis, it is the job of academics and other commentators to revisit the facts, update impressions, and try to acquaint politicians, the press, and the general public with the real lessons of the last crisis. And that gives me a perfect opportunity to plug my book. In my book, which will be coming out next year, I will try to do exactly that.[39] I have given you a summary of my arguments here.

Thank you for your attention. I will now turn it over to Mr. Grossman.

ERIC GROSSMAN: I will try not to repeat what Richard said. I think there is probably a fair bit of overlap for all of us. I sent Richard a note a couple of weeks ago that said, "What do you want me to talk about?" He said, "Well, the question for the day is, are we better able to prevent and weather another financial crisis?"

FBV-MPDL].

38. *See* Bailout Prevention Act of 2015, S. 1320, 114th Cong. (2015).

39. SQUIRE, *supra* note 2.

Hopefully, history informs in terms of where we are right now and the tools that are available. In that sense, history is quite helpful. As Richard points out, there is a fair bit of misunderstanding. There were lost opportunities all along the way for the narrative to be more fairly told. The one that resonates the most for me was the Financial Crisis Inquiry Commission ("FCIC").[40] After 9/11, there was the 9/11 Commission, which actually brought together the greatest and best minds to look at what had happened, at the failures of government, of intelligence, and of the business community, and to make concrete and specific recommendations.[41] You may agree or disagree with those, but it was done purely in the interests of the country.

The stated goal of the FCIC was to do the same, but it basically turned into a political circus. It was handed over to plaintiffs' lawyers, who created a narrative that sort of suited them, which was that the banks were solely responsible. The FCIC contributed to the demonization of the banks and financial services. I am not here to argue with the outrage because I live here in New York and I lived through it. I think, to some extent, clearly the outrage, coupled with the misunderstanding, has left us in a difficult spot on the "weather" side.

On the prevention side, an extraordinary amount has been done. While Richard was talking, I wrote down that I think a financial crisis is less likely, but that we are less ready. Why is it less likely? Fundamentally, if you look at it from a banker's perspective, which I lived through, and if you pull together the strands from all of the various episodes, whether it is the Bear Stearns episode, the Lehman Brothers episode, the Morgan Stanley episode, or the Bank of America episode, it really comes down to confidence. Runs on banks go back to the beginning of time because the banking system is fundamentally built on confidence. People take their money, they bring it to a bank, and they leave it there expecting it to be there when they come back. You have to trust that your life savings, your inheritance, and the product of your labors are going to be there when you come back. And then what do banks do? Of course, banks then borrow themselves and enhance the size of their balance sheet, and they lend and provide capital so that the economy grows. This is all done with the implicit understanding that

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40. FIN. CRISIS INQUIRY COMM'N, *supra* note 9.

41. NATIONAL COMMISSION ON TERRORIST ATTACKS UPON THE UNITED STATES, THE 9/11 COMMISSION REPORT (2002).

when you come back asking for your money, you will get it back. So, confidence is key.

As one thinks about whether the public should be more confident in the banking sector, the answer is unequivocally yes, in my mind, provided that people think rationally. I will talk a little bit about irrationality in a minute, and, of course, rationality to irrationality is across a continuum. But from a rational perspective, banks are much safer than they were before the crisis. If any blame can be laid at the feet of the banks prior to the crisis, it is that the things that we do now should have been done before, and certainly done more thoughtfully. We have far more capital now. Banks in the United States, and globally, unequivocally have way more capital than we ever had before. We carry way more liquidity. If you think about a banking crisis as fundamentally being a concern that your cash, when you come back for it, would not be there, we carry way more liquidity than we did before. And, our balance sheets are far less levered. If you take our capital and then think about the size of our balance sheet, the ratios are all constrained.

Why do we do all these things? We started to do all of these things after the crisis. We saw what happened and we learned these lessons ourselves. On top of that, the Federal Reserve, which came within a hair's breadth in Dodd-Frank of losing its supervisory authority over United States banks, retained that authority and has constructed a regulatory framework with two pillars: Comprehensive Capital Analysis and Review ("CCAR") and Comprehensive Liquidity Assessment and Review ("CLAR").[42] Every bank holding company in the United States is subject to annual tests by the Federal Reserve Bank to ensure that under the absolute worst, draconian scenario that you could imagine—the Great Recession, the Great Depression, a singular idiosyncratic loss, all of those things coming at one time—you can still deliver capital back to your shareholders in the form of either stock repurchases or dividends. The last time around every bank in the country passed CCAR.

If you want a perspective not dissimilar to the one that Richard and I have about what has happened here, Dick Bove would tell you that, as an investor, banks are in fact the safest place to put your money these

42. Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Res. Sys., Speech at the Clearing House 2014 Annual Conference (Nov. 20, 2014), http://www.federalreserve.gov/newsevents/speech/tarullo20141120a%20.htm [http://perma.cc/RL54-SY9N].

days[43] because there is no industry anywhere on the planet that is subject to these kinds of tests that go to their fundamental capital structure. We at Morgan Stanley cannot deliver a dividend to our shareholders without the approval of the Federal Reserve. We cannot buy stock back without the approval of the Federal Reserve. We cannot make a significant acquisition without the approval of the Federal Reserve. We do that every year. Our balance sheet, of course, is constrained by the supplemental leverage ratio, which is built into the CCAR process.

I could go on and on about the various things banks are now subject to, and I am not complaining about these things. What I am here to tell you is that, in terms of the financial sector, it is drastically different. From a rational perspective, banks are safer, and in that sense, I am not a Dodd-Frank "hater." There are aspects of it that I think are misguided, but I think that is quite clear that a crisis is less likely to occur because banks are better situated.

Now, there is always a place for irrational behavior. I just want to touch on that. It is fair to say that in the environment we live in today, it is much more likely. With the Internet, hedge funds and investors who generally have an incentive to put downward pressure on a stock can do so much more easily than they could before. We at Morgan Stanley, just a couple of years ago, saw about a 10% decline in our stock based on an anonymous report that came out on the Internet suggesting that we were disproportionately exposed to Greece during the Greek crisis, which was not true.[44] We rushed out a disclosure in which we identified all of our European country periphery exposure so that we could disabuse the world of that.[45] However, within the time period that it took us to correct that, our stock was down 10%. And what is stock price? Actually, it has no bearing on capital, liquidity, or anything other than it is the easiest proxy for whether or not a bank is doing well. So there is a place for irrationality; if they start coming after you, and if it is all built on confidence, then there is really no defense to that.

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43. *See* Dan Weil, *Richard Bove: Banks Are 'Healthiest They've Been Since Depression'*, NEWSMAX (Jan. 7, 2014, 2:38 PM), http://www.newsmax.com/Finance/StreetTalk/Bove-banks-healthiest-depression/2014/01/07/id/545735/ [http://perma.cc/4U29-AAX8].

44. Paul R. La Monica, *Is Morgan Stanley the Next Lehman?*, CNN (Oct. 3, 2011, 1:26 PM), http://money.cnn.com/2011/10/03/markets/thebuzz/ [http://perma.cc/Z4DF-GNC6].

45. MORGAN STANLEY, 3Q 2011 FINANCIAL SUPPLEMENT 13 (2011).

To get back to my basic thesis, from a rational perspective, we are far more able to prevent a financial crisis. As to whether or not we are in a better position to weather a financial crisis, I largely agree with everything that Richard said. There has been a great distortion of what the lender-of-last-resort purpose is and what a bailout is. I agree the term "helping hand" would have been better. "Bailout," of course, suggests that the role being played is not a proper one.

Take a bigger bank than the bank that I work at. For example, let us consider J.P. Morgan—a big, giant bank. If J.P. Morgan gets in trouble, with all of the depositor money that is there—there is a Chase on every corner—there is no entity out there large enough, other than the United States Government, that can actually prevent them from toppling over. We need that. That is the foundational element of an economy. Dodd-Frank, in the interest of an overheated political environment, robbed the Federal Reserve of those powers to act. Both of the gentlemen to my right and left here understand the provisions and the changes to those far better than I do, but I can tell you that as a citizen that scares me. It is not out of self-interest. I work at a bank every day. People in the wake of the crisis formed views about bankers. There was this very clear sense that Main Street bailed out Wall Street. My view is that the government actually bailed out Main Street. We have developed this sort of fundamental disconnect in the United States of the role and the criticality of financial services to our success as a country and the success of our economy.

I am not going to sing our praises at Morgan Stanley, but we have a very basic strategy. We raise, manage, and distribute capital for individuals, sovereigns, corporations, and institutions. That is what we do, and that is what we view as our role fundamentally. A company, or great idea, needs to raise money in order to develop that great idea. They come to us and that is what we do. The people at Facebook develop a brilliant idea. They devote their lives to it. They want to become a public company. They come to Morgan Stanley.[46] In conjunction with the other banks, we underwrite their public offering to allow that company to prosper and grow. There are no greater and more developed capital markets than here in the United States.

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46. *See* Serena Saitto, Cristina Alesci & Lee Spears, *Facebook Underwriters to Split $176 Million in IPO Fees*, BLOOMBERGBUSINESS (May 18, 2012, 6:09 PM), http://www.bloomberg.com/news/articles/2012-05-18/facebook-underwriters-to-split-about-176-million-in-ipo-fees [http://perma.cc/BNY6-PKJM].

It is all fundamentally founded on the notion that, at the end of the day, when you go to a bank and put your money in the bank, it will be there when you come back. If you worry about that, you will just leave your money under your mattress at home, where it does no good for the rest of society and where it is at much greater risk.

I worry about that distortion. If you think fundamentally about Dodd-Frank, it put the tools, not entirely, but more in the hands of Congress to act. I remember watching in my office as the first TARP votes rolled in, and the no votes overwhelmed, I was thinking that it was the end. I went to a cash machine and took out some cash that day because I thought that this was the end. Obviously, none of us want to see that happen. I will touch on some of the other things that came out of Dodd-Frank, very briefly. Then, I will turn it over to the other Richard.

Included within Dodd-Frank were a number of ancillary provisions that I believe were intended to prevent excessive risk taking or excessive risk within financial institutions. The most prominent of those is the Volcker Rule.[47] I suspect if I asked everyone here what the Volcker Rule was, almost all of you would say it prohibits prop trading at banks. That is the way that Mr. Volcker himself would refer to it, but, in fact, the Volcker Rule prohibits non-prohibited proprietary trading because what goes on at banks all the time is that we put our capital at risk every day in making markets and in hedging our own risks. The citizen and the corporation actually want banks playing this fundamental market-making role.

In a crisis situation, one can take Morgan Stanley as an example. Richard, to my right, has a basket of securities that he needs to sell. He has to sell those in a crisis because he has to pay his employees or maybe he has an acquisition that he wants to do. He has a basket of securities that he wants to sell and it is critical for him to sell. Banks, before the Volcker Rule, would buy that basket of securities. They would give him a price and they would buy it, even if they had no idea necessarily what they were going to do with it. Now, under the Volcker Rule, when the banks buy Richard's basket of odd securities that do not trade readily on a market, the banks actually cannot buy those unless they reasonably expect that Richard, on my left, or some other Richard

47. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620-31 (2010) (codified as amended at 12 U.S.C. § 1851 (2012)).

out there is going to buy them. The banks have to prove to five different regulators that they reasonably expected Richard, on my left, or someone else to buy those securities. This puts aside all of the liquidity constraints, punitive capital charges, and the other things that have emerged from the credit crisis. In a crisis, am I going to do that? I do not know. So just when the country would want the major banks to jump in and provide liquidity, we are going to be less likely to do it, it is going to be harder for us to do it, and we are actually going to create risk for ourselves.

What has that done? That has pushed risk into places that are far less regulated. At Morgan Stanley, we have 175 bank examiners who come to work at Morgan Stanley every day. They have a card, they log in, we have a whole floor for them, and we pay for them. We are safe. We are less sound, but we are plenty safe. Again, I worry about the "weather" piece. In terms of prevention, I think the industry itself, with the Federal Reserve clearly leading the way, has unquestionably created a much safer banking system in terms of confidence. But I think if we find ourselves in a storm, we have far fewer umbrellas and raincoats.

RICHARD KIM: I think you are going to find that we are more or less in agreement. To go to the question that Professor Squire posed, are we ready for the next financial crisis? I would say, almost by definition, you do not see a financial crisis coming. So, I would say no, but I do think that all of the regulatory reforms that we have talked about should make the next financial crisis less severe.

As for whether we are now better positioned to handle the next financial crisis than we were in 2008, I think that is really the harder question. I would say, on balance, we are probably marginally better positioned, but I do not think that it is because of Dodd-Frank. I think Dodd-Frank has some redeeming provisions, but so much of it has just been an enormous, unnecessary burden on the banking industry. It has hurt the city. It has hurt the economy.

I am going to cover three topics: 1) how the financial regulatory system has evolved since 2008, 2) an overview of the regulatory environment today, and 3) whether today's regulators are better able to handle the next financial crisis than the regulators were in 2008.

If we go to the first topic, what has happened since 2008? There has really been a seismic change in the financial regulatory system. I think Eric gave a good summary of all the changes that have happened. Many point to Dodd-Frank as a reason for this. In my view, the real effective changes that mattered occurred independently of Dodd-Frank. Immediately following the financial crisis in 2008, there was a profound and lasting change in the perspective of the financial regulators. As early as 2009, a year before Dodd-Frank was enacted, the bank regulators were already out there toughening standards. They significantly raised the bar for United States banks. Much of this was done with four tools, and none of these were born out of Dodd-Frank. They were all done under statutory authority that existed before then.

First, immediately after the crisis, a large number of banks were downgraded by the regulators. You may know that the bank regulators rate banks and bank holding companies. There is a scale between one and five, with one being the best and five being the worst.[48] After the crisis, virtually no bank received a one. Before the crisis, it was not unusual for a well-run bank to have a one rating. That does not really exist anymore, so the curve has changed. They do not give out A's anymore. A rating of two is satisfactory. Once you get to a three, you have a problem. A rating of three essentially puts a bank in the penalty box. You are unable to acquire. You are unable to branch. You have caps on your ability to pay dividends. When you are downgraded to a four, you are deemed to be a troubled institution. That is when the problems really start. Formal, public enforcement actions are instituted by the regulators. You are subject to heightened oversight and the number of regulators at your bank dramatically increases. They place restrictions on your ability to hire new management and directors. They want the approval for any senior manager that you hire. If you want to change a position in the senior ranks, you have to get their approval to do that. If people leave, you cannot pay them the severance, even if they are doing it with a contract, without regulatory approval, which is very hard to get. If you are rated a five, you are deemed to be at probable risk of failure. I think if you look at the banks rated at five, very few of them actually come back from that. The ratings that are assigned to a bank are completely discretionary. They are strictly confidential and the banks are prohibited by law from disclosing them.[49] They are not subject to judicial review. So, they are really sort of the perfect supervisory tool. You immediately saw banks being downgraded, putting the pressure on them.

48. The scale refers to the CAMELS rating system. For a more in depth discussion of the scale, see CARNELL ET AL., *supra* note 6, at 434-40.

49. *See* 12 C.F.R. §§ 261.2(c)(1), 261.20(g), 261.22(e) (2015).

Second, there was an absolute battery of enforcement actions, the number and severity of which was without precedent. I think everyone would see, just by picking up a paper every other day, some massive enforcement action directed at a bank. They ranged from increasing capital to strengthening anti-money launder compliance, consumer compliance, or risk management. There were loads and loads of them, with civil money penalties that were exponentially higher than what was required pre-crisis.

The third tool is corporate governance. The regulators have been exerting an enormous amount of pressure on the boards of directors of banks to strengthen capital, liquidity, risk management, compliance, and internal audit. They did not used to do that. Effectively, they have used the pressure on boards in a very assertive way, and I think in a very effective way. I think the way it came about was, following the crisis, in the regulators' view, the industry then had what they would call an ethical crisis. You had scandals ranging from mortgage servicing to LIBOR, foreign exchange, and all the different things you see in the papers. I think at the time, the regulators realized that you cannot predict where the next scandal is going to occur. So, one way to get ahead of this is to put pressure on the boards and make them do it.

Over the past couple of years, it is a very common complaint from my clients that the Fed is putting dramatically increased pressure on their boards of directors. The Fed is out there positing that directors have a fiduciary duty not just to the shareholders, but to the regulators, which suggests causes of action to plaintiffs' lawyers. We all know the consequences there. They are widely criticizing bank boards for providing insufficient challenges to management. They are interviewing independent board members and independent chairmen to see whether or not they really have a strong grasp of the issues at hand by conducting ad hoc phone calls and quizzing them on things.

Fourth, Eric mentioned CCAR. I think CCAR is probably the most powerful tool the Fed has these days. Any large bank, $50 billion or more in assets, is subject to this annual stress test.[50] Each year you have to file a capital plan, proposing how much, in the way of dividends, you plan to pay out over the following nine quarters. If you plan to make material acquisitions, you note that there as well. You do not have to say who you are going to acquire, but you have to give them a sense of the amount and the impact on capital. Then you have to submit your

50. *See* 12 C.F.R. pt. 46.

stressed numbers. You actually have to show how your balance sheet will fare in a hypothetically adverse and severely adverse scenario that the Fed gives you. The Fed gives you the assumptions, and they are everywhere, such as stock market crashes or skyrocketing unemployment. We have had a euro collapse, and we have had to model for global pandemics. These are very detailed submissions. CCAR submissions can run up to 10,000 pages.

The Fed can object to a capital plan. First, on quantitative grounds, they can say, at the end of the day, "Under these hypothetical scenarios, you do not have enough capital, so we object," which means that you cannot do the acquisitions, and you cannot pay the dividends. They can object on what they call qualitative grounds, which really is any other reason. They can also object if they do not like the strength of your internal controls or if they do not like the strength of capital risk management. Unlike the bank ratings I previously discussed, whether you pass CCAR is publicly released by the Fed. It is a very tense day for the banks. If you fail CCAR, there is enormous pressure on the market to get it right the next time. You could look at the banks that failed CCAR, and there are repercussions. People get fired. It is an event with great consequences. The regulators are using all these tools today, I think, in a very effective manner, and none of them are rooted in Dodd-Frank.

On that note, let me move briefly to Dodd-Frank. When you look at Dodd-Frank, and I think when you look at any piece of financial services legislation, the key is lowering your expectations. The political process today makes it very hard to enact coherent, comprehensive reform of our financial regulatory system. Dodd-Frank is an unfortunate example of this. It was enacted in 2010 at a time when there was, and continues to be, a significant amount of resentment towards Wall Street. It is compounded by perceptions of outsized compensation packages. If you add to all of that the fact that Dodd-Frank suffered from the election cycle and politicians looking to foment and capitalize on populist anger, the financial regulation is very complicated. It is highly technical. It is almost like reforming the tax code. It is full of unintended consequences. The financial industry had almost no influence in Washington at that time.

Dodd-Frank itself was rushed to enactment. If you look at the conference process, it was done in a few short months, and even then, it was really done in episodic bursts of all-nighters, and not in a deliberate process, which should have taken a year or more. Normally, banking legislation does that. So, it is not that surprising, when you think about it that way, that you have an act, parts of which do not really provide any benefits, and parts of which just do not make any sense at all.

I am not in the camp that is advocating that Dodd-Frank ought to be repealed. There are portions of the act that I think are beneficial, and they were a long time coming. It did away with the Office of Thrift Supervision, the agency that regulated thrifts, which was largely ineffective.[51] It established an agency dedicated to consumer protection.[52] You may disagree with how aggressive they are, but I think there was a need for something like that. Dodd-Frank also made a lot of technical amendments to the banking laws that were very long overdue. But, at the same time, it came in at an enormous, needless cost. It did a number of things that did not need to be done. Eric talked about the Volcker Rule.[53] I think that is at the top of most people's list. If you look at what is happening in the trading markets today, especially for debt, you have discouraged the largest banks from trading in those markets, and you basically decrease their liquidity and increase their volatility, and it is going to get worse if we approach another financial crisis.

Professor Squire talked about how Dodd-Frank curtailed the Federal Reserve's emergency lending powers. This was invaluable during the crisis. Some have argued that this was necessary to reduce the so-called moral hazard because if you have a Federal Reserve that can bail out companies, you will encourage excessive risk taking. There was a quote by Ben Bernanke where he said that limiting the Fed's emergency lending power is like "shutting down the fire department to encourage fire safety."[54] It is just not a rational way to attack the problem.

As for how effective all of this has been, not just Dodd-Frank, but the other tools that I have talked about, I think it has been very effective. I think the financial regulatory system is much tougher than it was. But again, it is largely because of the efforts that started before Dodd-Frank. It really was not because of Dodd-Frank.

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51. Dodd-Frank Wall Street Reform and Consumer Protection Act § 312, 124 Stat. at 1521-23.

52. *Id.* § 1011, 124 Stat. at 1964-65.

53. *Id.* § 619, 124 Stat. at 1620-31.

54. Ben S. Bernanke, *Warren-Vitter and the Lender of Last Resort*, BROOKINGS (May 15, 2015, 11:00 AM), http://www.brookings.edu/blogs/ben-bernanke/posts/2015/05/15-warren-vitter-proposal [http://perma.cc/G8GW-KLQZ].

That brings me to today's regulatory environment. Where are we today? What is today's regulatory environment like? There has really been a sea of change in the philosophy underlying bank regulation. As the Fed would put it, they have shifted from what they would call micro-prudential concerns: ensuring that each bank had capital to prevent it from failing, but just enough so that banks were not at the same time compromising profitability, international competitiveness, and other commercial considerations. They have changed to what they call macro-prudential concerns: minimizing the possibility of another systemic failure. That is a very different standard and requires an entirely different level of capital. Now the Fed is demanding dramatically more capital, looking holistically at the financial system, and they are really not thinking anymore about maintaining profitability or international competitiveness.[55] I think we have some real problems because of that. At the same time, capital levels, as a result, have increased sharply.[56] For the first time, capital requirements increase the larger and more complex a bank grows because the failure of a large bank has more systemic risk than the failure of a smaller one. We have other mechanisms that I am sure you have heard about, such as living wills and other mechanisms designed to make it more orderly if a large institution fails, and so there is less disruption to the overall economy. We see the Fed reaching out to try to regulate the non-banks, GE Capital,[57] Prudential,[58] and MetLife,[59] the famous court case which I am sure you have read about.[60] They are

55. Ryan Tracy, Victoria McGrane & Justin Baer, *Fed Lifts Capital Requirements for Banks*, WALL ST. J. (July 20, 2015, 8:29 PM) http://www.wsj.com/articles/fed-set-to-finalize-amount-of-capital-big-banks-must-maintain-1437410401 [http://perma.cc/NJ8N-EDTT].

56. *See id.*

57. Press Release, Bd. of Governors of the Fed. Res. Sys. (July 20, 2015), http://www.federalreserve.gov/newsevents/press/bcreg/20150720b.htm [http://perma.cc/DJZ2-TUHF].

58. *Financial Stability Oversight Council – Designations*¸ U.S. DEP'T TREASURY, http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx [http://perma.cc/J8FU-MAU8].

59. *Id.*

60. Complaint, MetLife Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-00045 (D.D.C. filed Jan. 13, 2015).

going to try to reach into the shadow banking market.[61] I think we will see that in the coming year.

This shift in the regulatory philosophy has not just changed the policy; it has really changed the sort of people that regulate banks. If you look at what the Fed is doing today, it is a lot more data-driven. If each of the large banks submits 10,000 pages on their capital plans, regulation is much more data-driven than it was before. Banks now submit an enormous amount of data to the Fed in the form of CCAR stress tests and many other regulatory reports. All that data is centralized in D.C. and analyzed there. What has happened is that the Federal Reserve in D.C. has really sort of emerged with more prominence and the local Reserve Banks have less authority and less autonomy. If you look at the folks that are working at the Fed these days, they are changing over. This is more of a data-driven process. It demands younger employees that are more facile with computers and technology. They are able to manipulate large, complex models. A consequence of it is that you are seeing a lot of the veteran supervisors that had some real judgment being pushed out and replaced by what I will call technocrats, for lack of a better word. They have very little supervisory experience in the field, let alone industry experience.

The net result of all this is that you have a lot less discretion these days when there is a supervisory problem or an issue. The judgment by the regulators can lead to very unfair results. A capital shortfall, a regulatory violation these days, no matter how trivial, can lead to a disproportionately harsh response. I think adding to this disproportionality is that financial regulations have become very politicized. Punishing banks and bankers is still very much a priority of the current administration, and you are seeing the regulators continue to follow this theme.

On September 9, 2015, the Department of Justice sent new policies to its federal prosecutors across the country instructing them to increase their focus on punishing individuals in cases of corporate misconduct, and not just the corporations.[62] I think this is a direct response to what

61. Christopher Condon & Ian Katz, *Fed Focuses on Shadow Banking as It Gauges Financial Risk*, BLOOMBERGBUSINESS (Mar. 27, 2015, 12:00 AM), http://www.bloomberg.com/news/articles/2015-03-27/fed-focuses-on-shadow-banking-as-it-gauges-financial-system-risk [http://perma.cc/7HF5-EPW7].

62. *See generally* Memorandum from Sally Quillian Yates, Deputy Att'y Gen., U.S. Dep't of Justice, to All U.S. Att'ys et al., Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015), http://www.justice.gov/dag/file/769036/download

you see in the media. Why have we not seen more bankers gone to jail? They are still on it, and this is still an issue and a priority. When Eric Holder stepped down as Attorney General, he extracted more fines than any other Attorney General from the banking industry, yet he was widely criticized for not sending bankers to jail.[63] With the presidential elections next fall, I think you are going to continue to hear this refrain.

To get to the heart of the question, and the topic of the seminar, are we better able to handle the next financial crisis? As far as the regulators are concerned, we have seen a significant change in personnel, and they are equipped with different tools. If you look at them, are they better able to handle the next financial crisis than the regulators we had in 2008? I think of this question in three parts.

First, you think about the people manning the regulatory agencies, you look at their supervisory tools, and then you look at the fragility of the overall financial system. In 2008, I think the country was extraordinarily fortunate to have Ben Bernanke as the chairman of the Federal Reserve. As it happened, we had one of the guys who is a leading scholar of the Great Depression. I think we were equally fortunate to have Hank Paulson, who had just stepped down as CEO of Goldman Sachs, as a Secretary of the Treasury. Together, they really led the nation's response to the financial crisis. I felt they acted with courage and inventiveness. I do not think they have gotten their due from history. They had an extraordinary set of lieutenants, some of the most talented men and women in finance I have ever worked with. They had accomplished backgrounds in M&A, capital markets, and corporate finance. They were the exact skill sets we needed at the time. I had the privilege of working with them on a number of different crises. I hope they get the appreciation one day that they deserve. They made countless rush decisions. When you hear about the bailouts being criticized, I think it is important to keep in mind that these were done in quick succession, typically very late at night, with very little sleep, but I think, most importantly, with information that we all knew was

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[http://perma.cc/C3M7-SS2A] (describing the Department of Justice's new policy of individual accountability).

63. *See* Tom Schoenberg, *Holder Legacy on Financial Crime Cemented in Final Year*, BLOOMBERGBUSINESS (Sept. 25, 2014, 8:34 PM), http://www.bloomberg.com/news/articles/2014-09-25/eric-holder-legacy-on-financial-crime-built-in-final-year [http://perma.cc/KNQ6-DAP3].

imperfect and we all knew was incomplete. Yet, you had to make the decisions.

I think, if you look at those people, they were remarkable people. They were in D.C. because at that time and place it was considered a fitting capstone, or an interlude in a career on Wall Street or in finance, to serve some time in the public sector. That is not the case anymore, unfortunately, and I think it is a real negative for us. There has been a lot of negative press about the ties between Wall Street and Washington, and you do not see that flow of people going from Wall Street to Washington anymore. I think, almost to the contrary, when you look at the senior-most regulatory positions, the ones that require Senate confirmation, it is actually a negative to have had industry experience. I think that is very much the wrong result. It is not to diminish the people who operate the regulatory agencies today, but during the financial crisis, we happened to have some spectacular dealmakers, which is exactly what we needed, and now they are largely gone.

As far as supervisory tools, one of the great failings of Dodd-Frank was cutting back on the Federal Reserve's powers as a lender of last resort that Professor Squire talked about. It is Section 1101 of the Dodd-Frank Act.[64] It effectively precludes the Federal Reserve from using its emergency lending power to lend to a company that is not a bank in order to rescue it from bankruptcy or to take assets off the balance sheet of a company. That was the key power that the Fed used to rescue Bear Stearns, AIG, and people forget this, but they also used it to offer $300 billion in loss protection to Citigroup in 2008.[65] You think of all three and you think about all three failing. The economy would not have survived it.

There are new tools that they have via Dodd-Frank. The FDIC has broader resolution powers. They can now take over and operate a distressed financial services company, much the same way that they can with a failed bank. I think that is helpful. It means that liquidation is not an automatic necessity, but in a crisis, it is hard to see this authority being used, except in very rare circumstances. If you look at the times

64. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101, 124 Stat. 1376, 2113-15 (codified as amended at 12 U.S.C. § 343 (2012)).

65. *See* David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup*, WALL ST. J. (Nov. 24, 2008, 12:01 AM), http://www.wsj.com/articles/SB122747680752551447 [http://perma.cc/TB5G-S64K].

the FDIC has actually stepped in and run a bank, I can think of one instance, IndyMac, in the financial crisis.[66] They generally do not do it otherwise. It is a very hard thing to do.

I think as far as tools go, the regulators were better armed in 2008 than they are today because the Fed has less authority today than they did before to handle a financial crisis. But, I think, at the end of the day, the swing factor to me is that the financial system is better capitalized today than it was before the financial crisis. That, to me, is the difference that overwhelms everything else. It is the difference between a fire in a wet forest versus a dry forest. If you go back to 2008, fundamentally, we had a crisis of confidence. We now have dramatically higher capital levels and liquidity levels. They are proven each year by these comprehensive stress tests. For all these reasons, I think we are marginally better able today to handle a financial crisis than we were then.

RICHARD SQUIRE: Thank you, Eric and Richard. I actually have questions for my co-panelists, but you all have been hearing from us for a while. We want to give an opportunity for anyone who might want to ask a question to go ahead and do so. Yes, ma'am.

AUDIENCE MEMBER: I am with the insurance industry. I have a question about Dodd-Frank and the rise of clearinghouses. You spoke about systemic risk. I was wondering if you thought that clearinghouses actually would increase systemic risk because of the capital requirements for the clearinghouses.

RICHARD SQUIRE: Interesting. Would either of you like to talk about clearinghouses?

RICHARD KIM: I think you raise an excellent point. You look at what they are trying to do to banks. It is really spreading out risk, and clearinghouses concentrate risk. You questioned the wisdom of that. I am doubtful of that. I think you are creating more systematically important entities via these clearinghouses, and it does not seem like a wise thing to me.

RICHARD SQUIRE: I will note one thing on clearinghouses, so we are not always agreeing on everything on this panel, as we seem to be. In the United States, we have never had a major clearinghouse fail

66. Press Release, FDIC, FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, California (July 11, 2008), http://www.fdic.gov/news/news/press/2008/pr08056.html [perma.cc/6BPD-L5NP].

during a crisis. It has happened overseas, but it has never happened in the United States. One reason, I think, is that clearinghouses are a little bit unusual as a financial entity in that they do not have the maturity mismatch that most institutions have. They generally have liquid assets and short-term debts. They have short-term assets, for the most part, too. They are really not vulnerable to the same type of liquidity run and the same type of liquidity crisis that a depository bank, at the other end of the extreme, would be.

There are reasons to think that, through their netting and setoff functions, if one clearinghouse member fails and goes into bankruptcy or into the Orderly Liquidation Authority,[67] the clearinghouse can, through a certain legal arrangement, tie off the payment of cash into the bankruptcy estate, where it is not as valuable, and keep it out with the other members, who may have a need for liquidity and cannot tap such things as the Orderly Liquidation Authority's provision that allows the failed institution to borrow from the Treasury.[68] So, I think there are counterarguments here. I think there is an argument that, yes, you are concentrating risk, but you are concentrating it in a type of institution that is structurally more stable. There also may be liquidity allocation advantages to clearinghouses.

You mentioned that you are in insurance. I think insurance is another interesting type of institution because insurers also do not have maturity transformation. They are in the financial world, but they are generally kind of long on both sides. They do not have a lot of short-term debt. Nobody thought that an insurer could be at the center of a banking crisis, but AIG did things that insurers normally do not do. This reinforces my sense—and this is something that Richard also said—that while we do not know what the next crisis is going to look like, I do not think that anybody thought that an insurer was going to be at the center of the last crisis. It is just not in our model of how the financial sector works. Regulators need, and the central bank needs, flexibility because you never know when risk is going to manifest next.

Would anybody else like to offer a question? Yes, sir.

AUDIENCE MEMBER: With an increased trust in the market since the financial crisis, and as the synthetic credit, such as CDSs and CDOs, increases in usage, do you think that the provisions in place could prevent an abuse similar to what we saw in the financial crisis?

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67. 12 U.S.C. § 5384 (2012).

68. *See id.* § 5381(a)(12); *see also id.* § 5390(n)(1).

RICHARD SQUIRE: Eric, you talked a lot about confidence. Do you think there is more confidence than there used to be?

ERIC GROSSMAN: I think there is certainly more confidence. I do not want to quibble with the term "abuse." You did say abuse of those instruments. One of the great things about this country is that smart people come up with interesting ways to distribute risk. A lot of the derivatives that you saw were really quite valuable for distributing risk. There was a real concern and fear that we were throwing the baby out with the bath water post-crisis, and that all derivatives were bad. Warren Buffett called them "financial weapons of mass destruction."[69] That is just not the case.

There clearly was a place, I think, for greater transparency. I do think there was, perhaps, excessive creativity. There was great opportunity for short-term financial gain. For the most part, those aspects of derivative trading are gone. My sense is that, as a result, the trading that is now being done is at least more firmly in the heartland of risk mitigation and diversification.

RICHARD SQUIRE: Richard, would you say that your clients, through Dodd-Frank's provisions and these other pre-Dodd-Frank regulatory measures, have less flexibility in terms of the types of derivatives they can write and the types of risks they can take through that? Has this been a focus of regulators?

RICHARD KIM: I think very much so. I think they feel heavily constrained. It is one of the provisions they complain most about.

RICHARD SQUIRE: Because it was very profitable or because they actually think that derivatives were useful in off-laying risks that now they cannot use them for?

RICHARD KIM: It is really more the latter because there is now less flexibility to off-lay risk.

RICHARD SQUIRE: Interesting. Other questions?

AUDIENCE MEMBER: I am with a law firm in Midtown Manhattan and represented the SIPC trustee in the liquidation of Lehman Brothers. One of the things that we handled was the continuous linked settlement issues ("CLS"), and we discovered, in the course of that, that the Lehman executives, and almost everybody, did not

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69. Andrew Ross Sorkin, *Derivatives, as Accused by Buffet*, N.Y. TIMES: DEALBOOK (Mar. 14, 2011, 9:17 PM), http://dealbook.nytimes.com/2011/03/14/derivatives-as-accused-by-buffett/?_r=0 [http://perma.cc/CM4W-LQM8].

understand CLS and the process by which the majority of foreign exchange trading was handled through this system.

To what extent do you believe or do you understand that the complexity of modern financial transactions and the inability of financial executives to get a real handle on this complexity is making it likely that these kinds of problems will occur again, because no one really has a proper handle on them?

RICHARD SQUIRE: It is stunning that they did not understand what CLS is. I do not understand either, so I am going to let Eric speak.

ERIC GROSSMAN: I think your question is a good one. It does tend to relate to the danger that we have all tried to highlight here, which is that you cannot let the sins of the past inform your perception of the present. We could go on for hours in terms of the lessons that were learned on the back of the crisis, but one thing is clear: the financial services firms that were not banks or bank holding companies, of which my firm was one, Lehman Brothers was another, and Goldman Sachs too, we now all run ourselves like a bank. We are clearly far more rigorous about documentation and about legal entity structure management comprehension. We have invested billions of dollars in our management information systems, our basic accounting and documentation technology structures, all with the encouragement of the Federal Reserve.

I will say that we have not spent a lot of time talking about the living wills or the resolution process, which is really coming into its own right as another pillar of the Federal Reserve and the FDIC's tool bag in terms of regulating banks. But all banks are being held to an enormously higher bar in terms of the discipline that we have around legal entity, an understanding of risk across geographies, and business units. An enormous amount has been done. It is fair to say that a bit of the learning here was informed by the Lehman debacle. There is no question about that. I think we are all far more ready to withstand a crisis, because we better understand where risk is across the organization, and to the extent it ever became relevant, the sorts of decade-long efforts to unwind Lehman Brothers are far less likely at any major financial institution going forward.

RICHARD KIM: I think our clients have said the same thing. I am speaking from the bank side. I cannot really speak for the end-user side, be it a corporation or an individual, but these days there is so much more process associated with rolling out transactions. The regulators have made this so-called new product process a real priority. So, you have to show a very thorough vetting. It makes banks slower to the market for new products, but having said that, it is much more thorough than it used to be.

RICHARD SQUIRE: There is a theme here in some of these questions that I want to use to ask an additional question of both Eric and Richard, which has to do with the question of the opacity versus the transparency of the distribution of risk in the financial system generally. As I mentioned earlier, one of the hallmarks of a banking crisis is that there are going to be losses, but nobody knows exactly where the losses reside. So, everybody has a problem raising short-term cash. Depositors rationally, because they are uninformed, run on everyone. There has been a narrative told that derivatives exacerbated the opacity by making it harder to know exactly where risk resided. One justification that has been offered for clearinghouses is that they make it clear that the risk is here, and the regulators can use the clearinghouse as a microscope through which they can look into the financial system itself and see who is on both sides of these transactions. Do you think we are in a better position? Housing prices are going up again, but not very fast. Let's say they start going down again and we have $250 billion, just to throw out a number, in losses on mortgages. Do we know better now who exactly would be taking the losses and where the risk resides? What do you think?

RICHARD KIM: I would like to say yes, but I do not know that we do. That is a hard thing. We worked on the Treasury when they took the conservatorship over Fannie Mae and Freddie Mac.[70] You are sitting in a room and you are trying to figure out the consequences. If we were to zero out the preferred, who would get hit? If we were to zero out subordinated debt, who would get hit? No idea. You just cannot figure this stuff out. I do not know that much has really changed.

ERIC GROSSMAN: I do not know if I would say that little has changed, because there is, frankly, just less that one would need to understand. There are far fewer complex derivatives. There is far less trading of esoteric instruments. Take CDOs, for example. No one is writing CDOs, certainly none of any real complexity. You would still have a knotted ball to untangle, but it would be a much smaller, easier one to untangle. And when you layer on all the things that we have done

70. Statement, Fed. Housing Fin. Agency, Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac (Sept. 7, 2008).

around resolution and recovery inside the banks to better understand where our own risks lie, from a booking model perspective and from a legal entity perspective, we are clearly far better off in terms of untangling the knot. I do not think there is any question about that.

But the fundamental issue was a very real one. During "Lehman weekend," down at the Fed, all the banks were called in because the theory was that if everybody comes in we will figure out where the risk is between everyone, we will just take Lehman out, and you will guys will carry it and net it off amongst yourselves. Within a couple hours, that proved to be a complete fool's errand, both because Lehman itself did not really have a good handle, for all the reasons that I spoke about in response to the gentleman's question, and also because there was quite a bit of complexity.

RICHARD SQUIRE: My friend over here has a question.

AUDIENCE MEMBER: Thank you, Professor Squire. I will ask this question in terms of my personal capacity, not my job capacity. I have heard Mr. Grossman, in particular, state that banks serve a purpose, and they certainly do. They provide liquidity to commercial and residential properties. There is an implication that they are almost like utilities in certain ways. I am sure you would not characterize it that way, but there is an implied guarantee by the government. I am just wondering what the panelists would think about some sort of return to a split between investment banking and commercial banking. Let us call commercial banking what it is and give it government guarantees, and the let the investment bankers take their chances in the marketplace, rather than right now, where a lot of the banks at least have elements of both and some sort of confused guarantee as to whether the government would step in.

RICHARD SQUIRE: The dreaded Glass-Steagall question.[71] Richard, I am happy to let you go first.

RICHARD KIM: I went to the Federal Reserve straight out of law school in the 1980s. It was when we first started figuring out how to let banks into the underwriting business at levels permissible under Glass-Steagall, which was possible back then because it did not foreclose it, but it just permitted it up to a very low level. I think at the end of the day, though, when you look at what happened in the financial crisis, the companies that had the hardest time were the investment banks that did not have access to deposit funding, such as Lehman Brothers and Bear

71. *See generally* Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162.

Stearns. Merrill Lynch had to sell itself to Bank of America. Goldman Sachs and Morgan Stanley became bank holding companies. I think history has shown that that sort of model cannot survive a financial crisis, so I guess I never really saw the wisdom in going back to it.

ERIC GROSSMAN: If your fundamental view is that you do not need investment banks, so they should go in a crisis, and then the deposit-taking banks would stay, then you could go back to it. Those guys would be hanging out there. I guess the commercial banks would survive, but you sort of leap over the fact that there is a reason why the strongest investment banks on the planet are here in the United States. If you look at what is going on at European banks or Asian banks, none of them provide the global comprehensive benefit to United States multinational companies. We provide a vital service that is beneficial to the economy. You could go back to Glass-Steagall. From Morgan Stanley's perspective, it would not be the end of the world. We are not attached to a big deposit-taking bank like some of our competitors, but I think for the United States it would be a complete and total disaster.

RICHARD SQUIRE: One of the things I like about that question is that it reminds me of the difficulty that regulators have in limiting who can take deposits. We have a traditional sense of what a deposit is, like a checking account or a savings account. But we know, because people are innovators, that other deposit-like products are sold, where somebody gives money to a financial institution, or a company that is not supposed to be a financial institution, but ends up acting like one, and the agreement is that you can get your money back at any time. Once you are selling something like that, you are susceptible to systemic risk. Nontraditional bank deposits that have this character, including broker-dealer accounts at investment banks, repos, and money market mutual fund investments, can be run on too. So we seem to have this inability to stop smart financial sector people from innovating and inventing deposit-like substitutes outside the traditional depository banks.

Are there further questions from anyone in the group? Commissioner Gallagher.

DANIEL GALLAGHER: I had a theory back when I was in the government that there is complete and utter confusion generally as to the lender-of-last-resort role of the Fed. Go back to Bagehot, like you did in your opening remarks, and ask, are they going to lend or not? In the next crisis, is the Fed going to be there or not? I would say that I think there is complete confusion as to that question. There is no clear answer, and that is a real problem for policymaking in the United States. I think a lot of bad policy is made around this confusion. I personally think the Fed, in particular, has made a lot of bad policy due to the specter of a situation in which they cannot or will not lend, or there is confusion as to whether they can or will lend.

So, I think this is actually a fundamental issue that has confused policymaking since the crisis. It is one that both parties often get wrong. It is one in which Republicans sometimes confuse and conflate lender of last resort with bailout, which is a curse word to the party. It is also a curse word to Democrats, who say, "No bailouts, never. We like big government, but we do not like the Fed being that big," but they do not really get the fact that with Dodd-Frank, they have confused the message here.

If you read Fed pronouncements, like the Governor Tarullo speech that effectively says "We are never going to be able to lend again, and so Morgan Stanley's broker-dealer needs more capital, because we cannot lend to them. They need 58% capital now." This is really efficient, by the way. And New York Fed President Dudley, whom I respect tremendously, says, "We are going to have to lend to them if 2008 happens again, so give me a little more prudential supervision?" I do not think he should get it, but I do respect that he is transparent in his thinking. Those are two wildly divergent viewpoints within the broader Fed family, but they are emblematic of the confusion around this issue.

I guess to Professor Squire, I want to get your take on whether this is a bigger issue than simply Section 1101[72] and Section 13(3),[73] and what you think can be done about that.

RICHARD SQUIRE: Thank you for that. I very much agree. This is something I was trying to say—that the problem is the regulatory system, but it is not just the regulatory system. I call it the political environment, but maybe it is also an institutional problem in the government.

Let us go back to 2008. The Fed felt that, up to a certain point, it could provide what I call lender of last resort, not bailouts. A bailout sounds like a gift. It sounds like a handout. We did not have any actual

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72. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101, 124 Stat. 1376, 2113-15 (codified as amended at 12 U.S.C. § 343 (2012)).

73. Emergency Relief and Construction Act of 1932, Pub. L. No. 72-301, § 201, 47 Stat. 709, 715 (codified as amended at 12 U.S.C. § 343).

handouts. We had loans or investments that were more or less risky. The riskier it is for the taxpayer, the more it is on the handout/bailout side. So, the Fed did all of the direct lending to actual commercial banks, which it is allowed to do under its regular statutory authority, but then it started going forward and saying, "We are going to backstop Bear Stearns. We are going to backstop AIG." At some point, the Fed said, "This emergency power that we have," which was fairly broadly written and, arguably, maybe still is, although it has been curtailed a bit, "it just is not enough for us." Who would have standing to sue the Fed to say, "No, you were not allowed to give Lehman Brothers the same deal you did AIG"? It is not clear whether anyone would have had standing to legally stop that.

I think the Fed said at some point, "We do not feel comfortable politically. We do not feel comfortable as a constitutional matter. We feel like we need political cover." That is what gave us TARP. There was a sense that the Fed was thinking "There is some uncertainty here about our legal authority and our legitimacy in continuing to provide money, and so we need political cover," and so Congress gets involved, and then we have TARP.

First of all, you are absolutely right. That creates uncertainty. What will Congress do? This is where, I guess, Eric went to the ATM—the first time when TARP failed in Congress.[74] That is enough uncertainty that Eric wants to take his money out. So, there is uncertainty about what Congress will do. Also, Congress does not always do it right. I am not going to malign Congress, but this is not their institutional expertise, and they also have political considerations. They have constituencies putting pressure on them. I feel that, to the extent that the message is confused and there is continuing vilification of the people on both sides, between the bankers who received the bailouts and are vilified and the Federal Reserve officials, government officials, who provided them and are to some extent either vilified, or, at a minimum, what is said is that they were providing a necessary but evil function, this is something that we want to avoid again.

ERIC GROSSMAN: Any rational thinking on this is ignored. You have vilification and no one actually wants to hear. Long enough has

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74. *See e.g.,* Carl Huse & David M. Herszenhorn, *Defiant House Rejects Huge Bailout; Next Step Is Uncertain*, N.Y. TIMES (Sept. 29, 2008), http://www.nytimes.com/2008/09/30/business/30bailout.html [perma.cc/TXR6-5ZHK].

gone by, let us go back and look at what happened. I think the FCIC was a terribly lost opportunity to actually get people totally apolitical and disinterested, and to look at what happened and say, this is what happened, so how do we make the country better? That was a real lost opportunity. Frankly, that has led to this terrible feedback loop. The vilification continues because the narrative that is helpful to everybody on both ends of the spectrum, Republicans and Democrats, is lost. There is no definitive answer, which is why I am hoping your book is going to be that.

RICHARD SQUIRE: Thank you. Dan, you can give some sense of this. You were not at the Fed. You were the SEC. How responsive do you think that somebody who is even supposed to be from an independent agency, like the SEC or the Fed, is to political pressure? My sense is that at some point, even in the independent agencies, people say, "This is a political hot potato," and that contributes to this uncertainty.

DANIEL GALLAGHER: Going back to what was eons ago when I was in the government, my working thesis was I think that it works for the Fed. It does not work for other agencies whose registrants are affected by this confusion. If you are at the SEC and you have primary jurisdiction over the Goldman Sachs broker-dealer, for example, and now Goldman Sachs is within a bank holding company and the Fed has primary jurisdiction over that bank holding company, it is to the Fed's benefit that there is confusion about the Fed's ability to lend to that bank holding company and its subsidiaries in a time of stress. If you are the primary Fed governor for supervision, you can say in a speech, "We would like that broker-dealer to have a lot more capital that far exceeds what the SEC rules require, because maybe, if everything goes wrong, we might have to lend," or "maybe if something goes wrong, we cannot lend."

The confusion feeds into this notion that something needs to be done, but what? I gave a whole speech once on theories of capital that go right to this issue.[75] The theory of capital on the broker side is wind-down capital. You have enough capital around to wind the firm down and give the assets back to the clients. It is not this sort of risk-mitigating, shock-absorbing, keep-the-run-away-from-the-taxpayer level

75. Daniel M. Gallagher, Commissioner, SEC, The Philosophies of Capital Requirements (Jan. 15, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370540629644 [http://perma.cc/EM7Y-4XZH].

of bank capital that the Fed is used to. This is hugely important because the two are very different. There is an optimal level of capital, depending on the philosophy. Under the SEC theory of capital, you want to have enough to be safe to turn the lights off and give the assets back, but once you start getting into more than that, that is an inherent inefficiency in the market and makes no sense. Why? Say you go from 10% to 15%, for example. What is that 5% going to do in 2008? Nothing. Instead of going after that extra 5%, you are better off figuring out how to take that broker-dealer and wind it down more smoothly than we did with Lehman.

I do think it is a little bit more nefarious than it may seem. It is not just the Fed saying, "Oh, my goodness, Congress might come after us again." To be clear, as much skepticism as I have of central banks as supervisors generally, I think the Fed did bear the brunt of 2008. You remember, of course, that the Fed was going to be the systemic risk regulator, until early 2009, until the AIG bonuses were paid out, until Senator Chris Dodd had to have a hearing and got blasted by constituents and other members of Congress.[76] Then, all of a sudden, Sheila Bair came along with the FSOC and that changed a key component of Dodd-Frank.[77] I think you can trace it all back to the confusion of this role of lender of last resort. If you are going to say that the Fed should not do what they did, you really do have to ask whether we should have a Fed. The role of lender of last resort in 1913 was the main reason to create a central bank. They wanted to stop this cycle of runs that Bagehot wrote so well about in the 1870s.[78]

I think, until and unless we are brave enough to get to that core issue, and I am sure your book does it, but until we are going to do that, we are going to dance around these other issues. We are not going to get at the core of it. I find it frustrating. It suits the needs of certain constituencies a lot better than others.

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76. *See* Mark Landler & Steven Lee Myers, *Buyout Plan for Wall Street Is a Hard Sell on Capitol Hill*, N.Y. TIMES (Sept. 24. 2008), http://www.nytimes.com/2008/09/24/business/economy/24fannie.html [http://perma.cc/E9JF-3ABF].

77. *See* John Rogers, *CFA Institute Co-Sponsors Systemic Risk Council Led by Former Bank Regulator Sheila Bair*, CFA INSTITUTE (June 6, 2012), http://blogs.cfainstitute.org/marketintegrity/2012/06/06/cfa-institute-co-sponsors-systemic-risk-council-led-by-former-bank-regulator-sheila-bair/ [http://perma.cc/62UV-D8C6].

78. BAGEHOT, *supra* note 32.

RICHARD SQUIRE: We will take a break now. Just a bit of a preview of what is going to happen in fifteen minutes. We will have our break and then Commissioner Gallagher will give his keynote address.

Sometimes we have a problem at law schools and other academic institutions where current or even former government officials do not want to say anything too controversial, and so they give speeches that are not particularly interesting. They do not say things like "nefarious," for example. You just heard from Commissioner Gallagher that he is not that type, so get ready for a stem-winder. I want to thank my co-panelists for joining me today. Thanks for your attention.

KEYNOTE ADDRESS

RICHARD SQUIRE: Welcome back. It is my great pleasure to welcome back to Fordham Mr. Daniel M. Gallagher, Jr., who just completed his term as a Commissioner of the Securities and Exchange Commission.[79] It has been about a month since he stepped down, and he says he is busier than ever, but he still has the opportunity to come here and be with us, and that is wonderful.

During his time as a Commissioner at the SEC, Mr. Gallagher focused on initiatives aimed at strengthening our capital markets and encouraging small business capital formation, including staunchly supporting the changes introduced by the JOBS Act. He was an outspoken and frequent advocate for conducting a comprehensive holistic review of equity market structure issues, increasing the Commission's focus on fixed income markets, both corporate and municipal, addressing the outsize power of proxy advisory firms, and eliminating special privileges for credit-rating agencies, who should have borne more of the brunt of our criticism when we talked about the financial crisis than they did.

He has also addressed the creeping federalization of corporate governance matters and the concerted efforts of special interest groups to manipulate the SEC's disclosure regime to advance their political agendas. He has also been instrumental in educating the markets and investors about the shortcomings of the Dodd-Frank Act and the encroachment of bank regulatory measures and prudential measures into the capital markets. In addition, Mr. Gallagher has been an outspoken critic of the disturbing trend toward empowering supranational groups to enact one-world regulation outside established constitutional processes.

Before he joined the Commission, in the private sector, Mr. Gallagher advised clients on broker-dealer regulatory issues and represented clients in SEC and SRO enforcement proceedings as a partner with the Washington, D.C. law firm WilmerHale, where he began his career. He also served as the General Counsel and Senior Vice

79. Daniel M. Gallagher, Commissioner, SEC, Statement of Commissioner Daniel M. Gallagher on His Departure from the SEC (Oct. 2, 2015), http://www.sec.gov/news/statement/statement-commissioner-gallagher-on-departure-from-sec.html [http://perma.cc/4EH9-7LR4].

President of Fiserv Securities, Incorporated, where he was responsible for managing all of the firm's legal and regulatory matters.

He first joined the Commission as a summer honors program intern while pursuing his law degree, focusing on enforcement. In January 2006, he rejoined the agency, serving first as counsel to SEC Commissioner Paul Atkins, and later as counsel to SEC Chairman Christopher Cox, working on matters involving the Division of Enforcement and the Division of Trading and Markets.

Mr. Gallagher earned his J.D., magna cum laude, from the Catholic University of America, where he was a member of the law review, and graduated from Georgetown University with a degree in English.

Just yesterday, Mr. Kim's firm, Wachtell Lipton, issued a memo honoring Mr. Gallagher and celebrating his service to the country as the SEC Commissioner.[80] I have a copy here, and I am going to read it in its entirety—no, I am not going to do that. But it is excellent, and you really should take a look at it. It will be available on Wachtell Lipton's website. But I want to read just two excerpts that I thought were excellent.

The memo says, in part, that Commissioner Gallagher was a champion of free and efficient markets. He promoted capital formation and the growth of small businesses. With well-crafted and charismatically delivered speeches, he has energized debates and will be recalled as an advocate for market-oriented reform. The memo also noted something else. A lot of Dodd-Frank is a series of directives to agencies, such as the SEC, to enact rules implementing certain broad principles or guidelines. The Commission has struggled to write all of the rules that were required for it to write, even though the statute has now passed its fifth-year anniversary. Earlier this year, as the memo from Wachtell Lipton noted, Commissioner Gallagher gave the Commission a grade of "incomplete" on its regulation of capital formation. But his service as a Commissioner merits an A. Wachtell Lipton does not give A's very often, so that is a very high distinction. I am very pleased to introduce Commissioner Gallagher.

80. David A. Katz & Laura A. McIntosh, *Commissioner for Capital Markets: Daniel M. Gallagher's SEC Legacy*, N.Y. LAW JOURNAL (Oct. 29, 2015), http://www.newyorklawjournal.com/id=1202740951943/Commissioner-for-Capital-Markets-Daniel-M-Gallaghers-SEC-Legacy?slreturn=20151024113206 [http://perma.cc/8QHL-A86D].

COMMISSIONER GALLAGHER: If only Wachtell Lipton had been Georgetown University, things would have been a little different. Thank you very much, Professor Squire, for that overly kind intro. It is a real honor to be back here at Fordham Law School. It is just about a year since you honored me by asking me to deliver the keynote address at the Al Sommer Lecture.[81] As Professor Squire mentioned, I left the Commission earlier this month. Today is four weeks since I left, and I have to tell you, I am a little bit lost. I have done a couple of speeches since then, and I am lost not having to deliver a disclaimer to you before I get going here. I am not sure how to do these speeches these days without it. So, I am going to try one out on you, a new one I have been working on, and say that the views I express today are my own and unfortunately do not represent the views of the SEC or a majority of the commissioners, but they should.

All kidding aside, the topic of today's conference, "Are We Ready for the Next Financial Crisis?" is actually very timely in light of the recent fifth anniversary of Dodd-Frank, the so-called Wall Street Reform and Consumer Protection Act. As you know and as you have heard today already, Dodd-Frank was the congressional and Obama Administration response to the financial crisis.[82] It is fitting that the traditional five-year anniversary gift is wood, because Dodd-Frank is just one big wooden nickel sold to the unsuspecting public. As such, my assessment of the question posed today is that we are certainly not ready for the next financial crisis. Indeed, we have not even figured out what caused the last one. And that is, in large part, due to the gimmickry and false advertising surrounding the Dodd-Frank Act.

Dodd-Frank was a kneejerk, ill-informed, partisan response to the financial crisis that, at best, has only kicked the proverbial can down the road, leaving issues that may cause the next crisis unaddressed and ignored. Congress cobbled together the 2319 pages of the Dodd-Frank Act out of a hodgepodge of provisions and wish-list items long desired and advocated by special interest groups. It is truly frightening. Along

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81. Daniel M. Gallagher, Commissioner, SEC, The Securities and Exchange Commission – The Next 80 Years: The Fifteenth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities, and Financial Law, (Oct. 16, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543190122 [http://perma.cc/JC7G-GEGV].

82. *Wall Street Reform: The Dodd-Frank Act*, WHITE HOUSE, http://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform [http://perma.cc/7VPX-2VPD].

those lines, since tomorrow is Halloween, I will reprise one of my favorite Dodd-Frank monikers: "Dodd-Frankenstein." Very few of these wish-list items had a nexus with the actual causes of the financial crisis, and they certainly were not germane to the mission of the SEC. Instead, they were designed to fulfill the long-held ambitions of these special interest groups, as well as policymakers and bureaucrats.

But it was natural and expected that Congress would respond to the tragic financial crisis of 2008, just as it did in response to the 1929 stock market crash, and, for that matter, the back-office crisis of the late 1960s, the insider trading scandals of the 1980s, and the accounting scandals of the early 2000s. However, unlike the deliberate responses to these other crises, Congress rushed to judgment in responding to the 2008 financial crisis, passing the Dodd-Frank Act even before its own commissioned report, the FCIC report that Eric Grossman referred to a few times, was even finished.[83] Dodd-Frank also was enacted before the report of the Permanent Subcommittee on Investigations was finished.[84]

Dodd-Frank stands alone as the only piece of major securities legislation in United States history that was rammed through Congress without any meaningful bipartisan support. Yes, that is right; prior to the enactment of the Dodd-Frank Act, every major piece of securities legislation since the New Deal, including the Exchange Act,[85] which created the SEC, as well as the 1940 Acts,[86] the 1975 Act amendments,[87] the Remedies Act of 1990,[88] the National Securities Markets

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83. *See generally* FIN. CRISIS INQUIRY COMM'N, *supra* note 9.

84. *See generally* COMM. ON HOMELAND SEC. & GOV. AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (2011), http://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2 [http://perma.cc/3XNT-6H94].

85. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)).

86. *See* Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64); Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

87. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.).

88. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C.).

Improvement Act of 1996,[89] and, very notably, the Sarbanes-Oxley Act of 2002,[90] enjoyed bipartisan support. Despite the obvious dysfunction in D.C. these days, it is possible to pass bipartisan financial services legislation. Two years after the enactment of the Dodd-Frank Act, Congress passed with overwhelming bipartisan support and President Obama happily signed an important and impactful piece of federal securities legislation, the JOBS Act.[91] Again, the Dodd-Frank Act truly stands alone.

To be sure, obtaining bipartisan support for the Dodd-Frank Act would have been hard. But aren't our elected officials put in office to do hard things? It would have entailed tempering the statute through compromise. Policymakers would have had to listen to competing ideas and jettison some of the progressive wish-list items jammed into the 2300-plus-page behemoth. This lack of legislative debate set the stage for some very dubious policy decisions, most notably, the empowerment of the very regulators who failed so miserably in the years leading up to the crisis.

Just for fun, let us think about the Dodd-Frank Act as a series of comic books, each with a different set of superhero bank regulators, tasked with slaying evil, albeit unnamed and poorly understood, villains responsible for the financial crisis. The Fed is clearly Superman, with his myriad powers. Dodd-Frank created the Fed-dominated Financial Stability Oversight Council, or FSOC,[92] the Fed-dominated SIFI designation process,[93] and the Fed-dominated Title VIII oversight regime for clearance and settlement activities.[94] Dodd-Frank also greatly

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89. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

90. *See* Sarbanes-Oxley Act of 2002, Pub. L. 107–204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

91. *See* Jumpstart Our Business Startups Act, Pub. L. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

92. So-Yeon Lee, *Review of Banking and Financial Law*, 30 REV. BANKING & FIN. L. 528, 528 (2011) (explaining the creation of the Financial Stability Oversight Council).

93. Daniel K. Tarullo, Governor, Capital and Liquidity Standards Testimony Before the Committee On Financial Services, U.S. House of Representatives, Wash. D.C., at 3 (2011), http://www.federalreserve.gov/newsevents/testimony/tarullo20110616a.htm [http://perma.cc/44TC-ARSD].

94. Press Release, Bd. of Governors of the Fed. Reserve Sys., (July 30, 2012), http://www.federalreserve.gov/newsevents/press/bcreg/20120730a.htm [http://perma.cc

enhanced the Fed's traditional oversight authority. The FDIC, the Batman of our financial-comics universe, was given the keys to Dodd-Frank's shiny new Title II Orderly Liquidation Authority, as well as the power to mandate so-called living wills.[95] As for the OCC, well, I understand there is an Aquaman movie scheduled for 2018. The point is, in the comic book world of Dodd-Frank, the bank regulators are superheroes. Funny, though, it did not seem superhuman when the commercial banks they supervised were failing in 2007 and 2008. While Dodd-Frank gave prudential regulators greatly broadened prudential authority over the economy, the SEC was tasked with writing long, complicated rules to interpret and implement many ill-formed mandates. In this regard, and to complete the cartoon metaphor, the SEC was treated by Dodd-Frank like a minion.

I spent much of my four years on the Commission working on and speaking about some of the most egregious and irrelevant of these Dodd-Frank rulemaking mandates. The early part of my tenure as a Commissioner featured the sociopolitical conflict minerals and extractive resources mandates that the SEC spent the better part of two years implementing between 2010 and 2012.[96] And, in case you have not noticed, and there is a reason you have not noticed because people do not want you to notice, the SEC is still in active, mostly losing, litigation on both of those rulemakings. Mind you, the SEC got to work on these misguided rulemakings immediately after Dodd-Frank was enacted, to the exclusion of matters actually related to the financial crisis or the agency's core blocking and tackling duties. While the elimination of gang violence in the Congo is a laudable goal, I am 100% sure that a lack of corporate disclosures about Tantalum did not bring down Lehman Brothers or AIG.

The Commission also created an entirely new regulatory regime for municipal securities advisors and rushed to put out rules under Title IV of the Dodd-Frank Act to regulate hedge funds and private equity funds,

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/7W43-EDLA] (stating the passage of Regulation HH which establishes risk-management processes for "clearing and settlement activities" for financial market utilities).

95. Press Release, FDIC, FDIC Board Issues Proposed Rule on Dodd-Frank Resolution Authority (Oct. 12, 2010), http://www.fdic.gov/news/news/press/2010/pr10224.html [http://perma.cc/DK3F-EPPZ].

96. *See* Conflict Minerals; Disclosure of Payments by Resource Extraction Issuers, 77 Fed. Reg. 56,274 (Sept. 12, 2012) (codified at 17 C.F.R. pt. 240, 249, and 249b (2012)).

despite the lack of any evidence whatsoever that any of these entities contributed to the crisis. Then came the Volcker Rule, despite the fact that the rule's namesake, as well as the then-Secretary of the Treasury, who presided over the creation of the Dodd-Frank Act, both publicly stated that its subject, proprietary trading, had nothing to do with the financial crisis.[97] Most recently, in August, the Commission, on a 3-2 vote, adopted a rule requiring public companies to disclose the ratio of CEO compensation to their median employee.[98] In my dissent in that vote, I noted that that rule, which was inserted into the legislation by special interest groups literally at the eleventh hour, may very well have been the most useless of all of the Commission's Dodd-Frank mandates. And that says a lot. The AFL-CIO, which lobbied relentlessly for the rulemaking mandate's inclusion into Dodd-Frank, helpfully explains for us on its website its true purpose, and I quote: "Disclosing this pay ratio will shame companies into lowering CEO pay."[99]

Will this costly, irrelevant, and burdensome rule, designed purely to shame CEOs, prevent the next financial crisis or in any way address the failures of 2008? The answer is clearly no. But to be fair, despite its vast shortcomings, the Dodd-Frank Act actually did address a few sources of

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97. *See* Kim Dixon & Karey Wutkowski, *Volcker: Proprietary Trading Not Central to Crisis*, REUTERS (Mar. 30, 2010, 4:55 PM) (quoting Paul Volcker: "proprietary trading in commercial banks was there but not central" to the financial crisis), http://www.reuters.com/article/2010/03/30/us-financial-regulation-volcker-idUSTRE62T56420100330 [http://perma.cc/9NAD-N77L]; *see also Volcker Rule is the Wrong Response to the Financial Crisis*, FINANCIAL SERVICES FORUM: FORUMBLOG (Sept. 19, 2009) (quoting Treasury Secretary Geithner: "If you look at the crisis, most of the losses that were material for the weak institutions — and the strong, relative to capital — did not come from [proprietary trading] activities. They came overwhelmingly from what I think you can describe as classic extensions of credit"), http://financialservicesforum.org/2010/05/volcker-rule-is-the-wrong-response-to-the-financial-crisis/ [http://perma.cc/U67W-PSKJ].

98. *See* Press Release, SEC, Rule Implements Dodd-Frank Mandate While Providing Companies with Flexibility to Calculate Pay Ratio (Aug. 5, 2015), http://www.sec.gov/news/pressrelease/2015-160.html [http://perma.cc/5LTX-LCS7].

99. Andrew Ross Sorkin, *S.E.C. Has Yet to Set Rule on Tricky Ratio of C.E.O.'s Pay to Workers'*, N.Y. TIMES: DEALBOOK (Jan. 26, 2015, 8:17 PM), http://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/ [http://perma.cc/CJH5-G6CV]; Christopher Matthews, *The Government Regulation Corporate America Hates Most*, TIME (Sept. 20, 2013), http://business.time.com/2013/09/20/the-government-regulation-corporate-america-hates-most/ [http://perma.cc/8EAH-AD56].

the 2008 financial crisis. It did, for example, mandate that federal agencies remove references to nationally recognized statistical rating organizations, or NRSROs, from their rules and forms.[100] Unlike the examples I cited earlier, an overreliance on credit ratings was indeed at the heart of the collapse of securitized products that played a key role in the financial crisis. However, it took until last month for the Commission to finalize the removal of ratings references from our rules governing money market mutual funds, and the Commission still has work to do to fully implement the ratings removal requirements of Section 939(a) of Dodd-Frank.[101]

There are some provisions of Dodd-Frank that appear facially relevant to the financial crisis, but truly were part of a larger, long-pent-up, command-and-control program. For example, Title VII of Dodd-Frank mandated the Commission to regulate securities-based swaps.[102] Of course, it separately mandated that the CFTC regulate all other swaps, about 95% of the notional value of the OTC derivatives market.[103] This split jurisdiction is silly and confusing, much like having a separate commodities and futures regulator is silly and confusing, and the line drawing to allocate responsibility between the agencies would make congressional gerrymanderers proud. Speaking as someone who was on the thirtieth floor of Lehman the week of September 15, 2008, I can tell you that over-the-counter swaps did not cause the financial crisis, but I can also tell you that increased transparency into these markets would have been incredibly helpful and could have staved off some very bad bailout decisions. But instead of incremental change, like mandated transparency, Title VII creates a broad and overly heavy-handed regulatory construct, imposing an equities market structure on an inherently OTC market. Last month I, along with my friend and former colleague Commissioner Michael Piwowar, called on the Commission to finalize these Title VII rules, which was especially important given that the CFTC completed its rules governing swaps two years ago.[104] We

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100. *See* Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, 80 Fed. Reg. 58,123 (Sept. 25, 2015) (to be codified at 17 C.F.R. pts. 270 and 274).

101. *See id.*

102. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, tit. VII, 124 Stat. 1376, 1641-1802 (2010).

103. *See id.* § 712, 124 Stat. at 1641-46.

104. Daniel M. Gallagher & Michael S. Piwowar, SEC, Statement Regarding Security-Based Swap Rules (Sept. 25, 2015), http://www.sec.gov/news/statement/gallag

noted that, instead of focusing on completing these rules, the Commission has been asked to consider wholly political Dodd-Frank rules such as the pay ratio proposal.

The Dodd-Frank Act has created collateral consequences that will likely only accelerate the next financial crisis and will definitely not serve to prevent one. First, the approximately 100 Commission rulemaking mandates required by Dodd-Frank have shifted important Commission resources away from addressing issues intended to prevent the next systemic market events, or, worst-case scenario, another financial crisis. The very volume of the Dodd-Frank Act's prescriptive mandates to the SEC has had the unintended effect of significantly limiting the agency's ability to bring its traditional expertise and judgment fully to bear in the rulemaking process. In that sense, it has had a negative impact on the Commission's ability to develop sound, sensible regulation and to adapt quickly and flexibly to the continuing transformation of global capital markets. I have spoken many times about these important yet forgotten priorities, including, among others, a comprehensive review of our equity market structure rules and updated transfer agent rules.

The Dodd-Frank Act was built on a false narrative of Wall Street greed and regulatory failures. While these two factors certainly played a role in the crisis, they were not fundamental, underlying causes of the crisis so much as symptoms of a much larger illness: failed federal housing policy. Policymakers who played a role in the irrational exuberance of the housing markets in the years leading up to the financial crisis understandably were not interested in revisiting and shining a light on their pre-crisis actions when they drafted the legislative response to the crisis. Indeed, the words "Fannie Mae" and "Freddie Mac" do not appear in the Dodd-Frank Act in any substantive way, and after recent administration pronouncements, it seems that failed housing policy will not be addressed anytime soon. In fact, seven years after the beginning of the financial crisis, Freddie Mac and Fannie Mae have morphed into a pair of two taxpayer-owned zombie banks—another Halloween theme—that continue to be the nerve center of the U.S. housing markets. This failure to address the fundamental housing issues that underlay the past financial crisis may very well be setting up another financial crisis tied to the housing market, as housing prices

her-piwowar-security-based-swaps.html [http://perma.cc/2VXF-H5ME].

reach pre-bubble levels, and the Fed's lack of courage on monetary policy is not helping the situation, that is for sure.

Earlier this year, my good friend Peter Wallison of the American Enterprise Institute, the author of the must-read book on the crisis—okay, *one* of the must-read books on the crisis when Professor Squire's comes out—called *Hidden in Plain Sight*, pointed out that the administration was going back to the very same housing policies that were pursued before the financial crisis, including reducing underwriting standards for Fannie Mae and Freddie Mac, and reducing the insurance premiums for risky mortgages they take on, which were the very things that caused the financial crisis by building up low-quality mortgages.[105]

Separately, I have spoken many times in the past about another significant set of risks that have been brewing in the U.S. fixed income markets, which could have serious repercussions for investors and the U.S. economy as a whole. Since the release of a certain book early last year, the impact of high-frequency trading on our equity markets has been the topic du jour. However, as I have stated many times before, if we are setting our regulatory agenda based on Michael Lewis books, we need to address *Liar's Poker*[106] before *Flash Boys*.[107] Twenty-six years after the publication of the former tome, our fixed income markets are shockingly similar to and include many elements unchanged from those described by Lewis in 1989. In any case, the debt markets that are the subject of *Liar's Poker* are crucial to the U.S. capital markets. The numbers speak for themselves. Municipal bonds, of which there are approximately $3.7 trillion outstanding, allow state and local governments to finance their infrastructure projects and provide for cash flow and other government needs. They also constitute a large percentage of retail investors' retirement assets.[108]

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105. *See* PETER WALLISON, HIDDEN IN PLAIN SIGHT: WHAT REALLY CAUSED THE WORLD'S WORST FINANCIAL CRISIS AND WHY IT COULD HAPPEN AGAIN (2015).

106. *See* MICHAEL LEWIS, LIAR'S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET (1989).

107. *See* MICHAEL LEWIS, FLASH BOYS: A WALL STREET REVOLT (2014).

108. *See* BD. OF GOVERNORS OF THE FED. RES. SYS., FINANCIAL ACCOUNTS OF THE U.S.: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS at tbl. L.212, http://www.federalreserve.gov/releases/z1/current/z1.pdf [http://perma.cc/9XWK-484A] (providing market capitalization numbers for municipal securities).

Meanwhile, the corporate bond market enables companies to operate and grow their businesses through capital investments. There is over $11 trillion outstanding in the corporate debt markets.[109] The value of U.S. corporate bond issuances in 2014 reached a record of more than $1.4 trillion, and we are on pace to eclipse that number this year. The average daily trading volume for fixed income securities of all kinds just this August was $135 billion. It is undoubtable that the search for yield arising from more than six years of near-zero interest rates is driving investors into the debt markets. Yet, as I have repeatedly pointed out, despite these record issuances of corporate bonds, dealer inventory and liquidity in the secondary markets has dramatically decreased. Even the Chair of the Financial Stability Board, Mark Carney, has acknowledged that new prudential regulations have caused dealer inventories to drop. As Chairman Carney has noted, "The time to liquidate a given position is now seven times as long as in 2008, reflecting much smaller trade sizes in the fixed income markets."[110] With a record notional amount of outstanding corporate debt and dealers unable to commit capital and hold significant inventories, there is a real liquidity crisis brewing.

A significant risk is that when the Fed starts to hike interest rates, if that ever happens, investors may rush to exit their positions in high-yielding but less liquid debt and may have severe difficulty in doing so. Interestingly, while the biggest banks have cut back on their positions in more risky debt, insurance companies and mutual funds have increased their positions in those assets.[111] These firms have boosted their holdings of corporate and foreign bonds to $5.1 trillion, a 65% increase since the end of 2008.[112] This has offset the $800 billion decline in holdings at banks and securities firms in the same period.[113] Rather than banks

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109. *See id.*at tbl. L.213 (providing outstanding notional values of corporate debt and holdings of foreign issues by U.S. residents).

110. *See* Speech, Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board, The Future of Financial Reform (Nov. 17, 2014), http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf [http://perma.cc/E73P-UZQZ].

111. *See* Lisa Abramowicz, *Major Firms Are Saying the Stage is Set for Another Crisis in the Bond Market*, BLOOMBERGBUSINESS (Feb. 26, 2015, 11:38 AM), http://www.bloomberg.com/news/articles/2015-02-26/ubs-to-invesco-detect-bond-accidents-brewing-in-unstable-markets [http://perma.cc/52XE-2BBV].

112. *Id.*

113. *Id.*

holding the inventory, there are now ever-expanding bond funds that own more and more risky debt, and it is unclear how institutional asset managers and their clients will react when interest rates eventually rise.

To address this impending crisis, the SEC can and should take several actions. As the primary regulator of the nongovernment fixed income markets, the SEC needs to champion the tough reforms that are needed to modernize the fixed income markets. First and foremost, the SEC needs to bring transparency to the markets for retail investors by requiring broker-dealers to disclose markups to customers of so-called riskless principal trades, most of which are really just agency transactions in sheep's clothing. The SEC also needs to ensure that there are no regulatory impediments to the development of electronic fixed income trading platforms. They should work to reduce the number of bespoke bond offerings in favor of encouraging more standardized offerings, if that would result in more liquidity. The SEC needs to take steps to facilitate bond market liquidity, ideally by working with the industry and investors to create workable market-based solutions. We do not need another Title VII.

Now that I am a near-private citizen, an unemployed one at that, I can only hope, alongside all of you, that we are ready for the next financial crisis. What I can say for sure is that the Dodd-Frank Act did not address many of the root causes of the 2008 financial crisis. In some cases, such as the Volcker Rule, the Dodd-Frank Act may have, in fact, exacerbated factors that could lead to the next crisis, while in other cases, such as the pay ratio rule, we have created enormous growth-stunting costs for corporations while providing absolutely no benefit to investors. Furthermore, risks within the real estate and fixed income markets remain unaddressed, potentially setting us up for the next financial crisis. Other than that, we are all good.

Thank you for inviting me today to discuss this important topic with you and for your attention. I think we have some time here and I would be happy to take some questions.

RICHARDS SQUIRE: Commissioner Gallagher has graciously agreed to answer any questions. If anybody has a question, please go ahead and raise your hand.

AUDIENCE MEMBER: My question is another derivatives-related question. I am curious as to why the SEC has been so slow in enacting regulations under Title VII when the CFTC has largely completed its regulations.

DANIEL GALLAGHER: This is a pretty easy answer. A lot of it you could read in between the lines of the speech I just gave. It is all about priorities in the agenda. I gave a speech last year literally called "You Are What You Prioritize."[114] An agency like the SEC had, at the time of Dodd-Frank, seventy-five years' worth of federal securities laws on the books, and Lord knows how many rules under those statutes, many of which I mentioned in the speech.[115] These are hugely important and core federal securities laws, and when Dodd-Frank came along, it did not get rid of those and create a new set of federal securities laws. It amended the federal securities laws. So the SEC still had a day job, as I used to say, the basic blocking and tackling of administering seventy-five years' worth of highly technical securities laws, and then Dodd-Frank added to it roughly a hundred rulemaking mandates. If you think about the average bandwidth at the Commission, and unless you are there, it is really hard to understand, but a hundred rulemaking mandates is about twenty times the normal load for the Commission. And that is post-Sarbanes-Oxley, which spiked the average up itself.

How do you do twenty times the normal load while administering seventy-five years' worth of federal securities laws? It is hard to do. You have five commissioners that need to vote on everything. You only have so many staffers. You are an appropriated agency. As much as people wanted endless resources to hire an endless number of staffers, it did not happen. What should have been done or what could have been done? As much as I do not like Dodd-Frank, had I been in charge, what would I have done? I would have come up with a rational way to approach the hundred mandates. In one speech I outlined how I would have done it.[116] I would have three buckets. In bucket one, of these mandates, what is directly related to the financial crisis? Not a lot. In bucket two, what is actually highly relevant? What is germane to the SEC's mission? In bucket three, include other things, such as pay ratio, conflict minerals, or whatever you want to put in bucket three. You

114. Speech, Daniel M. Gallagher, Commissioner, SEC, The Importance of the SEC's Rulemaking Agenda — You Are What You Prioritize, Remarks at the 47th Annual Securities Regulation Seminar of the Los Angeles County Bar Association, (Oct. 24, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543283858 [http://perma.cc/XX9H-68P4].

115. *Id.*

116. Speech, Daniel M. Gallagher, Commissioner, SEC, SEC Priorities in Perspective (Sept. 24, 2012), http://www.sec.gov/News/Speech/Detail/Speech/1365171491262 [http://perma.cc/69SS-BM99].

could have proceeded along those lines: let's prioritize this, then move to this, and then leave pay ratio until the end.

But that is not what happened. Weeks after Dodd-Frank was enacted, the Commission put out a proxy access rule that was later overturned in the D.C. Circuit, stunting SEC rulemaking for months and months and months, as the agency developed a new cost-benefit paradigm.[117] What did the Commission turn to after proxy access in 2010? In December of 2010, the proposal went out for conflict mineral disclosure, mine safety disclosure, extractive resource disclosure. That means that the Division of Corporation Finance at the SEC spent July of 2010 until December of 2010 working on those things. Maybe the Division of Corporate Finance did not have anything better to do, but that was taking up the Commission's bandwidth at the time. The Commission had better things to do, including addressing Title VII.

Chairman Gary Gensler and the CFTC, which has a much more limited jurisdiction than the SEC and much more limited resources, but a much more discrete jurisdictional authority, went right after Title VII. That was their big task in Dodd-Frank. They went at it relentlessly. I tip my hat to Chairman Gensler; he is a brilliant guy and a hard worker, and he got it done, he got it done quickly, and he got it done before he left. The SEC did conflict minerals, hedging disclosure, and pay ratio, and we got sued on them and we are litigating them. The staff is writing briefs on them instead of finishing Title VII. It is all about priorities, and the priorities were, and in some ways are, still a mess. I think things have gotten a little bit better as of late, but the fact that we are years behind in Title VII is a real problem. I do not like Title VII, as you might have read into my remarks, but guess what? 95% of the market is covered by a regime that has existed for two years. It is like the hanging chad in Florida. Let us just take the care of the 5%, get some surety, and let folks work with a consistent regime, but it has not happened.

That was a very longwinded answer to your question. It is actually quite simple: it is how you prioritize things. That is why Commissioner Piwowar and I put that statement out before I left.

RICHARD SQUIRE: Other questions?

AUDIENCE MEMBER: Since greed is part of human nature in the investment community, do you think the people in the community are a

117. Bus. Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

little more cautious, a little bit less likely to take dangerous speculative action, because we might get in trouble with Dodd-Frank? Is it possible?

DANIEL GALLAGHER: I think that is one of these X factors that folks do not ascribe enough to post-crisis, which is when things got excessive. I do not say, as I did in the speech, there was no Wall Street greed. I do not say that there were no regulatory failures because there were. But Wall Street greed in an era of a bubble of any sort is going to breed market behaviors that are irrational in some ways, and when the bubble bursts, those market players, whether it is firms, people, products, and sometimes investors, should bear the brunt of it. That is just not what happened in 2008, in some ways.

I think the lessons learned in the private sector have resulted in much more prudent risk management, outside of Dodd-Frank. The government is never going to be able to manage risk in the private industry. They tried it; it was called the Soviet Union and it did not work. But some folks cannot learn that lesson and they want the nanny state to try to protect everybody. They want an SEC enforcement lawyer sitting next to every investor on their E*TRADE account saying "No, no, no. You really don't want to do that." It cannot happen and it should not happen. Markets need to operate.

I do think that there has been, from the private sector risk management perspective, a change in behavior from 2008 and a real learning about proper risk management. That is something the government never could mandate. I think some mandated increased disclosure and a heightened level of enforcement over these disclosures, whether it be in the asset management industry or the brokerage industry, is all a positive role played by the government, but I think the notion that Dodd-Frank somehow fixed it is silly.

AUDIENCE MEMBER: So, people might be a little more careful despite the law?

DANIEL GALLAGHER: It is human nature. Who wants their business to be run into the ground? Who wants to sell toxic product to clients, besides really bad people? And most people in any market are good people. It is hard to say in Washington these days. Not everyone is a felon. Not everyone should be "perp-walked" for operating in a private market. You do not want to sell a product to a client that is going to blow up on them because then they are not a client anymore. It is not sensible business logic. Therefore, I think there have been private sector corrections that are much more meaningful than anything you could put in a 2300-page piece of legislation, which, by the way, is about 2200 pages longer than any of the New Deal pieces of legislation.

AUDIENCE MEMBER: I am curious about your thoughts on high-frequency trading. Do you think it should be a priority to deal with it?

DANIEL GALLAGHER: Again, it is another sort of market reaction to governmental dicta when it comes to high-frequency trading. I have been calling for years, starting with a speech in the fall of 2012, for a holistic review of equity market structure. We thought at the time it was the shot heard around the world, but we sit here, three years later none the wiser.

One of the reasons I called for a review of the equity markets, specifically, is that in 2005, the SEC proposed a rule called Reg. NMS, and in 2007, that rule was implemented.[118] It has been in effect for about eight years. That rule, as you read in the Michael Lewis book *Flash Boys*, actually mandated high-frequency trading in the equities markets. Michael Lewis says it, and it is really what happened. The government basically said that when you trade equities in the United States, the way to do it is to compete on price and speed, so we are going to connect all the exchanges, we are going to treat them like utilities, and we are going to homogenize what otherwise was a very diverse set of factors that investors consider when they trade. When you put speed into the calculus, of course, you need big computers to satisfy that government rule. Post-NMS you see the specialists of the New York Stock Exchange washed out, and NASDAQ's model prevailing, along with all of the new electronic-based exchanges that have come thereafter. You basically mandated high-frequency trading.

Now it is kind of fashionable in Washington to vilify high-frequency trading. When you see the Flash Crash of May 2010,[119] this recent August 24, 2015 failure at the New York Stock Exchange,[120]

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118. Regulation NMS, 70 Fed. Reg. 37,496 (June 29, 2005) (codified in 17 C.F.R. pts. 200, 201, 230, 240, 242, 249, and 270).

119. Economist Online, *One Big, Bad Trade*, THE ECONOMIST, (Oct. 1, 2010, 6:42 PM), http://www.economist.com/blogs/newsbook/2010/10/what_caused_flash_crash [http://perma.cc/CJ95-UV9Q].

120. Bob Pisani, *What Happened During the Aug. 24 'Flash Crash'*, CNBC (Sept. 25, 2015, 3:59 PM), http://www.cnbc.com/2015/09/25/what-happened-during-the-aug-24-flash-crash.html [http://perma.cc/54U6-WD9S].

where they were closed for a while, the Facebook IPO failure,[121] and all these other little market failures, people say, "Oh, my god, what's going on here?" and no one understands the market. It is just remarkable to me that here we sit eight years after Reg NMS mandated high-frequency trading, the SEC is still prone to vilify, as are other regulators in Washington, high-frequency traders, but there has never been a retrospective review of that rule to ask whether we are happy with what we did here.[122] We totally transformed equity market structure in the United States. We mandated high-frequency trading. We can sit back and be proud that Grandma Jones gets a $7.99 trade on her 100-share IBM order. Is that not really the measure of good markets? If Grandma Jones trades, and if she is going hold that for ten or fifteen years, it is a pretty good deal. There is liquidity, but is that really the market we want? We have never done that review.

The answer could be yes, by the way. I am not saying that I disagree with where we are, but it is an arrogance of government to say, "We don't have to look back and decide." The impulse of government is to say, "Oh, my gosh, we have had an outage. Those damn market participants. They must be up to something. It is not our rules, and it is not even the law." By the way, the laws are worse than the rules. I mentioned the 1975 Act amendments. The 1975 view of the world controls U.S. equity markets from a statutory perspective. 1975 was a time very similar to 2009, which is not a good thing. You have to question the law. You have to question the rules. Nobody is doing that. We are just putting out more and more. Every time there is a market failure, there is a kneejerk response.

One of the funniest things I will talk a little bit about is this new notion in Washington after the Treasury Flash Crash of October of last year.[123] There was a report issued by the SEC, the CFTC, Treasury, and

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121. Tim Worstall, *The Failure of Facebook's IPO*, FORBES (May 20, 2012, 7:54 AM), http://www.forbes.com/sites/timworstall/2012/05/20/the-failure-of-facebooks-ipo/#6cf41d2a5c2f [http://perma.cc/46XV-ULWZ].

122. Jacob Bunge, *A Suspect Emerges in Stock-Trade Hiccups: Regulation NMS*, WALL ST. J., (Jan. 27, 2014, 11:00 PM), http://www.wsj.com/articles/SB10001424052702303281504579219962494432336 [http://perma.cc/KRW7-4XL7].

123. Tracy Alloway, *Here's What We Learned from the Official Report on the 'Flash Crash' Treasuries*, BLOOMBERGBUSINESS, (July 13, 2015, 11:48 AM), http://www.bloomberg.com/news/articles/2015-07-13/here-s-what-we-learned-from-the-official-report-on-the-flash-crash-in-u-s-treasuries [http://perma.cc/E53A-NXEX].

the Fed, talking about those events.[124] It includes some vilification of high-frequency trading. Treasury markets are totally different now. Eric Grossman's firm is no longer playing such a big presence in Treasury markets, and it is no wonder as to why. High-frequency trading has moved in. We had a Flash Crash and the government says, "Those high-frequency traders, I cannot believe them. What are they doing? They are not going to stand in front of a moving bullet coming right at them, the way Morgan Stanley used to? We cannot control them the way we control Morgan Stanley. Let's vilify them." That is really what is going on. It is not regulation, it is not the lack of liquidity, it is not the Volcker Rule, it is not the Basel rules, and it is not CCAR or CLAR, or all of these things that Eric was talking about that keep the dealers away from these markets now because they are just not worth it for them anymore. It is the high-frequency traders that have moved in to provide that liquidity that used to exist through the dealers.

It carries in Washington. It is convenient in Washington because it sounds like shadow banking markets. "High-frequency trading, they are out to get you. Don't look at us. Don't open this curtain. It is high-frequency traders." Not too many people want to stand in front of that one, but I am one of the few. There are some bad practices in high-frequency trading. There are firms and individuals out there who just simply do not provide liquidity to the markets, but take away both liquidity and profits that they do not deserve. Committing capital is a very American thing and you should get a return for committing capital. If you are not, you have to question what they are actually providing. I think that type of analysis and thoughtfulness is what you need in Washington, but you are not going to get it right now.

A very longwinded response to the question, but I think high-frequency trading is providing needed liquidity right now, whether you like the fact or not that it is fleeting compared to Morgan Stanley standing there taking their lumps when the market moves against them, and then having the Fed tell them to stand there and take it. High-frequency trading is not going to do that, and that is what drives them crazy because they cannot control it. In this day and age in Washington,

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124. Joint Press Release, Dep't of Treasury, Bd. of Governors of the Fed. Reserve Sys., Fed. Reserve Bank, SEC, CFTC, Release of Joint Staff Report on October 15, 2014 (July 13, 2015, 11:30 AM), http://www.federalreserve.gov/newsevents/press/other/20150713a.htm [http://perma.cc/Y7AD-G7WW].

they will try to find a way to control it because it is all about command-and-control.

RICHARD SQUIRE: You said in your remarks that if there had been more transparency, and you were remembering being at Lehman on September 15, 2008, then we could have avoided some of the worst aspects of the bailouts. What were the worst aspects of the bailouts, in your view?

DANIEL GALLAGHER: Before I was a Commissioner, I was on the staff of the SEC. I ran the investment bank oversight side of the Division of Trading and Markets. I started six weeks before Lehman, so that was a great job choice. I always tell people it is not that I know substantively more about these issues than everyone else, but if you were there at the time and you saw all this stuff that is being written about now, years later, and you lived through it and you saw how decisions were made firsthand, it would have, I would hope and expect, a major impact on you. To watch the government respond to something like 2008, to see the dialogue, to see the imperfect information upon which these crucial decisions were made, I have to tell you, is a scarring thing to go through, to sit and realize that no one knew what AIG's positions were in derivatives, and that no one knew who the counterparties were because there was no regulatory transparency and much less market public transparency. I give Tim Geithner credit—in the years leading up to the crisis, he led the voluntary push, first on credit derivatives, and then on equity derivatives, to get the firms to file the gold copy with DTC of their transaction details to try to start to size these markets, and to try to understand which firms were most at risk.[125] He had the right idea, but it was not in place by the time things blew up.

To me, it was this notion that we now have to pump AIG full of money because we have imperfect information. We have to fear the worst, and we have to move in. I think, based on what you knew post-crisis, you might have decided differently. You might have said it might be all right if they go under. I think that transparency would have been critical to decision making. This is something, even as a very free-market, small-government conservative, I can get my head easily

125. Robert O'Harrow Jr. & Jeff Gerth, *As Crisis Loomed, Geithner Pressed but Fell Short*, WASHINGTON POST (Apr. 3, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/04/02/AR2009040203227.html [http://perma.cc/FG96-2YYK].

around. Despite it coming from the New Deal, and the 1933 and 1934 Acts, the idea of transparency and disclosure, either to regulators or the markets generally, of material information is something that makes a lot of sense. This makes a lot of sense so long as you are not taking too much property from somebody. In this instance, when you have a $700 trillion notional market in swaps, a little bit of transparency would have gone a long way.

But you open yourself up to all of the second-guessing. "Oh, you only bailed out AIG because Goldman was a counterparty," or, "You bailed out the European banks." I do not think they did because I was in those rooms at the New York Fed, and I was in those rooms at Lehman, and I do not think that is what the thought process was, but you do you open yourself up to that narrative, and it can get kind of ugly.

If I had to write Title VII it would be one sentence: "You shall disclose to X regulator all positions in OTC derivatives." Then it could have been five, ten, twenty pages of authority to the right regulators, to say, "Not earlier than three years after sentence one is enacted, you can do this: you can mandate more disclosure, you can mandate central clearing, you can mandate equities-like trading, if you think it is the right thing based on three years of experience in markets that you have never regulated before." That is humility. That is the government saying, "Gosh, we really did not get it, did we? We bailed out AIG and we did not have to."

It would have made a lot of sense, but instead they just went for the whole mousetrap: thirty pages of complicated equities-like market structure being overlaid on OTC swaps markets and dividing the jurisdiction over these markets between the SEC and the CFTC. I did not even get to that fun part, by the way. The Dodd-Frank Act said it was going to clean up the alphabet soup of Washington. It got rid of OTS and created four more regulators, and it did not merge the SEC and the CFTC.[126] So we are in a position where the rules have been done for two years, and you cannot really trade swaps unless you trade all of the swaps in a meaningful way. Anyway, I could go on and on and on, Professor. Did I answer your question?

RICHARD SQUIRE: Yes. Another question?

AUDIENCE MEMBER: I think there have been a few allusions today to shadow banking practice. I think that is one of the commonly

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126. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. III, 124 Stat. 1376, 1520-70 (2010).

levied criticisms against Dodd-Frank, that it is pushing borrowers towards money markets and hedge funds and the like. I think the *Financial Times* reported in May that just over half of new home mortgages are being issued by institutions with no depositors.[127] Is that something that needs to take a more central focus in forecasting what the next crisis looks like, or are the current measures in Dodd-Frank sufficient to curb the riskiest practices?

DANIEL GALLAGHER: This is an interesting question. Shadow banking is loosely defined by me as non-bank markets. Bank regulators like to call it something ugly to scare you into thinking it is scary. It is capital markets, the non-bank capital markets, which in the United States provide 80% of the financing for our economy, which, by the way, in Europe provide 20% of the financing for the European economy.[128] No wonder the *Financial Times* is writing about how bad shadow banking markets are.

There are all these initiatives and this lore that is put out there after the crisis that the shadow banking markets are the riskiest part of our markets, that the prudential regulators, the central bankers, and other bank regulators need further control of these markets to take the risk out of them. Remember, when you hear "shadow banking market," think capital markets. So when the bank regulators say they want to de-risk capital markets, just sit back and think to yourself, what are capital markets for? They are for investors to put capital at risk, whether those investors are retail, institutional, or whoever, in the hope of seeking a return. That is America. You want to de-risk that? Do you think you are going to get the same return in a de-risked banking-like market? I will tell you, no. Then you ask yourself, what are these markets? You mentioned mortgage lending. I do not know that statistic, but it does not

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127. Ben McLannahan, *Shadow Banks Grab Record US Loans Share*, FINANCIAL TIMES, (May 31, 2015, 3:12 PM), http://www.ft.com/intl/cms/s/0/3754ac32-0644-11e5-89c1-00144feabdc0.html#axzz42vThnNID [http://perma.cc/JJ2J-FKL4].

128. Helmut Kraemer-Eis with Francesco Battazzi, Remi Charrier, Marco Natoli & Matteo Squilloni, *Institutional Non-Bank Lending and the Role of Debt Funds* 10 (Euro. Inv. Fund, Working Paper No. 2014/25, 2014) ("ECB president Mario Draghi mentioned in an often quoted statement that 'in the United States 80% of credit intermediation goes via the capital markets. . . . In the European situation it is the other way round. 80% of financial intermediation goes through the banking system.'"), http://www.eif.org/news_centre/publications/eif_wp_25.pdf [http://perma.cc/ZGF9-X2FN].

surprise me. If I was J.P. Morgan or Morgan Stanley, I would not want to be in the market for issuing mortgages after 2008. But, of course, now you are fine, because you have the Consumer Financial Protection Bureau, which regulates mortgages, and if not the institutions directly, then the practices and the products that are issued, whether you be a bank or a non-bank. You have a whole new agency within the Fed, if you can call it an agency, dedicated to ferreting out those abuses. I do not know what they do in Europe.

But there is this big mindset that we have to de-risk these so-called shadow banking markets. If you go back and you look at the financial crisis, just ask, what evidence is there? Where is this big source of systemic risk in the capital markets? Capital markets, as in our exchange earlier on the panel, are supposed to be about risking capital, getting a return, and if things get out of whack, whether it is a failure—a failure of the product or the failure of a firm, taking your losses. 2008 skewed all of that. The bail out of Bear Stearns, which was supposed to fail because they were not a bank and they did not have access to the taxpayer window, created a moral hazard that played out in Lehman, AIG, and elsewhere. It created a big mess. So in the "shadow banking" markets, when you hint, as the government, that maybe you are not going to fail, then you distort the whole notion of what a capital market is or what shadow banking markets are. That is what the government did. They bailed out Bear Stearns and then they could not figure out how to get off that slippery slope. That is what they are trying to figure out. I think it is pure folly. We saw it play out in the asset management industry in a very real way, as they determined whether to designate big mutual funds as systemically important and regulate them like banks. If you regulate everything like banks, we will live in France, whether you like it or not. You might like France, but I do not want to live in France.

Any other questions? Thank you very much for having me.

CAITLIN FAHEY: Thank you all so much for coming today. Thank you, Commissioner Gallagher. My name is Caitlin Fahey. I am the Symposium Editor of the *Journal of Corporate and Financial Law*. I just want to take a brief moment to say a special thank-you to people who have been instrumental in putting this event together today. Commissioner Gallagher, Mr. Kim, Professor Squire, Mr. Grossman, thank you for dedicating your valuable time and sharing your insight with us today. Professor Gentile, Professor Griffith, Professor Squire, thank you for your support and your guidance in organizing today's symposium. The *Journal* is so grateful to have such dedicated faculty. This event would not have been possible without your help. I would like to also thank Carrie Johnson, Julian Phillippi, and Shanelle Holley for their help coordinating today's event. I would also like to recognize Max Dillan and Chris Bonser, who are our Editor-in-Chief and Managing Editor. Also a special thank-you to the Symposium Committee for doing such a great job with today's event. Lastly, I would like to say that on behalf of the *Journal*, we want to say a special thank-you to our alumni who are here today. One of Fordham's greatest strengths is the alumni's longstanding commitment to the school and its students. The *Journal* is so grateful that its alumni have come here to support us today. I hope you will all join us next door for a cocktail reception. You will get a chance to meet our panelists and keynote speaker. Thank you all again for coming today.