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FROM GRAMM-LEACH-BLILEY TO DODD-FRANK: THE UNFULFILLED PROMISE OF SECTION 23A OF THE FEDERAL RESERVE ACT*

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This Article examines the recent history and implementation of one of the central provisions in U.S. banking law, section 23A of the Federal Reserve Act. Enacted in 1933 in response to one of the perceived causes of the Great Depression, section 23A imposes quantitative limitations on certain extensions of credit and other transactions between a bank and its affiliates that expose a bank to an affiliate's credit or investment risk, prohibits banks from purchasing low-quality assets from their nonbank affiliates, and imposes strict collateral requirements with respect to extensions of credit to affiliates. The key purpose of these restrictions is twofold: to protect federally insured depository institutions from excessive credit exposure to their affiliates, and to prevent transfer of federal subsidy to nondepository financial institutions. After the enactment of the Gramm-Leach-Bliley Act of 1999, which removed the Glass-Steagall era prohibition on affiliation between commercial banks and investment banks, section 23A effectively became the principal statutory safeguard preventing the depository system from subsidizing potentially risky activities of nonbanking institutions. However, despite its officially endorsed significance, section 23A remains a largely obscure statute that has not attracted much scholarly attention to date.

This Article seeks to fill that important gap and to explore how effective section 23A is in achieving its purported goals in practice. It examines the body of interpretive letters issued by the Board of Governors of the Federal Reserve System (the "Board") between 1996 and 2010, in

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which the Board granted individual banking institutions' requests to exempt their proposed transactions with affiliates from the requirements of section 23A. This Article argues that section 23A falls short of delivering the kind of robust protection for the depository system it allegedly promises, primarily because it was not designed for fulfilling such a grand task. This mismatch between its professed function and practical efficacy became particularly clear during the global financial crisis of 2007–2009. The Article puts together a comprehensive record showing how the Board's use of exemptive authority effectively rendered section 23A irrelevant during the crisis, by allowing commercial banks to provide financing to their affiliated securities firms, derivatives dealers, money market funds, and even automotive companies, in order to prevent potentially disastrous effects of their failure on the financial system and the broader economy. Crisis containment and systemic risk considerations consistently prevailed over the statutory purpose of preventing the leakage of the federal subsidy outside the depository system. This Article further argues that the recent amendments to section 23A under the Dodd-Frank Act of 2010 fail to address this fundamental tension in the operation of the statute. The Article concludes with a discussion of potential implications of this argument for future financial regulatory reform.

INTRODUCTION

The recent financial crisis forcefully underscored the continuing importance of protecting the safety and soundness of the U.S. banking system, which is increasingly intertwined with, and vulnerable to risks generated in, the rest of the global financial services industry. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[1] the most far-reaching financial reform legislation since the New Deal,[2] seeks to address this problem, among other things, by creating new statutory firewalls separating deposit-taking institutions from other market players and activities deemed to be particularly risky. Thus, the famous Volcker Rule generally prohibits banking organizations from conducting proprietary trading or investing in private equity and

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.A. (West Supp. 2011)).

2. *See, e.g.*, Viral Acharya et al., *A Critical Assessment of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, N.Y. UNIV.: LEONARD N. STERN SCH. OF BUS. (Oct. 20, 2010, 4:18 PM), http://w4.stern.nyu.edu/blogs/regulatingwallstreet/2010/10/a-critical-assessment-of-the-d.html ("This is widely described as the most ambitious and far-reaching overhaul of financial regulation in the US since the 1930s.").

hedge funds above a certain level.[3] Another provision of the Act seeks to establish a firewall between commercial banking and derivatives[4] trading by prohibiting banks from conducting certain derivatives activities, which must be moved to their nonbank affiliates.[5] It remains to be seen whether or not these new rules will make the federally insured banking system safer in practice. To a great extent, their future success depends on effective functioning of another, much older and less widely acclaimed, statutory firewall: section 23A of the Federal Reserve Act, which imposes limitations on transactions between banks and their affiliates.[6] A closer look at the recent history and implementation of this important statute helps to shed light on the potential future impact of the Volcker Rule and similar provisions of the new legislation.[7] More generally, it provides a valuable insight into the practical operation and efficacy of legal mechanisms designed to keep U.S. commercial banks safely insulated from their riskier counterparts.

Enacted in 1933 as part of the regulatory reform in response to the Great Depression, section 23A of the Federal Reserve Act restricts the ability of U.S. commercial banks to provide funding to their nonbank affiliates above a certain quantitative limit and imposes certain collateral and other qualitative requirements with respect to such transactions. The main purposes of section 23A are (1) protecting federally insured depository institutions from excessive credit exposure to their riskier affiliates, and (2) preventing transfer of federal subsidy (access to federal deposit insurance and liquidity backup facilities) to nondepository financial institutions.[8] Prior to the passage of the Dodd-Frank Act, the Board of Governors of the

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3. § 619, 124 Stat. at 1620–31 (codified at 12 U.S.C.A. § 1851 (West Supp. 2011)). The Volcker Rule was named after Paul Volcker, a former chairman of the Board of Governors of the Federal Reserve System (the "Board"), whose ideas formed the basis for these provisions of the Dodd-Frank Act.

4. Derivatives are financial instruments whose value is "derived" from the value of another asset, referred to as the underlying or reference asset. R. STAFFORD JOHNSON, INTRODUCTION TO DERIVATIVES: OPTIONS, FUTURES, AND SWAPS 1–10 (2009).

5. § 716, 124 Stat. at 1648–51 (codified at 15 U.S.C.A. § 8305 (West Supp. 2011)).

6. 12 U.S.C. § 371c (2006) (amended 2010). The Dodd-Frank Act amended section 23A to reinforce these limitations. § 608(a), 124 Stat. at 1608–10 (codified at 12 U.S.C.A. § 371c(c)(1) (West Supp. 2011)).

7. In fact, Wall Street attorneys informally refer to certain requirements of the Volcker Rule as "Super 23A" provisions. *See infra* notes 351–52 and accompanying text.

8. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,560 (Dec. 12, 2002). In addition, section 23A seeks to promote competition and prevent banks from favoring their affiliates in allocating credit. *See* RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 427 (4th ed. 2009).

Federal Reserve System (the "Board") had the exclusive statutory authority to grant, by regulation or order, exemptions from the quantitative and qualitative limitations of section 23A, if such exemptions were in the public interest and consistent with the purposes of the statute.[9]

After the enactment of the Gramm-Leach-Bliley Act of 1999 (the "GLB Act"),[10] which removed the Glass-Steagall era prohibition on affiliation between commercial banks and investment banks,[11] section 23A effectively became the principal statutory firewall protecting the depository system from subsidizing potentially risky activities of nondepository financial institutions and, in a broader sense, safeguarding the foundational U.S. principle of separation of banking and commerce.[12] However, despite being referred to as the "Magna Carta" of U.S. banking law,[13] section 23A remains a largely obscure, and often not very well understood, statute. Even in the midst of an intense debate on financial regulation reform, neither legal academics nor policy experts have been paying much attention to this particular area of banking law.

This Article fills that gap in the debate and explores how effective section 23A is in achieving its purported goals in practice. The focus of this inquiry is on the use of the Board's exemptive power as a crucial indicator of the efficacy and resiliency of the statutory firewall.[14] This Article examines the body of the Board's published interpretive letters, issued between 1996 and 2010, granting individual

9. 12 U.S.C. § 371c(f)(2) (2006) (amended 2010). The Dodd-Frank Act amended section 23A to split the exemptive authority among several federal bank regulators, thus ending the Board's exclusive power to do so. *See infra* notes 362–69 and accompanying text.

10. Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 and 15 U.S.C.).

11. Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), *repealed in part by* Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338.

12. *See, e.g.*, LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 68 (2011) (describing the historical persistence of the fundamental separation between banking and commerce in the United States).

13. CONG. OVERSIGHT PANEL, THE UNIQUE TREATMENT OF GMAC UNDER THE TARP 24 (2010) [hereinafter COP REPORT], *available at* http://cop.senate.gov/reports/library/report-031110-cop.cfm (citing an interview with an expert analyst).

14. Section 23A operates in tandem with section 23B, which generally requires that banks transact with their affiliates on an arms-length basis. *See* 12. U.S.C. § 371c-1 (2006) (amended 2010); *see also infra* notes 31–34 and accompanying text (describing the requirements of section 23B). However, this Article focuses on the implementation of section 23A as the key statute governing banks' transactions with affiliates.

banking institutions' requests to exempt their proposed transactions with affiliates from the requirements of section 23A.[15]

As usually is the case with federal bank regulatory agencies, presenting a complete picture of how the Board implements section 23A is an extremely challenging task. U.S. bank regulators have a great deal of discretion in interpreting and applying the statutes they administer and often make important decisions through informal action, such as individual orders and interpretive issuances. Most of these decisions are made outside of public view, in highly confidential communications between agency officials and representatives of the banking institution in question. Bank regulators typically do not publish any negative determinations in specific cases.[16] Moreover, even published regulatory interpretations and orders are often highly sanitized and devoid of specific details negotiated behind the scene.

The Board's interpretations of section 23A exhibit all of these characteristics that make a researcher's task very difficult. Nevertheless, even acknowledging these blind spots and potential for incomplete assessment, an analysis of the Board's published decisions exempting individual transactions from the requirements of section 23A reveals certain key trends and fundamental tensions in the practical operation of this important statute.[17]

This Article argues that, contrary to common belief, section 23A is not only ineffective, as a matter of practice, but inherently ill-suited,

15. These interpretive letters are publicly available on the Board's official website. *See Legal Interpretations*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/boarddocs/legalint/ (last updated Mar. 18, 2011). There are other unpublished interpretive letters issued prior to January 1996, some of which are available through the Federal Reserve Bulletin and Regulatory Service. In some cases, exemptions from the requirements of section 23A were included in the Board orders issued under the Bank Holding Company Act of 1956 ("BHC Act"). However, based on a review of a large sample of these publicly available materials, there is no reason to believe that including these additional documents in the universe of decisions examined here would add anything substantively new or otherwise alter the argument. Therefore, this Article focuses on the Board's interpretive letters dealing specifically with section 23A and published on the Board's website. These letters provide a sufficiently rich source of information on the evolution of the Board's use of exemptive authority under section 23A.

16. As a matter of practice, if an institution receives an informal indication of the agency's reluctance to approve a proposed transaction, it does not proceed with a formal request.

17. It is important to note that the main purpose of this Article is not to provide a comprehensive ethnographic account of the Board's inner workings. Even if the real reasons behind the Board's individual decisions may not be fully known or disclosed, once these interpretations are published, they take on a life of their own and their publicly stated reasoning becomes regulatory precedent that shapes subsequent decisions. This Article focuses on that "public" life of the statute.

as a matter of principle, to perform the monumental task of keeping the depository system safe from externally generated risks. At the time of its enactment in 1933, the statute's approach was based on the key premise that, as a result of the Glass-Steagall Act prohibitions, none of banks' nonbank affiliates would engage in securities dealing or other financial activities viewed at the time as unacceptably risky for federally insured commercial banks.[18] In that context, section 23A was expected to provide an extra bit of protection for banks in transacting with affiliates that were already limited to conducting less risky financial activities. A partial repeal of Glass-Steagall in 1999 suddenly propelled section 23A to new prominence as the "successor" to its mission of preserving the integrity of the federally insured depository system. Proponents of the GLB Act successfully used the very existence of section 23A to justify the repeal of the old regime.[19] Ironically, this unexpected ascent took place just as the fundamental premise on which section 23A rested ceased to exist and U.S. banks were allowed to affiliate with investment banks and other nondepository institutions within large diversified financial conglomerates.

The passage of the GLB Act heightened the importance of protecting the U.S. depository system from potential abuse by nonbank affiliates and, at the same time, created a whole new universe of opportunities for such abuse. However, the Board's pattern of granting exemptions under section 23A during that period generally shows that it did not fully appreciate the fundamental nature of these changes. Applying a narrow microprudential approach to exempting individual transactions from the statutory limits, the Board consistently failed to take into account potential systemic implications of such transactions. Partly, this may be a result of the regulator's inability to adjust its implementation and enforcement practices to the more complex post-GLB Act environment. Partly, however, the Board's myopia was a product of, and consistent with, the statute's own narrow and inherently entity-centric focus. As the U.S. financial sector was undergoing a fundamental transformation, section 23A remained a largely obscure and deceptively calm area of banking law, seemingly oblivious to the

18. *See infra* notes 40–43 and accompanying text.

19. *See* Veryl Victoria Miles, *Banking Affiliate Regulation Under Section 23A of the Federal Reserve Act*, 105 BANKING L.J. 476, 478 (1988) ("Although absent from recent banking law discussions, section 23A has been the focus of recent proposals by Congress and banking regulators to repeal the Glass-Steagall restrictions in order to permit banks to engage in full-fledged securities activities through securities affiliates.").

dangerous growth of the so-called "shadow banking system" it indirectly helped to fuel.[20]

The implosion of the shadow banking system in 2007 unexpectedly brought section 23A to the forefront of the Board's interpretive activity. Shifting into full wartime mode, the Board aggressively used its exemptive authority under section 23A as an integral part of its response to the unfolding financial crisis. This Article argues that, during the crisis, the Board effectively rendered section 23A irrelevant by repeatedly allowing depository institutions to provide financing to their affiliated securities firms, derivatives dealers, money market funds, and even automotive companies, in order to prevent potentially disastrous effects of their failure on the financial system and the broader economy. Crisis containment and systemic risk considerations consistently prevailed over the statutory purpose of preventing the leakage of the federal subsidy outside the depository system. In effect, the Board dismantled the entire section 23A regime in order to make an emergency transfusion of the federal subsidy into the shadow banking system and beyond.

This Article presents a comprehensive account of the Board's use of exemptions from the requirements of section 23A both as a contributing factor to the recent financial crisis and as a crucial element of the Board's crisis response. By putting together the first such systematic record, this Article shows how the superficial transformation of section 23A from a relatively modest statutory provision into a core legal device presumably protecting the fundamental principles of U.S. bank regulation created a false sense of security with respect to systemic risk containment. Section 23A may still be effective as a method of limiting individual banks' direct exposure to affiliates' credit risk, at least in certain circumstances. If properly enforced, it may even potentially curb the excessive growth of shadow banking and bank-centered financial conglomerates. However, section 23A is not well-suited to serve as the principal guarantee of the safety and soundness of the depository system in today's increasingly complex and dynamic financial marketplace. As the recent crisis demonstrated, safety and soundness of the banking sector is intimately tied to the stability of the broader financial system. Yet, section 23A is not directly aimed at systemic risk

20. For a discussion on the growth of the shadow banking system, see generally ZOLTAN POZSAR ET AL., FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS: SHADOW BANKING (2010), *available at* http://www.ny.frb.org/research/staff_reports/sr458.pdf.

prevention. This conspicuous lack of a macroprudential, systemic focus undermines the statute's ability to fulfill its presumed function as the main firewall keeping banks "safe."

This Article further argues that the recent amendments to section 23A under the Dodd-Frank Act fail to address these fundamental tensions in the operation of the statute. If the key statutory firewall, ostensibly designed to protect banks' safety and soundness by separating them from affiliated nonbank entities, inevitably disappears in times of financial stress, tightening individual requirements of the statute is not likely to make that wall strong enough to withstand the next crisis. And if we admit and accept the fact that the need to contain systemic crisis will always legitimately supersede the statutory limits on bank affiliate transactions, whose operation would thus be limited only to noncritical times, it would create serious moral hazard issues and potentially undermine the functioning of the entire bank regulation regime.

The real dilemma, therefore, is much deeper than Dodd-Frank assumes and goes to the very heart of our existing system of financial regulation. If section 23A does not deliver the kind of protection for the depository system it supposedly promises, we have to stop depending on it as the principal source of such protection. We need to reassess the fundamental policy goals underlying the statute and to reevaluate whether or not, in today's financial markets, it is prudent or efficient to continue relying on intra-company firewalls to protect depository institutions from affiliate risk. These substantive policy decisions should guide our search for new methods of implementing and enforcing desired protections. While this Article does not endeavor to tackle these issues, facing the reality of what section 23A is, and what it is not, is a necessary step on the path toward designing a more effective system of financial regulation.

This Article is structured as follows. Part I provides a brief overview of the history and key provisions of section 23A before the enactment of the Dodd-Frank Act. Part II examines the Board's interpretations granting exemptions from the requirements of section 23A in the period preceding the recent financial crisis. Part III provides a detailed analysis of the Board's unprecedented and aggressive use of its exemptive authority under section 23A during the financial crisis of 2007–2009. Part IV offers a critique of the Dodd-Frank Act's amendments to section 23A and discusses potential policy implications of the preceding analysis for future financial regulatory reform.

I. REGULATION OF BANKS' TRANSACTIONS WITH AFFILIATES: OVERVIEW

This Part briefly describes the requirements and evolution of section 23A of the Federal Reserve Act prior to the adoption of the Dodd-Frank Act. It shows how a relatively modest provision of the U.S. banking law, intended originally to work in tandem with the broader prohibitions on banks affiliating with securities firms, was elevated to great prominence after the GLB Act repealed such prohibitions in 1999. Under the new regime allowing the growth of large, diversified financial conglomerates, section 23A became the principal statutory mechanism shielding the U.S. depository system from risks associated with such conglomeration. However, despite the major update of section 23A in the Board's Regulation W, the fundamental structure and focus of the statute remained largely unchanged, which affected its ability to meet that challenge.

A. *Key Provisions and Purposes of Section 23A*

Congress enacted section 23A of the Federal Reserve Act in 1933, in response to one of the perceived causes of the banking crisis of the early 1930s: preferential loans banks made to their affiliates.[21] In essence, section 23A seeks to restrict transfers of assets between banks that are members of the Federal Reserve System, or member banks,[22] and their "affiliates."[23] It imposes quantitative limitations on certain "covered transactions" between the bank and its affiliates, based on the amount of the bank's capital and surplus.[24] Under

21. *See* S. REP. NO. 72-584, at 9 (1932).

22. Although provisions of section 23A apply technically only to member banks, 12 U.S.C. § 1828(j) extends their application to transactions between insured state nonmember banks and their affiliates. Thus, all federally insured deposit-taking institutions are currently subject to restrictions and limitations of section 23A of the Federal Reserve Act. *See* 12 U.S.C. § 1828(j) (2006) (amended 2010); *see also infra* note 32 (describing applicability of section 23B to nonmember banks' transactions with affiliates).

23. 12 U.S.C. § 371c(a) (2006) (amended 2010). Under section 23A, a bank's "affiliates" generally include any entity that controls the bank, any entity under common control with the bank, and certain investment funds for which the bank or any of its affiliates act as an adviser. § 371c(b)(1).

24. § 371c(a)(1). The limitations are ten percent of the bank's capital stock and surplus, in the case of transactions with any one affiliate, and twenty percent of the bank's capital stock and surplus, in the case of transactions with all affiliates. *Id.* Regulation W defines "capital stock and surplus" as the sum of (1) "a member bank's tier 1 and tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency," based on the bank's most recent Report of Condition and Income; (2) "the balance of a member bank's allowance for loan and lease losses not included in its tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency," also based on the bank's most recent Report of Condition and Income; and (3) "the amount of any

section 23A, "covered transactions" generally include loans and other extensions of credit[25] to an affiliate, investments in the securities of an affiliate, purchases of assets from an affiliate, issuances of guarantees on behalf of an affiliate, and other transactions exposing a bank to an affiliate's credit or investment risk.[26] In addition to imposing quantitative limitations, section 23A requires that all covered transactions be on terms and conditions that are consistent with safe and sound banking practices[27] and prohibits banks from purchasing certain "low-quality" assets[28] from their nonbank affiliates.[29] Finally, the statute requires that all extensions of credit by the banks to their affiliates be secured by a statutorily mandated amount of collateral.[30]

A companion section 23B,[31] which was added to the Federal Reserve Act in 1987, requires, among other things, that transactions between member banks[32] and their affiliates be on market terms.[33] Section 23B applies to a much broader range of financial transactions.

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investment by a member bank in a financial subsidiary that counts as a covered transaction and is required to be deducted from the member bank's capital for regulatory capital purposes." 12 C.F.R. § 223.3(d) (2010).

25. The statute does not define what constitutes "a loan or extension of credit." *See* § 371c(b). Regulation W defines "extension of credit" as "the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis, to an affiliate." 12 C.F.R. § 223.3(o).

26. *See* § 371c(b)(7).

27. *See* § 371c(a)(3).

28. For a statutory definition of the term "low-quality asset," see § 371c(b)(10). In essence, this term refers primarily to various types of troubled loans. *Id.*

29. *See* § 371c(a)(3). The statute provides an exception for this prohibition where the bank, pursuant to an independent credit evaluation, committed to purchase the asset in question before it was acquired by the affiliate. *Id.*

30. *See* § 371c(c). The amount of collateral required under section 23A varies depending on the type of securities or other assets used to collateralize an affiliate's obligation. For example, if the collateral consists of U.S. government obligations, its value must be equal to 100% of the value of the extension of credit. However, if collateral consists of corporate stock or real or personal property, it must have a value equal to 130% of the value of the extension of credit. § 371c(c)(1).

31. 12 U.S.C. § 371c-1 (2006) (amended 2010).

32. Section 1828(j) makes section 23B applicable to transactions between insured nonmember banks and their affiliates. *See* 12 U.S.C. § 1828(j) (2006) (amended 2010).

33. § 371c-1(a)(1). The "market terms" requirement means that each covered transaction must be conducted on terms and under circumstances, "including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies." *Id.* In the absence of comparable transactions, the transaction must be conducted on terms and under circumstances "that in good faith would be offered to, or would apply to, nonaffiliated companies." *Id.*

It applies to all covered transactions within the meaning of section 23A and to many transactions that do not fall into that category.[34]

Both section 23A and section 23B contain an "attribution rule" whereby a transaction with any person is considered a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.[35] Thus, under the attribution rule, if the bank lends money to an unaffiliated company, which then uses the borrowed money to purchase securities from the broker-dealer firm affiliated with the bank, the original loan transaction would be subject to the qualitative and quantitative limitations of sections 23A and 23B, as if the bank extended credit directly to the broker-dealer affiliate. The attribution rule aims to prevent depository institutions from indirectly subsidizing or supporting their affiliates' business by, among other things, financing their customers and counterparties.[36]

The twofold purpose of the quantitative and qualitative restrictions on transactions between banks and their nonbank affiliates under section 23A is to protect the safety and soundness of commercial banks and to prevent them from subsidizing affiliates' risky business activities with the protection afforded by federal deposit insurance.[37] As originally enacted in 1933, section 23A sought to ensure "the safer use of the assets of banks, to regulate interbank control [and] to prevent the undue diversion of funds into speculative operations."[38] At the time, the prevailing sentiment was that the main underlying cause of the Great Depression was the unlimited participation of commercial banks in securities underwriting and investment activities and using unregulated affiliates to assume speculative risks and generate profits at the expense of depositors.[39]

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34. *See* § 371c-1(a)(2). Examples of such additional types of transactions governed by section 23B include the sale of securities or other assets by a bank to an affiliate, payment of money or furnishing of services by a bank to an affiliate, transactions in which an affiliate acts as an agent or broker for a bank (or for any other person if the bank is a participant in the transaction), and any transaction by a bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction. *Id.*

35. *See* § 371c(a)(2); § 371c-1(a)(3).

36. Under the so-called "sister-bank exemption," covered transactions between affiliated depository institutions are exempt from the quantitative and collateral requirements of section 23A if the same company controls eighty percent or more of the voting securities of each institution. 12 C.F.R. § 223.41(b) (2010).

37. *See supra* note 8 and accompanying text.

38. H.R. REP. NO. 73-150, at 1 (1933).

39. *See generally* GEORGE J. BENSTON, THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED

Although the growth of banks' affiliates was considered one of the evils behind the crisis,[40] a total prohibition on affiliation did not appear feasible at the time.[41] Instead, Congress enacted section 23A, designed to prevent banks from engaging in excessively risky lending activities with their affiliates.[42] Importantly, however, section 23A was adopted as part of the same legislative reform that included the Glass-Steagall Act, which addressed the broader issue of systemic risk prevention, as it was understood at the time, by severely restricting the range of financial activities permissible for bank affiliates.[43]

B. *Recent History of Section 23A*

Since 1933, Congress has amended section 23A several times, gradually expanding and refining its scope and applicability, so that, by the 1990s, all insured depository institutions became subject to sections 23A and 23B.[44] Yet, for decades, regulation of affiliate

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(1990) (examining the key reasoning behind the separation of commercial and investment banking under the Glass-Steagall Act); Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483 (1971) (detailing historical events that led to the passage of the Glass-Steagall Act).

40. S. REP. NO. 73-77, at 10 (1933) ("The greatest of such dangers is seen in the growth of 'bank affiliates' which devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank.").

41. *Id.* In addition to the difficulty of enforcing such a total prohibition in practice, Congress faced the fact that state legislation allowed state-chartered banks and trust companies to affiliate with nonbank entities. In the U.S. dual-banking system, where banks could choose to be chartered either by the federal government or by individual states, this raised significant competitive concerns. *See id.*

42. *See* Miles, *supra* note 19, at 480–82.

43. *See* S. REP. NO. 73-77, at 10 (stating that the proposed legislation aimed "[t]o separate as far as possible national and member banks from affiliates of all kinds" and "[t]o limit the amount of advances or loans which can be obtained by affiliates from the parent institutions with which they are connected"). This important statement in the Senate Committee's report clearly underscored the intimate link between Glass-Steagall's prohibition on affiliation between commercial banks and securities firms, on the one hand, and the principle of limiting access to bank funds by any nonbank affiliates, on the other.

44. Congress amended the Federal Deposit Insurance Act in 1966 to apply section 23A to state nonmember banks with federally insured deposits to the same extent as if they were state member banks. Act of July 1, 1966, Pub. L. No. 89-485, § 12(c), 80 Stat. 236, 242 (codified as amended at 12 U.S.C.A. § 1828(j) (West 2001 & Supp. 2011)). The statute underwent a comprehensive revision in 1982, with the enactment of the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 410, 96 Stat. 1469, 1515 (codified as amended at 12 U.S.C.A. § 371c (West 2001 & Supp. 2011)). Among other things, Congress expanded the definitions of "affiliate" and "covered transactions" to close certain loopholes in the statute, but also created greater flexibility for banks' transactions with affiliates that were considered as not posing undue risks to deposit insurance funds. *Id.* In 1989, Congress revised the Home Owners' Loan Act to apply section 23A to insured savings associations, or thrifts. Financial Institutions Reform,

transactions remained a relatively low-profile area of banking law. The enactment of the GLB Act[45] in 1999 brought these statutory provisions from near total obscurity to the center stage of U.S. financial regulation. The GLB Act repealed the Glass-Steagall Act's prohibition on common ownership of deposit-taking institutions and firms underwriting and dealing in securities.[46] Its adoption followed more than a decade of intense policy debate on the pros and cons of dismantling the Great Depression era wall between commercial banks and securities firms.[47] The proponents of repealing Glass-Steagall stressed the importance of sections 23A and 23B as the key statutory mechanisms perfectly capable of maintaining the necessary degree of separation between banks and their newly permitted securities, insurance, merchant banking, and other potentially risky affiliates.[48] The winning argument in favor of allowing these affiliations relied heavily on the assumption that the existing regulation of affiliate transactions effectively protected depository institutions from excessive risk exposure and prevented the misuse of the federal safety net.[49]

As it removed the sixty-six-year-old prohibition on combining commercial and investment banking activities within a single holding company structure, Congress recognized the need to strengthen the limitations on affiliate transactions. Thus, the GLB Act made covered

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Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 301, 103 Stat. 183, 342 (codified as amended at 12 U.S.C.A. 1468(a) (West 2001 & Supp. 2011). Congress added section 23B to the statute as part of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, §102, 101 Stat. 552, 564 (codified as amended at 12 U.S.C.A. § 371c-1 (West 2001 & Supp. 2011)), and later expanded its scope to apply to the same broad universe of depository institutions as section 23A.

45. *See supra* note 10 and accompanying text.

46. Banking (Glass-Steagall) Act of 1933, ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), *repealed in part by* Financial Services Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338. The GLB Act repealed sections 20 and 32 of the Glass-Steagall Act, which prohibited affiliations and management interlocks between commercial banks and investment banks.

47. *See* Joseph Karl Grant, *What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008–2009 American Capital Markets Crisis*, 73 ALB. L. REV. 371, 380–81 (2010) (detailing congressional action from 1987 until the enactment of the GLB Act).

48. *See, e.g.*, S. REP. NO. 106-44 (1999), *reprinted in* 1 WILLIAM H. MANZ, LEGISLATIVE HISTORY OF THE GRAMM-LEACH-BLILEY ACT 54, 66 (William H. Manz ed. 2001) (quoting FDIC Chairman Tanoue's 1999 testimony).

49. *See, e.g.*, Board of Governors of the Federal Reserve System, Supervisory Letter, SR 03-2 Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act (2003) ("A key premise of GLBA was that sections 23A and 23B would limit the risk to depository institutions from these broader affiliations.").

transactions between banks and their "financial subsidiaries," with certain exceptions, subject to the quantitative limits and the collateral requirements of section 23A.[50] It also created a rebuttable presumption that any portfolio company in which the financial holding company ("FHC")[51] holds fifteen percent or more of equity pursuant to its merchant banking[52] authority is an "affiliate" of any bank controlled by the FHC.[53] In addition, the new law required the Board to adopt rules under section 23A "to address . . . credit exposure arising out of derivative transactions between member banks and their affiliates and intraday extensions of credit by member banks to their affiliates."[54] It stands to reason that the inclusion of this requirement reflected the explosive growth of over-the-counter ("OTC") derivatives markets in the preceding decade[55] and the realization that the partial repeal of the Glass-Steagall Act would likely lead to an increase in the volume and value of derivatives transactions between banks and securities firms affiliated with them.

On October 31, 2002, the Board issued Regulation W, a comprehensive implementation of sections 23A and 23B of the

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50. 12 U.S.C. § 371c(e) (2006) (amended 2010). For a definition of a "financial subsidiary," see § 371c(e)(1). The GLB Act allowed financial subsidiaries of commercial banks to conduct financial activities not permissible for banks to conduct directly, including securities dealing and underwriting. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,562 (Dec. 12, 2002). Accordingly, the GLB Act amended the definition of "affiliate" for purposes of sections 23A and 23B to include financial subsidiaries of banks, even though other types of bank subsidiaries do not fall into that category. *See* § 371c(e)(2).

51. A "financial holding company" is a new category created by the GLB Act. *See* 12 U.S.C. § 1841(p) (2006) (amended 2010). An FHC is a "bank holding company" ("BHC"), that is, an entity that owns or controls a U.S. bank, which satisfies certain statutory conditions and which is permitted to engage in a broader range of financial activities, including securities dealing and underwriting, insurance, and merchant banking. *See* 12 U.S.C. § 1843(k) (2006) (amended 2010).

52. The GLB Act permitted FHCs to make what essentially amounts to passive private equity investments and investment management activities under the so-called merchant banking authority. *See* § 1843(k)(4)(H). The Act allowed collective investment funds sponsored and advised by an FHC's nonbank subsidiaries to invest in a wide variety of nonfinancial companies, subject to certain conditions and limitations. *Id.*

53. *See* § 371c(b)(11). If an FHC owns or controls more than twenty-five percent of a class of voting shares of a company under the merchant banking authority, such portfolio company is an "affiliate" of any bank controlled by the FHC by operation of the statutory definitions in section 23A. *See* § 371c(b).

54. § 371c(f)(3)(A).

55. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 334 n.489 (showing that there was over a ten-fold increase in OTC derivatives trading from 1989 to 1999).

Federal Reserve Act.[56] Regulation W codified various Board decisions made in prior years and clarified the new interpretations of the statute in light of the enactment of the GLB Act.[57] Among other things, Regulation W provided that private investment funds that are not registered as publicly traded mutual funds are also included in the definition of an "affiliate,"[58] listed examples of what constitutes an "extension of credit,"[59] and clarified that a bank need not unwind an existing transaction if it crosses one of the quantitative limits under section 23A but is temporarily barred from entering into new covered transactions.[60]

Regulation W also provided a complicated web of important and often overlapping exceptions to, and exemptions from, section 23A limitations.[61] Perhaps the most important policy choice the Board made in Regulation W was a decision not to extend the quantitative and qualitative limitations of section 23A to derivatives transactions between banks and their affiliates.[62] Instead of including derivatives

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56. Regulation W, 12 C.F.R. pt. 223 (2010). Regulation W became effective on April 1, 2003.

57. *See* Stephen Hayden, Note, *Developments in Banking Law: 2002: VII. Regulation W*, 22 ANN. REV. BANKING & FIN. L. 108, 108 (2003).

58. *See* 12 C.F.R. § 223.2(a)(6) (2010). Specifically, under Regulation W, private funds (1) for which a bank or its affiliate acts as an investment adviser, and (2) of which the bank or its affiliate owns or controls more than five percent of any class of voting shares, are included in the definition of "affiliate" for the purposes of section 23A. *Id.*

59. The list includes, inter alia, advances to and overdrafts by an affiliate, the sale of federal funds to an affiliate, and a lease that is functionally equivalent to an extension of credit. *See* 12 C.F.R. § 223.3(o) (2010).

60. *See* 12 C.F.R. §§ 223.11, 223.12 (2010). The prohibition of additional covered transactions is lifted once the bank has room under the applicable statutory limits. Regulation W also allowed a bank that crossed the ten percent limit on covered transactions with one affiliate to engage in covered transactions with other affiliates. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,572 (Dec. 12, 2002).

61. *See* 12 C.F.R. § 223.32(a) (2010). For instance, Regulation W exempted covered transactions between banks and their financial subsidiaries from the ten percent limit on aggregate transactions between a bank and a single affiliate. *Id.* Purchases of "marketable" securities from affiliated broker-dealers were exempted from the quantitative and collateral requirements of section 23A and Regulation W, but remained subject to the prohibition on purchases of low-quality assets and safety and soundness conditions. 12 C.F.R. § 223.42(f) (2010). The Board exempted certain "riskless principal" securities transactions from the quantitative limitations, collateral requirements, and prohibition on purchases of low-quality assets. 12 C.F.R. § 223.42(m). These are only a few examples of the complex hierarchy of exemptions in Regulation W.

62. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,588. The only exceptions to this approach were credit derivatives in which a bank protected a nonaffiliated third party from a default on, or a decrease in the value of, the obligation of a bank's affiliate. In the Board's view, these credit derivatives were

in the definition of a "covered transaction," the Board required banks to establish and maintain internal policies and procedures for managing their exposure to affiliates under derivatives transactions.[63] Regulation W also clarified that all bank-affiliate derivatives transactions were subject to the market-terms requirement of section 23B.[64]

The decision not to treat derivatives as "covered transactions" for the purposes of section 23A, in effect, created a crucial gap in the

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functionally equivalent to a guarantee issued by the bank on behalf of an affiliate and thus fell within the statutory definition of a covered transaction. *Id.*

63. 12 C.F.R. § 223.33(b) (2010). Historically, the Board refrained from taking a position on whether or not derivatives transactions between banks and their affiliates were covered transactions for the purposes of section 23A. However, as noted above, *see supra* note 54 and accompanying text, the GLB Act required the Board to adopt a rule that would address this issue. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,587–88. In May 2001, the Board published the interim final rule that subjected derivatives transactions between banks and their affiliates to the requirements of section 23B and required banks to adopt internal policies and procedures dealing with credit exposure under such bank-affiliate derivatives. The Board also sought public comment on the desirability of subjecting such derivatives transactions to the quantitative and qualitative limitations of section 23A. *Id.* The financial industry actively lobbied against such an expansive approach and argued strongly in favor of allowing banks to handle their credit exposure to affiliates under derivatives transactions on an individual basis. According to industry comments, such an approach would give banks the necessary flexibility to design an internal risk management system that was best-suited for their unique derivatives portfolios and risk exposure. Subjecting such bank-affiliate derivatives to the limitations of section 23A, the argument went, would be unnecessarily burdensome and would potentially reduce the ability of banking organizations to manage their risk and maintain their profitability. *See, e.g.*, Letter from James E. Riley, Chair, Holding Co. Comm., Sec. Indus. Ass'n, to Jennifer J. Johnson, Sec'y, Bd. of Governors of the Fed. Reserve Sys. 4 (Aug. 15, 2001), *available at* http://www.sifma.org/issues/item.aspx?id=1177. Acknowledging that commentators uniformly argued against including derivatives in the definition of a "covered transaction," the Board retained its original approach and explicitly incorporated the interim final rule on derivatives in the final Regulation W. Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,588.

64. 12 C.F.R. § 223.33(a). The Board adopted a similar approach to intraday extensions of credit by banks to their affiliates. 12 C.F.R. § 223.42(l). Intraday extensions of credit include daylight overdrafts and other similar extensions of credit by a bank to an affiliate arising out of "mismatches between the timing of funds sent and received during the business day," typically in the context of settlement of financial transactions. Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,595–96. More generally, an intraday extension of credit is any extension of credit that the bank expects to be repaid by the end of the business day. *See* 12 C.F.R. § 223.42(l)(2). Although, unlike derivatives, intraday extensions of credit are "covered transactions," Regulation W exempted all such transactions from the quantitative and collateral requirements of section 23A, as long as the bank maintained policies and procedures for managing the intraday exposure and had no reason to believe that any affiliate receiving intraday credit would have difficulty repaying it in accordance with its terms. Like derivatives transactions, all intraday extensions of credit became fully subject to the requirements of section 23B. *See* 12 C.F.R. § 223.42(l).

operation of the statute. Derivative instruments enable the counterparties to create high levels of hidden leverage and are frequently used as functional equivalents of credit extensions. Excluding them from statutory limitations effectively opened up a nearly unlimited channel for such extensions of credit. The Board reasoned that derivatives transactions between banks and their nonbank affiliates were used primarily for risk management and not for funding purposes.[65] However, in practice, it is difficult to draw a clear line and prove that securities firms do not use access to affiliated depository institutions to finance their speculative derivatives activities. To the extent intra-group derivatives transactions are driven by profit maximization, this type of regulatory arbitrage is virtually certain to happen.[66]

In the preamble to Regulation W, the Board heralded sections 23A and 23B as "important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates" and to "limit the ability of a depository institution to transfer to its affiliates the subsidies arising from the institution's access to the Federal safety net."[67] After the GLB Act opened the way for the formation of giant diversified financial conglomerates, these sections became the key statutory firewall protecting depository institutions—and the federal deposit insurance fund—from exposure to risks associated with their securities, insurance, investment management, and a variety of unregulated affiliates.[68]

However, the potential significance of section 23A goes beyond the traditional area of bank safety and soundness. In practice, the statutory limitations on bank affiliate transactions may also function as one of the principal mechanisms of preventing the excessive growth of nonbank financial institutions taking advantage of their affiliation with a depository institution. In that respect, section 23A can potentially serve as an important tool for containing the growth of the shadow banking system that feeds off of the federal safety net and access to cheap sources of funding through affiliation with

65. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,587.

66. As the Board acknowledged in its discussion of Regulation W derivatives provisions, "Banks and their affiliates often choose to use each other as their derivative counterparties ... to maximize the profits of and manage risks within the consolidated financial group." *Id.*

67. Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. at 76,560.

68. *See* Wilmarth, *supra* note 55, at 456 ("The GLB Act relies on Sections 23A and 23B of the Federal Reserve Act to prevent abusive transactions between banks and their nonbank affiliates within the new financial holding company structure.").

depository institutions. Moreover, if properly enforced, the limitations on bank affiliate transactions may reduce the incentives for excessive conglomeration in the financial services sector and potentially impose meaningful checks on the size and complexity of bank-centered financial groups.[69]

Whether section 23A lives up to these great expectations and functions effectively as a strong statutory wall protecting the integrity of the U.S. banking system depends on its implementation and enforcement. In other words, the real question is how penetrable the statutory wall is in practice and how difficult, or easy, it is for financial institutions to get around it.

Under the statute, the Board has considerable discretion to interpret its meaning and determine the scope of its application.[70] The statute also gave the Board authority to exempt, at its discretion, either by regulation or by order, transactions and relationships from the requirements of section 23A, if such exemptions were in the public interest and consistent with the statutory purposes.[71] The ability to grant exemptions by order provided a great deal of flexibility and power to the Board, allowing it to make decisions in individual cases without going through the formal rulemaking process that involves publishing proposed rules for public comments.[72] Although the Dodd-Frank Act limited this exemptive authority, it did not eliminate it.[73]

How the Board uses its exemptive authority in practice is critical to assessing the effectiveness of the statute in achieving its stated purposes. It has been noted that, in recent years, the Board "has repeatedly waived the application of affiliate transaction rules to large financial conglomerates during financial crises."[74] However, to

69. *See infra* notes 353–58 and accompanying text.

70. For instance, section 23A explicitly authorizes the Board to determine, by regulation or order, whether any company other than those enumerated in the statute is an "affiliate" of the bank for the purposes of applying the statutory limitations. *See* 12 U.S.C. § 371c(b)(1)(E) (2006) (amended 2010).

71. *See* § 371c(f)(2). By contrast, under section 23B, the Board may grant exemptions only by regulation. *See* 12 U.S.C. § 371c-1(e) (2006) (amended 2010).

72. *See* Administrative Procedure Act § 1, 5 U.S.C. § 553 (2006).

73. *See infra* notes 362–69 and accompanying text.

74. Arthur E. Wilmarth, Jr., *Subprime Crisis Confirms Wisdom of Separating Banking and Commerce*, BANKING & FIN. SERVICES POL'Y REP., May 2008, at 1, 9. Thus, after the terrorist attacks on September 11, 2001, the Board reportedly announced a blanket suspension of the statutory restrictions on affiliate transactions and "urged major banks to make large transfers of funds to their ... affiliates," in order to prevent a prolonged liquidity crunch in the markets. Wilmarth, *supra* note 55, at 472. Of course, this was an

date, there has been no in-depth analysis of the Board's evolving approach to making these determinations. A systematic examination of the Board's decisions reveals some of the fundamental tensions in the operation of the statute in the context of today's complex and interconnected financial marketplace.

II. GUARDING THE WALL IN TIMES OF CALM: THE USE OF EXEMPTIONS FROM SECTION 23A BEFORE THE GLOBAL FINANCIAL CRISIS

Two key events serve as important markers in the evolution of the Board's use of its exemptive power under section 23A: the passage of the GLB Act in 1999 and the global financial crisis of 2007–2009. Accordingly, the Board's interpretations can be divided into three categories: the pre-GLB Act exemptions, the post-GLB Act exemptions issued during the period between 2000 and mid-2007, and the crisis-driven exemptions issued during the period between mid-2007 and 2010.[75] This Part examines the Board's interpretive letters exempting financial institutions from the limitations of section 23A, which were issued before the global financial crisis erupted in mid-2007. While the early exemptions provide a baseline for assessing subsequent decisions, the primary focus of this Part is on the Board's use of its exemptive authority after the GLB Act's repeal of the prohibition on affiliation between commercial and investment banks.

This Part argues that, in granting exemptions from the requirements of section 23A, the Board failed to appreciate fully the radical change in the regulatory landscape as a result of the repeal of the Glass-Steagall era restrictions on bank affiliations. Faced with the rapid rise of large, diversified financial conglomerates, closely interconnected through an intricate web of complex financial transactions, the Board continued to rely heavily on its pre-1999 precedent, with its exclusive focus on potential risks dealing with affiliates posed to individual banks. This approach, while consistent with the letter of the statute, failed to reflect the heightened risk of indirect transfers of the federal subsidy to the growing shadow banking sector. Although it is difficult to draw direct causal links between individual exemptions and the accumulation of excessive risk in the financial system, this Part argues that, by ignoring systemic

extreme, and probably unique, instance of such a blanket suspension of the statute, which is why this Article does not specifically analyze it.

75. While generally chronological, these three periods denote qualitatively distinct stages in the evolution of the Board's use of exemptive authority under section 23A.

factors, the Board's decisions indirectly contributed to that process and facilitated the growth of the dangerously unstable shadow banking system. This Part also shows how the inherently nonsystemic focus of section 23A undermined its ability to fulfill its new role as the principal firewall guarding the integrity of the depository system in the post-GLB Act era of financial conglomeration, innovation, and interconnectedness.

A. *Early Interpretations: In Sleepy Backwaters*

Before the GLB Act made section 23A the central statutory mechanism for preventing depository institutions from subsidizing risky activities of their newly permitted affiliates in securities and other financial markets, it was a fairly quiet and uneventful area of banking law. It appears that, during that period, banking organizations rarely approached the Board with requests for interpretations of, or exemptions from, the statutory limitations on transactions with affiliates.[76]

Many of these early published letters were responses to banks' requests for clarification of the requirements of section 23A, as they applied to their transactions. Banking organizations commonly approached the Board with requests to define in greater detail the scope of section 23A and to determine whether specific transactions were properly treated as covered transactions subject to the quantitative and collateral requirements of section 23A[77] or exempted from its limitations.[78] The Board also routinely responded to banks'

76. Thus, on the Board's website, out of more than eighty published interpretations of section 23A, less than ten were issued between January 1996 and November 2000, when the GLB Act became effective. *See Legal Interpretations*, *supra* note 15. As noted above, this Article does not examine the Board's interpretive letters issued prior to 1996. *See supra* note 15. Nevertheless, by analyzing the published letters from that initial period in the context of the entire body of the Board's interpretations over the past fourteen years, it is possible to discern some of the principal trends and themes in the process.

77. Thus, the Board determined that a loan extended to farmers who used the proceeds to grow crops on farmland leased from the bank's affiliate was a covered transaction. Letter from J. Virgil Mattingly, Gen. Counsel, Fed. Reserve Bd., to Charla Jackson, Am. State Bank (Aug. 26, 1996), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/1996/19960826/. On the other hand, the Board concluded that reinsurance by a captive insurance subsidiary of a bank's parent company of corporate-owned life insurance policies purchased by the bank on the lives of its directors and officers was not a covered transaction for the purposes of the statute. Letter from J. Virgil Mattingly, Gen. Counsel, Fed. Reserve Bd., to Michael Phenner, Hopkins & Sutter (Nov. 14, 1996), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/BHC_ChangeInControl/1996/19961114/.

78. For instance, the Board clarified that a bank's purchase of mortgage loans originated by its mortgage affiliate qualified for an exemption from the quantitative limits

questions with respect to proper calculations in connection with the quantitative requirements of section 23A.[79] These types of purely interpretive questions effectively ceased after the issuance of the final Regulation W that addressed many uncertainties in the language of the statute and included the Board's interpretations of the key statutory provisions.

An important theme that emerges in the Board's early interpretations concerns the treatment of bank purchases of assets of their affiliates, both in the ordinary course of business and in the course of corporate reorganizations.[80] Perhaps the most common example of an ordinary business transaction that could cause a bank to cross the applicable statutory quantitative thresholds is a one-time purchase of a high-price piece of real or personal property, such as its office building or a corporate jet, from its parent company or another affiliate.[81] These cases rarely presented any difficulty, primarily because the possibility of using such one-time property transfers to shift a worthless asset from an affiliate to an insured depository

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of section 23A where the bank made an independent credit evaluation of each loan and agreed to purchase it before the affiliate extended credit. Letter from J. Virgil Mattingly, Gen. Counsel, Fed. Reserve Bd., to Steven Alan Bennett, Senior President & Gen. Counsel, Bank One (Jan. 17, 1996), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/1996/19960117.

79. *See, e.g.*, Letter from William W. Wiles, Sec'y of the Bd., Fed. Reserve Bd., to Jack Otten, AVP, Credit Admin. Officer, The Bank of Bentonville (Mar. 6, 1997), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/1997/19970306/ (responding to a three-part inquiry as to how to calculate the applicable quantitative threshold).

80. *See, e.g.*, Letter from Jennifer Johnson, Sec'y of the Bd., Fed. Reserve Bd., to Ronald C. Mayer, Senior Vice President & Assoc. Gen. Counsel, The Chase Manhattan Bank (Aug. 18, 2000) [hereinafter Chase Bank Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2000/20000818/ (responding to request for exemptions from section 23A to assist in a reorganization following an acquisition); Letter from J. Virgil Mattingly, Gen. Counsel, Fed. Reserve Bd., to Bruce Moland, Wells Fargo & Co., (Jan. 21, 1999), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/1999/19990121/ (concerning the quantitative limits of section 23A "when a loan is made to an unrelated third party and is secured by securities issued by an affiliate").

81. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Irwin M. Berman, Omni Nat'l Bank (Apr. 8, 2005) [hereinafter Omni Nat'l Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2005/20050408/ (granting a retroactive exemption from section 23A and Regulation W to permit Omni Bank to retain an aircraft purchased from an affiliate); Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Athena Skaleris, Boardman, Suhr, Curry & Field, LLP (Bank of Wausau) (Nov. 19, 2003) [hereinafter Bank of Wausau Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2003/20031119/ (permitting the Bank of Wausau to purchase its premises from an affiliate).

institution or otherwise take unfair advantage of the federal bank subsidy was generally remote.[82] Reduction in the bank's operating expenses as a result of owning its premises or a corporate airplane was generally the key fact sufficient to establish that an exemption was in the public interest and consistent with the purposes of section 23A.[83] The key condition for an exemption was an independent appraisal of the property's fair market value, which ensured the quality of the purchased asset and satisfied the market terms requirements of section 23B.[84]

Exemptions for purchases of assets of affiliated companies in the course of a corporate reorganization raised a broader spectrum of potential concerns, as they could result in the transfer of risky loans or other low-quality assets from an uninsured entity to a federally insured depository institution.[85] On the other hand, strictly formalistic application of section 23A to bona fide internal restructuring of a banking organization's operations may have unnecessarily harsh consequences not intended by Congress. Throughout the years, the Board has routinely granted exemptions for such reorganizations from the statutory limitations as being in the public interest and consistent with the statutory purpose.

However, the Board explicitly made the exemptions subject to a set of conditions that began to take shape before 1996.[86] Thus, the Board typically conditioned an exemption for corporate reorganizations on the bank and bank's parent company making certain asset-quality commitments. While specific conditions varied from case to case, they typically included the following commitments:

82. In granting these types of requests for an exemption, the Board emphasized, "The legislative history of this section indicates that Congress gave the Board the authority to permit a bank to purchase from an affiliate certain expensive properties such as a building because 'such transactions are not the type of transactions that section 23A is designed to cover.' " Bank of Wausau Letter, *supra* note 81 (quoting S. REP. NO. 97-536, at 32 (1982), *reprinted in* 1982 U.S.C.C.A.N. 3054, 3078).

83. Omni Nat'l Letter, *supra* note 81; Bank of Wausau Letter, *supra* note 81.

84. *See* Omni Nat'l Letter, *supra* note 81; Bank of Wausau Letter, *supra* note 81. The letters often referred to other "commitments and representations" made by the applicants and deemed to be conditions upon which an exemption was granted.

85. For the purposes of section 23A, corporate reorganizations, in which a bank acquires all of the shares of an affiliated company and that company becomes the bank's subsidiary, are generally treated as purchases of assets of an affiliate in the amount equal to the sum of the consideration paid for the shares and total liabilities of the affiliate in question. *See* 12 C.F.R. § 223.31 (2010).

86. In several published interpretations, the Board cited a number of its own interpretive letters dating back to 1987, in which it had granted similar exemptions for corporate reorganizations. *See, e.g.*, Chase Bank Letter, *supra* note 80 (noting that the Board had previously approved similar transfers relating to reorganizations).

(1) that none of the assets purchased by the bank would be "low-quality" within the meaning of section 23A; (2) that the parent company would periodically repurchase from the bank any transferred assets that become "low-quality" within a certain time period (typically, two years after the transaction) or reimburse the bank in cash for any loss of value of such assets; (3) that the majority of the bank's directors would review and approve the transaction;[87] and (4) that, after the transaction is consummated, both the bank and its parent bank holding company ("BHC") remain "well capitalized" under the applicable standards.[88]

These core commitments, aimed at ensuring the quality of the assets purchased by banks from their affiliates, were later codified in Regulation W and continued to play a key role in a wide variety of the Board's decisions to grant exemptions from section 23A for bank purchases of assets from their affiliates.[89]

B. *After the Gramm-Leach-Bliley Act: New Challenges, Old Standards*

The enactment and implementation of the GLB Act had a profound effect on the structure and development of the U.S. financial services industry. Once Congress finally removed the Glass-Steagall Act's prohibition on combining commercial and investment banking under common corporate ownership, the financial industry went through a wave of consolidation and formation of large, diversified financial conglomerates.[90] Under the new legal regime, BHCs that qualified for the newly created FHC status were able to

87. The Board's early interpretations often specified that the directors approving the transaction had to be independent. *See, e.g.*, Letter from Robert deV. Frierson, Assoc. Sec'y of the Bd., Fed. Reserve Bd., to Thomas J. Pax, Shaw Pittman (HSBC Bank) (Nov. 21, 2000) [hereinafter HSBC Bank Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2000/20001121/ ("Before the purchase of the assets, the majority of the members of [the] board of directors who are not affiliated with [the bank] ... will review and approve the purchase of assets."). However, this requirement largely disappeared, as more recent interpretations condition exemptions on the approval of the proposed transactions by the relevant bank's directors, without the reference to their independence.

88. *See id.*; Letter from Robert deV. Frierson, Assoc. Sec'y of the Bd., Fed. Reserve Bd., to Bruce Moland, Wells Fargo & Co. (Jan. 8, 2001) [hereinafter 2001 Wells Fargo Letter], *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2001/20010108/; Chase Bank Letter, *supra* note 80.

89. *See* 12 C.F.R. § 223.41(d) (2010).

90. *See* Arthur E. Wilmarth, Jr., *How Should We Respond to the Growing Risks of Financial Conglomerates?*, *in* FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 1, 6 (Patricia C. McCoy ed., 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=291859.

move aggressively into securities underwriting, dealing and trading, investment management, merchant banking, and other capital markets activities.[91] As a result, many commercial banks significantly expanded their affiliations.[92] Not only did they acquire a far greater number of nonbank affiliates, but those more numerous affiliated entities engaged in a much broader range of newly permissible financial activities.[93]

As noted earlier, in the post-GLB Act world, section 23A and Regulation W became the principal legal and regulatory mechanisms for shielding deposit-taking institutions from increased exposure to risks associated with their affiliates' expanded activities, especially in capital markets.[94] Perhaps even more importantly, the quantitative and qualitative limitations on affiliate transactions became the main safeguard against the transfer of the federal bank subsidy to investment banks, insurance companies, private investment funds, or other entities allowed to affiliate with deposit-taking institutions under the GLB Act.

Compliance with section 23A became one of the key concerns for commercial banks and their parent companies that were eager to leverage their subsidiary banks' high credit ratings and access to cheap sources of funding to increase profitability of their nonbank subsidiaries.[95] To realize the newly possible synergies among their various business segments, FHCs needed more flexibility to transfer assets and funds between banks, securities firms, and other entities within their corporate structure. As the volume and range of such affiliate transactions increased, the old quantitative limits of section 23A quickly became too restrictive. Not surprisingly, after the passage of the GLB Act, the volume and range of requests for exemptions from the requirements of section 23A and Regulation W submitted to the Board by commercial banks and their parent

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91. *See* Vincent DiLorenzo, *Cost Benefit Analysis, Deregulated Markets, and Consumer Benefits: A Study of the Financial Services Modernization Experience*, 6 N.Y.U. J. LEGIS. & PUB. POL'Y 321, 348–51 (2003) (detailing the changes in the banking sector in the years immediately following the passage of the GLB Act).

92. *See id.*

93. *See id.*

94. *See supra* notes 45–49 and accompanying text.

95. Commercial banks generally have the highest credit rating of all entities within the entire holding company. They also have access to the cheapest source of funding, demand deposits, and the federal safety net. Although banks are required to hold a certain amount of regulatory capital against their assets, a variety of financial structuring techniques, including securitization, can be used to reduce or eliminate entirely that additional regulatory cost.

companies expanded radically. Accordingly, the significance of these seemingly mundane administrative decisions for maintaining systemic stability increased greatly with the rise of the ever-bigger and more complex global financial conglomerates of the post-GLB Act era.

1. Corporate Reorganizations: Citigroup's Subprime Moment

The overwhelming majority of exemptions from the requirements of section 23A granted by the Board in the period between the passage of the GLB Act and the onset of the global financial crisis in mid-2007 dealt with corporate reorganizations. As financial institutions developed new activities, engaged in mergers and acquisitions, and otherwise expanded their operations, they sought to reorganize and consolidate their growing businesses in order to lower costs and increase profits. Thus, the Board issued numerous interpretations exempting from the quantitative and qualitative limitations of section 23A one-time transfers of mortgage assets,[96] credit card and other consumer loans,[97] agricultural loans,[98] student loans,[99] and hedge fund loans[100] from nonbanking entities to their affiliated banks and thrifts.

The Board's reasoning followed the same logic as in the earlier, pre-GLB Act, interpretations. It continued to follow earlier precedent with respect to corporate reorganizations and consistently

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96. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Karen Grandstrand, Fredrikson & Byron, P.A. (Klein Financial, Inc.) (Apr. 1, 2005), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2005/20050401/; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Karen M. Nee, Exec. Vice President, GMAC Commercial Holding Corp. (July 7, 2004), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2004/20040707/; Letter from Margaret McCloskey Shanks, Assistant Sec'y, Fed. Reserve Bd., to Winthrop N. Brown, Milbank, Tweed, Hadley & McCloy LLP (HSBC Bank) (Dec. 29, 2003), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2003/20031229/.

97. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Winthrop N. Brown, Milbank, Tweed, Hadley & McCloy LLP (HSBC Bank) (Dec. 22, 2004), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2004/20041222/.

98. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to S. Alan Rosen, Horgan, Rosen, Beckman & Coren (Valley Indep. Bank) (Aug. 14, 2003), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2003/20030814/.

99. *See, e.g.*, 2001 Wells Fargo Letter, *supra* note 88.

100. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to David Teitelbaum, Sidley Austin Brown & Wood LLP (Merrill Lynch Bank USA) 3 (May 15, 2006), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2006/20060515/20060515.pdf.

imposed a standard set of conditions on proposed transactions.[101] As long as the parent company promised to protect the bank from getting saddled with low-quality assets, either at the time of the transaction or for a couple of years after its consummation, the Board did not seem to view such internal reorganizations as raising any particularly serious concerns under section 23A. The Board typically reasoned that these transactions were in the public interest because they enhanced the efficiency and profitability of the firms in question.[102] As the body of Board precedent grew on this issue, it further entrenched the assumption that transfers of affiliates' assets to a bank in the course of an internal reorganization were a routine and uncontroversial matter and that certain standard conditions were sufficient to control the key risks of such transfers.[103]

However, the case of Citigroup illustrates how deceptive these assumptions can be. One of the largest U.S. financial conglomerates, Citigroup nearly failed during the recent financial crisis, in large part because of excessive exposure to toxic subprime mortgage assets.[104] In the early 2000s, Citigroup started aggressively growing its residential mortgage business, especially in the subprime sector, both organically and through acquisition. In 2000, Citigroup completed acquisition of a Texas-based consumer finance company, Associates First Capital Corporation (the "AFCC"), which at the time was one of the

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101. *See supra* notes 86–88 and accompanying text. In 2002, Regulation W codified the exemption from the quantitative and collateral requirements of section 23A for certain corporate reorganizations and made it explicitly subject to these conditions. 12. C.F.R. § 223.41(d) (2010). However, these exempted corporate reorganizations remained subject to the statutory prohibition on the purchase of low-quality assets from an affiliate and the requirement that each such transaction was consistent with the bank's safety and soundness considerations. *Id.*

102. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Robin J. Maxwell, Goodwin Procter LLP (The Royal Bank of Scotland Group plc) 2 (Nov. 22, 2005), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2005/20051122/default.pdf.

103. Of course, there is a possibility that the Board refused to exempt some of the proposed transfers of assets that it considered to be too risky. Since the Board does not typically issue such negative determinations in a documented form, there is no way to know whether, or how frequently, the Board denied banking organizations' requests for exemptions, and what reasons it gave for its decisions. However, based on the Board's general approach to this issue in published decisions, it does not seem very likely that the Board would, in fact, interfere with an internal reorganization by refusing to lift the quantitative limits of section 23A.

104. *See* David Enrich et al., *U.S. Agrees to Rescue Struggling Citigroup*, WALL ST. J., Nov. 24, 2008, at A1 (detailing government actions designed to keep Citigroup from failing).

country's largest subprime lenders.[105] The bulk of AFCC's consumer lending assets, including subprime mortgage assets, were transferred to CitiFinancial Mortgage Company, Inc. ("CitiFinancial"), Citigroup's nonbank subprime lending unit.[106] However, in order to fully absorb the wide-ranging assets of the acquired company, Citigroup needed an exemption from the quantitative and qualitative requirements of section 23A. On August 28, 2001, the Board issued a letter granting such an exemption allowing Citigroup to transfer a total of $46.7 billion in AFCC's commercial finance, credit card, and international consumer finance assets to its bank subsidiaries, including Citibank, N.A. ("Citibank"), the group's flagship commercial bank.[107] In granting this exemption, the Board followed its precedent and imposed the same standard conditions on the transaction, with one important exception: unlike the previous cases, this transaction involved a transfer of $2.4 billion of low-quality assets.[108] The Board accepted Citigroup's proposal to contribute cash

105. *See* Paul Beckett, *Citigroup Completes Associates Purchase as It Agrees to Improve Lending Practices*, WALL. ST. J., Dec. 1, 2000, at C22. The acquisition of AFCC created a host of problems for Citigroup, not only because it contributed to the growth of Citigroup's subprime mortgage assets that later sustained huge losses, but also because of the company's predatory lending practices and the bad publicity it generated for Citigroup. Thus, in March 2001, the Federal Trade Commission ("FTC") charged AFCC, Citigroup, and CitiFinancial with abusive lending practices. *See* Press Release, Fed. Trade Comm'n, FTC Charges One of Nation's Largest Subprime Lenders with Abusive Lending Practices (Mar. 6, 2001), *available at* http://www.ftc.gov/opa/2001/03/associates.shtm. Citigroup later settled the suit with the FTC for a record sum of $215 million. Press Release, Fed. Trade Comm'n, Citigroup Settles FTC Charges Against Associates: Record-Setting $215 Million for Subprime Lending Victims (Sept. 19, 2002), *available at* http://www.ftc.gov/opa/2002/09/associates.shtm.

106. *See Citigroup Settles Predatory Lending Charges for $215 Million*, CONSUMERAFFAIRS.COM (Sept. 19, 2002), http://www.consumeraffairs.com/news02/citi_settles.html.

107. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl V. Howard, Gen. Counsel, Citigroup, Inc. (Aug. 28, 2001) [hereinafter 2001 Citigroup Letter], *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2001/20010828/.

108. *Id.* According to the Board,

> In previous cases, any low-quality assets held by the affiliate being transferred to the bank were removed before the transfer of the affiliate's shares. The low-quality assets then were either separately transferred to the bank for no consideration after consummation of the share transfer or retained at the holding company level.

Id.

capital to offset the value of these low-quality assets, so that the banks would not be deemed to "purchase" such assets.[109]

In an effort to get a better handle on managing its sprawling and highly complex business operations and to simplify its corporate structure, Citigroup sought to consolidate its mortgage origination, servicing, and securitization activities. Between 2003 and 2006, the Board issued three more letters granting Citigroup exemptions from section 23A to allow the transfer of residential mortgage assets from nonbank subsidiaries (mortgage lenders) to deposit-taking subsidiaries (national banks and thrifts). In 2003, the Board exempted from section 23A the transfer of all shares of CitiMortgage, Inc. ("CitiMortgage"), a nonbank consumer finance unit that specialized in prime mortgage lending, to Citigroup's thrift subsidiary, Citibank (West), FSB ("CitiWest").[110] The exemption was subject to the same general set of conditions consistent with the Board's precedent. Again, the Board agreed to allow a transfer to CitiWest of certain low-quality assets, in light of Citigroup's commitment to make a cash contribution to CitiWest in the amount equal to the value of such low-quality assets.

A year later, in 2004, the Board granted another exemption from section 23A and Regulation W for transfer of all the shares of CitiFinancial, and all of its subprime mortgage assets to Citicorp Trust Bank ("CTB"), another thrift subsidiary of Citigroup.[111] The Board based its decision on Citigroup's commitments (1) not to transfer any low-quality assets to CTB,[112] and (2) for a five-year period following the purchase of assets (rather than the typical two-year commitment required in prior cases), to make quarterly cash payments reimbursing the thrift for any losses in the value of any

109. *Id.* Section 23A provides that "a member bank and its subsidiaries may not purchase a low-quality asset from an affiliate unless the bank or such subsidiary, pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time such asset was acquired by the affiliate." 12 U.S.C. § 371c(a)(3) (2006) (amended 2010).

110. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl V. Howard, Gen. Counsel, Citigroup, Inc. (Feb. 27, 2003), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2003/20030227/.

111. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to James E. Scott, Citigroup, Inc. (May 14, 2004) [hereinafter 2004 Citigroup Letter], *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2004/20040514/.

112. Approximately $8 billion in CitiFinancial's low-quality assets were transferred to another nonbank subsidiary of Citigroup. *Id.*

transferred assets that become low-quality assets.[113] The Board stressed that CTB's board of directors reviewed the transferred assets and approved the proposed transaction. The Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision ("OTS"), CTB's primary federal regulator, also reviewed the proposal and informed the Board that they had no objection.[114] In light of these circumstances, the Board concluded that the proposed reorganization appeared to be "consistent with safe and sound banking practices and on terms that would ensure the quality of assets transferred."[115]

In 2006, Citigroup sought to further rationalize and simplify its banking operations by bringing most of them into Citibank, its main commercial bank and the largest single legal entity.[116] A part of this restructuring plan was the consolidation of Citigroup's residential mortgage origination and servicing operations, conducted by CitiFinancial and CitiMortgage, within Citibank. In June 2006, the Board granted Citigroup's request to lift statutory limitations on affiliate transactions to permit the transfer of all the shares of CitiFinancial, the subprime mortgage lender, to CitiWest, which would later merge into Citibank.[117] This transaction, valued at approximately $17.3 billion, involved a transfer of $561 million in low-quality assets.[118] The Board allowed the transfer to proceed based on

113. *Id.* It is difficult to determine the precise reasons why (or even whether) the Board insisted on a longer commitment by the parent company to reimburse the depository institution for losses from deterioration in the quality of transferred assets. Most likely, it reflected the Board's potential unease with the fact that the bulk of CitiFinancial's assets were in subprime mortgage loans.

114. *Id.*

115. *Id.*

116. *See* Press Release, Office of the Comptroller of the Currency, The Dugan Testimony, Appendix E: OCC Supervision of Citibank, N.A. 3 (Apr. 8, 2010), *available at* http://www.occ.treas.gov/news-issuances/news-releases/2010/nr-occ-2010-39g.pdf. Thus, in 2006, Citibank constituted 49.5% of Citigroup's total assets, while at year-end 2009 its share of the group's assets grew to 62%. *See id.*

117. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl Howard, Gen. Counsel, Citigroup Inc. 4 (June 30, 2006) [hereinafter 2006 Citigroup Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/Federal ReserveAct/2006/20060630/20060630.pdf. The consolidation of residential mortgage business in Citibank was structured as a series of consecutive transactions, with the first step being a transfer of the shares of CitiFinancial, the subprime mortgage lender, to CitiWest, a thrift subject to regulation by the OTS, which already owned CitiMortgage and which later would merge into Citibank. In this interpretive letter, the Board technically reviewed and exempted from the requirements of section 23A the initial step in the transaction, the transfer of CitiFinancial to CitiWest, but with the full view to its ultimate result.

118. *Id.* at 4.

the familiar reasoning that Citigroup's cash contribution offsetting the value of such low-quality assets was sufficient to deem the transfer as not involving a "purchase" by a depository institution of any low-quality assets.[119] The Board conditioned the exemption on the commitment by Citigroup to make quarterly cash payments to reimburse CitiWest for losses on the transferred assets that became low-quality assets.[120] Citigroup also made a separate promise to continue tracking CitiFinancial's assets originally transferred to CTB pursuant to the Board's exemption granted in 2004 and to continue making cash reimbursements to CitiFinancial's parent depository institution in accordance with that earlier commitment for the remainder of the five-year period.[121] As long as CitiWest's directors reviewed and approved the transaction, and in light of the FDIC's and the OTS's stated lack of objection, the Board determined that the proposed reorganization appeared to be "consistent with safe and sound banking practices and on terms that would ensure the quality of the assets transferred" and granted the requested exemption.[122]

As a result of these series of corporate reorganizations, by late 2006, Citigroup's considerable subprime mortgage assets were ultimately transferred to Citibank. Unfortunately, the subprime mortgage market began showing serious signs of crisis by January 2007 and effectively collapsed by March 2007.[123] By that time, CitiFinancial was already the fourth-largest subprime mortgage lender in the country.[124] Citigroup incurred particularly high losses from direct exposure to subprime mortgage markets.[125] The losses sustained by Citibank, in particular, were a direct result of Citigroup's aggressive acquisition of subprime mortgage assets and placing them

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119. *Id.*

120. *Id.* Citigroup committed to make these cash payments until CitiWest was merged into Citibank. *Id.*

121. *See* 2004 Citigroup Letter, *supra* note 111.

122. 2006 Citigroup Letter, *supra* note 117, at 4.

123. *See, e.g.*, KATALINA M. BIANCO, THE SUBPRIME LENDING CRISIS: CAUSES AND EFFECTS OF THE MORTGAGE MELTDOWN 12–13 (2008), *available at* http://business.cch.com/bankingfinance/focus/news/Subprime_WP_rev.pdf.

124. Chris Isidore, *Subprime Woes: How Far How Wide?*, CNNMONEY.COM (Mar. 5, 2007), http://money.cnn.com/2007/03/05/news/economy/subprime/index.htm.

125. The bulk of Citigroup's total losses during the crisis resulted not from origination of subprime mortgages but from exposure to collateralized debt obligations ("CDO") and other mortgage-backed securities structured by its nonbanking subsidiaries and held off-balance sheet by special purpose vehicles ("SPVs"). Citibank, N.A., became exposed to the risk of the CDO SPVs by issuing "liquidity puts" guaranteeing their obligations. Press Release, Office of the Comptroller of the Currency, *supra* note 116, at 6–7. The off-balance sheet SPVs were not even considered affiliates of Citibank and so were not subject to the limitations of section 23A.

within Citibank's chain of ownership, to reduce the cost of doing business.[126] According to the recent public testimony of the former Comptroller of the Currency, John Dugan,

> Additional subprime mortgage losses resulted from a major corporate restructuring completed in October 2006. In this action, Citigroup reduced the number of insured depository institutions from twelve to five as it consolidated approximately $200 billion of assets into Citibank. Approximately 10 percent of this total consisted of subprime mortgages originated primarily by Citigroup's consumer finance company, CitiFinancial. Many of these mortgages were originated in 2005 and 2006, when underwriting standards were weakest, and Citibank has taken large losses and made substantial loan loss provisions as a result. Subprime mortgages subsequently issued by Citibank in 2007 have also produced losses.[127]

Dugan's testimony, phrased carefully in neutral terms, does not mention the fact that federal bank regulators—the Board, the FDIC, the Office of the Comptroller of the Currency ("OCC"), and the OTS—reviewed and approved the entire chain of transactions that transferred to Citibank, one of the largest federally insured commercial banks in the country, almost $20 billion in subprime mortgage assets.[128] Each time Citigroup requested an exemption from section 23A for an internal reorganization of its mortgage operations, the Board had a chance to evaluate potential dangers of allowing it to proceed and to limit Citibank's exposure to potentially toxic subprime mortgage assets. Ironically, the Board, with the explicit concurrence of other agencies, repeatedly opted to remove the key legal impediment to such accumulation of risk by exempting Citigroup's transactions from the quantitative and qualitative limitations of section 23A.

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126. Since 2007, CitiFinancial has been generating a large portion of Citigroup's loan losses. *See* Bradley Keoun, *CitiFinancial to Close 376 Branches, Cut 720 Jobs*, BLOOMBERG (June 1, 2010), http://www.bloomberg.com/news/print/2010-06-01/citigroup-s-citifinancial-unit-will-cut-376-branches-720-jobs.html. In early 2009, CitiFinancial "became a part of Citi Holdings, a pen for Citi's noncore or distressed assets" slated for eventual sale. Heather Landy, *Why CEO Pandit Won't Shutter CitiFinancial*, AM. BANKER, Aug. 23, 2010, at 8, 8, *available at* http://www.americanbanker.com/news/citi financial-1024098-1.html.

127. John C. Dugan, Comptroller of the Currency, Office of the Comptroller of the Currency, Statement Before the Financial Crisis Inquiry Commission 16 (Apr. 8, 2010), *available at* http://www.occ.gov/news-issuances/congressional-testimony/2010/pub-test-2010-39-written.pdf.

128. *Id.*

While there is no basis for accusing regulators of directly causing Citigroup's subprime mortgage losses, a closer look at the Board's decisions to grant Citigroup exemptions from section 23A raises serious questions as to how diligent and how effective the Board was in exercising its statutory mandate. It appears that the Board did not probe into the proposed transfers too deeply, perhaps operating on an assumption that internal corporate restructurings were generally routine matters not likely to present serious problems.[129] As subsequent events demonstrated, the standard safeguards imposed by the Board as conditions on granting exemptions failed to ensure the quality of mortgage assets transferred to Citibank. Thus, regulators later admitted that the quality of mortgages transferred to Citibank in the course of Citigroup's consolidation of its business activities in 2006 "was substantially worse than expected."[130] Apparently, neither the directors of Citigroup's banking subsidiaries nor the FDIC were able to detect potential risks of CitiFinancial's subprime mortgage assets. Moreover, the Board actually deviated from its own precedent by explicitly allowing transfers of low-quality assets in Citigroup transactions if accompanied by a cash payment offsetting the value of such assets.[131] The Board did not seem to appreciate the danger that the "value" of low-quality mortgage assets at the time may not have reflected the true extent of risk exposure transferred onto Citibank's books.[132] Even the key safeguard that the Board imposed—Citigroup's commitment to make quarterly payments to reimburse the bank for losses on some of the transferred subprime mortgages for five years instead of the typically shorter two-year period—

129. Of course, it is possible that the Board did, in fact, scrutinize proposed transactions more closely than the reasoning in its interpretive letters reveals. However, it is very difficult to ascertain how diligent the Board's due diligence effort really was.

130. Press Release, Office of the Comptroller of the Currency, *supra* note 116, at 5–6.

131. In Citigroup's case, the Board created a fiction that no low-quality assets were transferred where the parent made a cash capital contribution to the bank to offset their value. *See* 2001 Citigroup Letter, *supra* note 107. More generally, however, even in cases where no low-quality assets were transferred as part of the corporate reorganization, such assets were sometimes transferred to banks after the reorganization and for no consideration. *Id.* Thus, even where the Board technically conditioned its exemption for corporate reorganization on excluding low-quality assets from the transfer, such transfers took place anyway, despite the statutory prohibition.

132. According to the OCC, Citibank and its sister national bank (a specialty credit card bank) lost $9.3 billion in 2008 and 2009. Press Release, Office of the Comptroller of the Currency, *supra* note 116, at 5.

ultimately failed, as Citigroup's dire financial condition in the midst of an unfolding crisis rendered that commitment hollow.[133]

More generally, the Citigroup example demonstrates the Board's failure to analyze the riskiness of individual transactions in the broader market context. The Board did not seem to connect Citigroup's internal reorganization project with the fact that such consolidation of mortgage operations was one of the important factors fueling the growth of the complex and increasingly risky markets for mortgage-backed securities and collateralized debt obligations ("CDOs"). Concentrating mortgage assets in bank subsidiaries enabled financial conglomerates to leverage banks' access to the federal safety net, higher credit ratings, and a lower cost of capital to create and sell CDOs and other structured products backed by subprime mortgages.[134] However, in considering Citigroup's requests for exemptions, the Board did not inquire into the broader aspects of the group's business strategy and did not analyze potential risks that concentrated exposure to subprime mortgage assets posed to the safety and soundness of Citibank, or the depository system as a whole. Instead, the Board's analysis remained narrowly focused on the formal attributes of the proposed transactions and on standard protections mandated in prior exemptions from section 23A for various types of corporate reorganizations.

At the same time, the Board's analysis is consistent with the statute's own inherently nonsystemic approach to regulating banks' transactions with affiliates. On its face, section 23A is concerned primarily with potential risks such transactions pose to individual banks and seeks to prevent transfer of federal subsidy within an individual conglomerate. Systemic risk prevention is not a direct purpose of section 23A. Thus, one could argue that the Board pursued the only legitimate interpretive strategy and that it would be a stretch to expect the Board to take into account systemic implications of its decisions under section 23A. However, the enactment of the GLB Act fundamentally altered the context in

133. Citigroup itself barely survived the crisis and had to be bailed out by the federal government to the tune of $45 billion. *See* Eric Dash, *U.S. Selling Last of Stake in Citigroup*, N.Y. TIMES, Dec. 7, 2010, at B1 (recounting the bailout required to save Citigroup). As a result, the U.S. government received about a thirty-six percent equity stake in Citigroup. *See* David Enrich & Deborah Solomon, *Citi, U.S. Reach Accord on a Third Bailout*, WALL ST. J., Feb. 28, 2009, at B1.

134. *See, e.g.*, POZSAR ET AL., *supra* note 20, at 26–30 (explaining the role of a bank subsidiary in securitization).

which section 23A operated and made systemic risk issues central to preserving the safety and soundness of depository institutions. Unfortunately, the Board failed to adapt the way it implemented and enforced the statute to these new circumstances and to adopt a broader, more systemic approach in its exercise of exemptive authority under section 23A.

2. Securities Lending and Borrowing: Letting the Shadow Grow?

The true impact of the GLB Act on the financial sector went far beyond allowing commercial banks to engage in investment banking. It created a myriad of opportunities for FHCs to increase profitability not only by moving into previously inaccessible markets but also by expanding their traditional lines of business. The new law, which allowed affiliations between depository institutions and securities firms, removed some of the natural constraints on the growth of their pre-GLB Act business activities. As a result, certain financial markets and instruments—including securitization and structured products, derivatives, securities lending, and repurchase markets—experienced unprecedented growth in the first decade of the twenty-first century.[135] These activities and markets formed the so-called shadow banking system, which became integral to the operation of the formal banking system, but remained largely outside regulators' reach.[136] Shadow banking served to create and hide the unsustainable levels of leverage in the financial system.[137] The accumulation of such hidden leverage and risk in the shadow banking system was one of the key causes of the global financial crisis from 2007 to 2009.[138]

135. *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 988–94 (2009) (examining the rise of securitization, structured products, and derivatives); Phyllis Plitch, *Funds' Lending Sparks 'Short' Debate*, WALL ST. J., May 25, 2005, at B2D (describing over $300 billion in growth in the securities lending market from 2003 to 2004); Gary Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007, at 29–30 (May 9, 2009) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882 (explaining that the securities repurchase market grew quickly and in step with securitization).

136. *See* FIN. CRISIS INQUIRY COMM'N, PRELIMINARY STAFF REPORT, SHADOW BANKING AND THE FINANCIAL CRISIS 7 (2010) [hereinafter FCIC SHADOW BANKING REPORT], *available at* http://www.fcic.gov/reports/pdfs/2010-0505-Shadow-Banking.pdf; Margaret M. Blair, *Financial Innovation and the Distribution of Wealth and Income* 3 (Vanderbilt Univ. Law Sch., Pub. Law & Legal Theory Research Paper No. 10-32, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656451.

137. *See* FCIC SHADOW BANKING REPORT, *supra* note 136, at 15–17; Blair, *supra* note 136, at 3.

138. *See Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 167 (2010) (statement

Numerous factors have contributed, directly or indirectly, to the rapid growth of shadow banking that reached its peak in 2007 and 2008.[139] It is often assumed that these markets were operating and expanding almost entirely outside of the government's view, as financial regulators did not have a jurisdictional window into their operation.[140] However, it is more likely that regulators and lawmakers purposely refrained from interfering in the process of financial innovation.[141] Through the process of regulating and supervising commercial banks, securities broker-dealers, mutual funds, and other regulated financial institutions, regulators had significant potential influence on the scope and speed of financial innovation driving the growth of the shadow banking system. While it is certainly true that substantial gaps in the existing system of financial regulation and supervision facilitated the accumulation of excessive risk in the fast-evolving financial markets,[142] at least some of the legal mechanisms already in place at the time could have provided important checkpoints on the path of financial innovation by giving regulators an opportunity to ask tough questions and potentially foreclose or significantly curb some risky activities.

Restrictions on banks' transactions with affiliates under section 23A were one such potentially important statutory mechanism. Even though the Board's interpretive decisions to exempt individual transactions from these restrictions appeared highly fact-specific and applied narrowly to the financial institutions requesting an exemption, it is important to understand potential cumulative effects of these decisions on broader market dynamics.

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of Timothy F. Geithner, Sec'y, United States Department of the Treasury) (arguing that the explosive growth of leverage and maturity transformation in the shadow banking system set the stage for the crisis).

139. *See id.* ("At its peak, the shadow banking system financed about $8 trillion in assets with short-term obligations, making it almost as large as the real banking system.").

140. *See* Peter S. Goodman, *Rule No. 1: Make Money by Avoiding Rules*, N.Y. TIMES, May 23, 2010, at WK3 (stating that the shadow banking system was completely unregulated); Paul Krugman, *Bubbles and Banks*, N.Y. TIMES, Jan. 8, 2010, at A27 (noting that bank regulators relaxed the rules and failed to expand them to cover shadow banking); Nelson D. Schwartz & Katrin Bennhold, *France's Minister in a Critical Role at Global Economic Talk*, N.Y TIMES, Nov. 14, 2008, at B5 (stating the system grew outside of regulatory control).

141. *See* Blair, *supra* note 136, at 3.

142. Thus, the fragmented nature of the U.S. financial regulation and lack of unified oversight of systemic risk allowed for the emergence of many "shadow banking" activities that ultimately led to the global crisis. *See, e.g.*, *Former Fed Chairman Volcker Dismisses Critics of Financial Regulatory Reform*, BANKING DAILY (Sept. 24, 2010), http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=17834015&vname=bbdbulallissues&fn=17834015&jd=a0c4g1q9y8&split=0.

One interesting and little-noticed trend in the Board's interpretations, which emerged in the aftermath of the GLB Act, was the grant of exemptions from the limitations of section 23A for banks' extensions of credit to their affiliated securities broker-dealers in connection with lending and borrowing of securities.

Securities lending is a widespread market practice whereby one party (the lender) temporarily transfers securities to another party (the borrower), for a fee.[143] The borrower is obligated to return the borrowed securities to the lender, either upon demand or at the end of a specified term. The borrower secures its obligation by delivering collateral to the lender (typically, cash or government bonds) in an amount slightly exceeding the value of borrowed securities.[144] The title to borrowed securities, as well as securities used as collateral, passes between the parties to the transaction.[145] The borrower receives voting rights and all rights of economic ownership with respect to the borrowed securities but is contractually obligated to "manufacture" the economic benefits (dividends, distributions, etc.) back to the lender.[146] Originally an informal practice among securities brokers who needed to deliver share certificates to settle their trades before receiving such certificates from their clients, securities lending now is an important market in its own right.[147] The rapid growth of OTC derivatives markets in recent decades greatly increased the demand from dealers and investors for borrowed securities to engage in market-making, arbitrage trading, and to hedge their risks.[148] Securities lending is often used by securities dealers, prime brokers, hedge funds, and other financial institutions to facilitate short-selling, both as a hedging technique and as a speculative trading strategy.[149] In

143. ASS'N OF BRITISH INSURERS ET AL., SECURITIES LENDING: AN INTRODUCTORY GUIDE 2 (2010), *available at* http://www.bankofengland.co.uk/markets/gilts/sl_intro_green_9_10.pdf.

144. *Id.*

145. *Id.*

146. To be able to exercise voting rights, the lender must negotiate a contractual right to recall equivalent securities from the borrower. *Id.*

147. *See* MARK C. FAULKNER, AN INTRODUCTION TO SECURITIES LENDING 13 (2004), *available at* http://www.isla.co.uk/uploadedFiles/Publications/Intro%20to%20Securities%20Lending.pdf.

148. Thus, according to some estimates, "[s]ecurities lending peaked in 2007, with transactions totaling $5 trillion." Emily Lambert, *Securities Lending Meltdown*, FORBES (June 22, 2009), http://www.forbes.com/forbes/2009/0622/mutual-funds-pension-securities-lending-meltdown_print.html.

149. *See* David P. McCaffrey, *Review of the Policy Debate over Short Sale Regulation During the Market Crisis*, 73 ALB. L. REV. 483, 483 (2010) (describing the purpose of short selling). A short sale is a trading strategy in which a trader sells securities borrowed from a third party (typically, a broker) with an intention to buy identical securities at a later date

a broader sense, securities lending supports higher trading volumes and greater complexity of trading strategies in securities and derivatives markets.[150] Securities lending is also closely tied to the market for securities repurchase agreements (or, repos), which serves as the principal source of short-term financing for securities broker-dealers, hedge funds, derivatives traders, and other financial market participants, particularly in the shadow banking system.[151]

JPMorgan Chase & Co. ("JPMCC") and Bank of New York Company ("BNYC") were the first firms to request an exemption from section 23A for setting up an in-house securities lending program.[152] In both of these cases, the proposal was to allow the

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in order to return them to the lender. *See id.* Typically, the short seller's strategy is based on an expectation that the price of securities sold would decrease between the time of sale and the time of repurchase. *See id.* Speculative short-selling often takes the form of so-called "naked shorting." *See* James W. Christian et al., *Naked Short Selling: How Exposed Are Investors?*, 43 HOUS. L. REV. 1033, 1035–40 (2006) (discussing the prevalence of naked short-selling). Naked shorting refers to a trading strategy in which a trader sells securities short without first borrowing them or ascertaining that they are available for borrowing. *See id.* at 1038. The recent financial crisis demonstrated the potentially pernicious effects of short sales on asset prices, prompting many governments to temporarily outlaw short sales of certain securities. *See* Takashi Nakamichi, *'Naked' Ban Is Extended by Japan*, WALL ST. J., Mar. 25, 2009, at C2; Kara Scannell, *Short Sale Ban Spreads Around the Globe*, WALL. ST. J., Sept. 22, 2008, at C1 (reporting on bans in the United Kingdom, Australia, Taiwan, and the Netherlands); Kara Scannell et al., *SEC Is Set to Issue Temporary Ban Against Short Selling*, WALL ST. J., Sept. 19, 2008, at A1.

150. State St., *Securities Lending, Liquidity and Capital Markets-Based Finance*, *in* SECURITIES FINANCE: SECURITIES LENDING AND REPURCHASE AGREEMENTS 39, 47 (Frank J. Fabozzi & Steven V. Mann eds., 2005).

151. A repo is very similar to a securities lending transaction, in which securities are lent overnight and secured by cash collateral. *See* Jose Gabilondo, *Leveraged Liquidity: Bear Raids and Junk Loans in the New Credit Market*, 34 J. CORP. L. 447, 458 (2009). In a repo transaction, one party (the seller) sells securities to another party (the buyer) and contractually commits to repurchase identical securities from the buyer at a future date (typically, the next day) at a price that is slightly higher than the price at which the buyer bought such securities. *Id.* The economic substance of a repo is secured financing: the "seller" in a repo borrows cash from the "buyer" and uses securities as collateral. *Id.* The repo market is a key source of short-term financing of broker-dealers' securities inventories. *See id.* ("Especially for investment banks with large securities portfolios, the repo market is one of their most important ways of funding their activities day to day because repo [transactions] let the firm reduce the carrying costs of their securities portfolios."). Repos and securities lending transactions are governed by different types of legal agreements. For general background on repos, see Peter Hordahl & Michael R. King, *Developments in Repo Markets During the Financial Turmoil*, BANK FOR INT'L SETTLEMENTS Q. REV. (Dec. 2008), http://www.bis.org/publ/qtrpdf/r_qt0812e.htm.

152. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Michael M. Wiseman, Sullivan & Cromwell LLP (BNYC) (May 5, 2005) [hereinafter BNYC Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2005/20050505/; Letter from Jennifer Johnson, Sec'y of the Bd., Fed. Reserve Bd., to Marjorie E. Gross, JPMorgan Chase & Co. (Oct. 31, 2001) [hereinafter JPMCC

commercial banking subsidiaries within the holding company structure to lend their customers' securities, held in trust or as collateral, to the affiliated securities broker-dealers.[153] The affiliated broker-dealers could use securities for their business purposes but were obligated to return borrowed securities to the bank on demand. The banks in these programs, acting as agents for their customers who owned securities, were obligated to indemnify the customers for any loss resulting from the affiliate's failure to return securities upon the customer's demand.[154]

The Board concluded in both cases that the bank's risk of loss in the proposed transactions was insignificant enough to warrant an exemption from section 23A limits. Under the Board's reasoning, the key factor mitigating the bank's credit exposure to the affiliated broker-dealer was collateralization by high-quality assets, such as cash or U.S. government securities. So long as the bank employed adequate daily mark-to-market and collateral maintenance procedures, the risk of the value of collateral falling below the value of securities on the loan would be insubstantial.[155] However, the Board specified that "[t]he case for exempting transactions collateralized by property other than cash or U.S. government

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Letter], *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserve Act/2001/20011031/.

153. *See* BNYC Letter, *supra* note 152; JPMCC Letter, *supra* note 152. Each holding company's proposal envisioned initially only its flagship commercial bank—the Bank of New York ("BNY") and the Chase Manhattan Bank ("Chase Manhattan"), respectively—lending securities to their largest securities broker-dealer entity. *See* BNYC Letter, *supra* note 152; JPMCC Letter, *supra* note 152. However, both proposals asked specifically for an ability to extend the securities lending program to other banks and broker-dealers in their corporate structure. *See* BNYC Letter, *supra* note 152, at n.2; JPMCC Letter, *supra* note 152, at n.14.

154. The Board noted that, in addition to this principal source of credit exposure to the affiliated broker-dealer, the bank may also have short-term exposure in the amount of any distributions that the bank credits to the customer's account prior to receiving the same amount from the broker-dealer. *See* BNYC Letter, *supra* note 152; JPMCC Letter, *supra* note 152.

155. As the Board noted, the bank's exposure on the obligation to indemnify the customers is limited to the amount by which the market value of the borrowed securities exceeds the value of the collateral posted by the borrower-affiliate. The Board further reasoned that, to the extent that collateral consists of cash or U.S. Treasury bonds, and the bank marks both collateral and lent securities to market daily in order to maintain a proper level of collateralization, it would be highly unlikely that the value of the collateral would fall below the value of securities on the loan. BNYC Letter, *supra* note 152; JPMCC Letter, *supra* note 152.

securities is not as strong"[156] and limited the exemption for securities lending transactions secured by corporate, municipal, or non-U.S. securities.[157]

Another important factor supporting the Board's decision was the fact that these transactions were subject to the market-terms requirements of section 23B. The Board stressed that both Chase Manhattan Bank ("Chase Manhattan") and Bank of New York ("BNY") already actively engaged in securities lending to unaffiliated securities firms and committed to treat their affiliated broker-dealers on the same terms as those applied to nonaffiliates.[158] Because including affiliates in their existing securities lending program enabled the banks' customers to increase the return on their assets, the Board found an exemption to be in the public interest.[159]

The Board used the same reasoning to grant exemptions from section 23A to Bank of America Corporation ("BAC") and Wachovia Corporation ("Wachovia"), both of which sought to establish similar in-house securities lending programs.[160] The same two companies also requested an exemption from section 23A for an in-house program whereby their flagship commercial banks—Bank of America, N.A. ("BANA") and Wachovia Bank, N.A. ("Wachovia Bank"), respectively—were allowed to borrow securities from their

156. JPMCC Letter, *supra* note 152; *see also* BNYC Letter, *supra* note 152 (granting the requested exemption subject to specific conditions for the transactions collateralized by property other than cash or U.S. government securities).

157. Under the Board's interpretation, such transactions were exempted from section 23A only to the extent that the total market value of securities lent against such collateral did not in the aggregate exceed the lesser of (1) five percent of the bank's total capital and surplus, or (2) five percent of the total market value of the securities the bank lent to the borrower-affiliate. *See* BNYC Letter, *supra* note 152; JPMCC Letter, *supra* note 152. The marginal amount above that threshold would be treated as nonexempt and thus count against the quantitative limits on covered transactions and be subject to the qualitative requirements of section 23A. *See* JPMCC Letter, *supra* note 152.

158. *See* BNYC Letter, *supra* note 152; JPMCC Letter, *supra* note 152.

159. *See* JPMCC Letter, *supra* note 152.

160. Letter from Jennifer Johnson, Sec'y of the Bd., Fed. Reserve Bd., to Patrick S. Antrim, Assistant Gen. Counsel, Bank of Am. Corp. 4–6 (Jan. 23, 2007) [hereinafter 2007 BAC Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070123/20070123.pdf; Letter from Robert deV. Frierson, Sec'y of the Bd., Fed. Reserve Bd., to Courtney D. Allison, Senior Vice President & Assistant Gen. Counsel, Wachovia Corp. 4–5 (Sept. 29, 2006) [hereinafter 2006 Wachovia letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2006/200609292/200609292.pdf. *Compare* JPMCC Letter, *supra* note 152, *and* BNYC Letter, *supra* note 152 (proposing similar section 23A exemptions), *with* 2007 BAC Letter, *supra*, at 1–3 & nn.7, 9, *and* 2006 Wachovia Letter, *supra*, at 1–3 & n.3 (using language similar to that contained in the JPMCC and BNYC letters regarding the proposed section 23A exemptions, as well as citing the same letters as precedent).

affiliated securities broker-dealers, in order to facilitate the banks' derivatives trading business.[161]

By the mid-2000s, both BANA and Wachovia Bank had developed thriving businesses trading and dealing in a wide range of derivatives.[162] As part of their equity derivatives business, they routinely took significant synthetic long positions in equities.[163] Part of their hedging strategy involved short sales of the underlying securities, which necessitated reliable access to securities borrowing.[164] Both BAC and Wachovia argued that borrowing securities from their affiliates would allow their banks to maintain the confidential and proprietary nature of their hedging activities and to lower operating expenses by utilizing the affiliated broker-dealers' existing securities borrowing infrastructure.[165]

Under these proposals, the bank would borrow securities from an affiliated broker-dealer and collateralize its obligation to return borrowed securities on demand by cash or U.S. government bonds.[166] Unlike situations where the bank lends securities to affiliates, the bank's potential risk exposure as a borrower is higher, because the value of the borrowed securities may fluctuate and is more likely to

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161. Letter from Robert deV. Frierson, Sec'y of the Bd., Fed. Reserve Bd., to Courtney D. Allison, Senior Vice President & Assistant Gen. Counsel, Wachovia Corp. 1–2 (June 12, 2007) [hereinafter 2007 Wachovia Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070612/20070612.pdf; Letter from Robert deV. Frierson, Sec'y of the Bd., Fed. Reserve Bd., to John H. Huffstutler, Assoc. Gen. Counsel, Bank of America Corp. (June 7, 2005) [hereinafter 2005 BAC Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2005/20050607/.

162. Thus, by the end of 2005, BANA and Wachovia Bank were listed as two of the top five U.S. commercial banks holding the largest notional amounts of OTC derivatives contracts. COMPTROLLER OF THE CURRENCY, OCC BANK DERIVATIVES REPORT FOURTH QUARTER 2005, at 18 tbl.1 (2005), *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq405.pdf (showing that, as of December 31, 2005, BANA held over $21.7 trillion in the total notional amount of OTC derivatives, and Wachovia Bank held over $3.6 trillion). The top five banks collectively accounted for ninety-six percent of the total notional amount of derivatives contracts in the U.S. commercial bank system, which at the end of 2005 reached $101.5 trillion. *See id.* at 1.

163. *See* 2007 Wachovia Letter, *supra* note 161, at 1; 2005 BAC Letter, *supra* note 161.

164. *See* 2007 Wachovia Letter, *supra* note 161, at 1; 2005 BAC Letter, *supra* note 161.

165. *See* 2007 Wachovia Letter, *supra* note 161, at 2; 2005 BAC Letter, *supra* note 161.

166. As is typical in all securities lending and borrowing transactions, the borrower's obligation would be overcollateralized, so that the market value of the collateral is between 102% and 105% of the market value of the borrowed securities. In the absence of an exemption from section 23A requirements, the entire value of the collateral posted by the bank would have to be counted toward the quantitative limits of section 23A. *See, e.g.*, 2007 Wachovia Letter, *supra* note 161, at 3 & n.8. In addition, if the bank borrows equity securities, section 23A would require that the amount of borrowed securities equal at least 130% of the value of the collateral posted by the bank. *See id.*

fall below the value of collateral securing them. Accordingly, the Board imposed several conditions on the exemption. First, the bank had to continue to mark to market its securities borrowing transactions with affiliated broker-dealers on a daily basis.[167] Second, the exemption was limited only to transactions involving borrowing securities with a "ready market" (i.e., securities publicly traded in the U.S. or OTC securities quoted by independent market makers in an interdealer network).[168] In addition, with respect to each securities borrowing transaction, the amount of the bank's unsecured credit exposure had to be treated as nonexempt and thus count toward the section 23A quantitative limits.[169] Third, the Board conditioned the exemption on the affiliated broker-dealer borrowing securities from an unaffiliated third party substantially contemporaneously with, and on the same basic terms as, the bank's securities-borrowing transaction with the broker-dealer.[170] The purpose of this requirement was to ensure that these transactions were "bank-driven" and not designed to provide financing for the affiliate.[171] Finally, to ensure the bank's ability to close out securities-borrowing transactions if the affiliate-lender became insolvent, the bank had to document the transactions as "securities contracts" for purposes of section 555 of the Bankruptcy Code.[172] As long as all of these conditions were satisfied, the Board reasoned, exempting proposed transactions would bring substantial public benefits by reducing the cost of securities borrowing for the banks and, as a result, making them more

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167. *See* 2007 Wachovia Letter, *supra* note 161, at 4; 2005 BAC Letter, *supra* note 161.

168. This condition aims at ensuring the banks do not borrow illiquid securities. However, the definition used here allows for the borrowing of securities with only limited liquidity, which may be susceptible to sudden liquidity shocks. *See* 2007 Wachovia Letter, *supra* note 161, at 4; 2005 BAC Letter, *supra* note 161.

169. 2007 Wachovia Letter, *supra* note 161, at 4–5; 2005 BAC Letter, *supra* note 161. The nonexempt amount consisted of the bank's (1) current unsecured exposure, or the amount by which the current value of the collateral exceeds the current value of the borrowed securities; and (2) an estimate of potential future exposure ("PFE"), which would be initially fixed at six percent of the current market value of the borrowed securities but may be ultimately calculated based on the bank's internal model. The PFE seems to function as a sort of safety cushion. *See* 2007 Wachovia Letter, *supra* note 161, at 4–5; 2005 BAC Letter, *supra* note 161.

170. *See* 2007 Wachovia Letter, *supra* note 161, at 5; 2005 BAC Letter, *supra* note 161. The broker-dealer would repledge the collateral to secure a contemporaneous borrowing of the same securities from an unaffiliated third party.

171. *See* 2007 Wachovia Letter, *supra* note 161, at 5; 2005 BAC Letter, *supra* note 161.

172. 2007 Wachovia Letter, *supra* note 161, at 5–6; 2005 BAC Letter, *supra* note 161. In certain qualifying securities contracts, the counterparty's ability to liquidate the transaction generally cannot be stayed, avoided, or otherwise limited by operation of the Bankruptcy Code. 11 U.S.C. § 555 (2006).

competitive in pricing their equity derivatives products and services.[173]

Once again, the Board stressed that these securities-borrowing transactions, just like the securities-lending transactions previously exempted from section 23A, remained subject to the market-terms requirements of section 23B, which would ensure that the banks did not treat their affiliated broker-dealers more favorably than unaffiliated counterparties.[174] In granting the requested exemptions for both securities-lending and securities-borrowing transactions, the Board's focus was on specific mechanisms—such as the requirements of section 23B and the entity-specific conditions and commitments—designed to minimize each involved bank's credit exposure to its securities affiliates. In that respect, the Board appears to diligently assess the risks to individual banks and to limit the exemptions in a manner reasonably expected to minimize such risks.

However, what was missing from the Board's interpretive letters, in some way, is more revealing than what these letters said. All of these interpretations conspicuously lacked a meaningful discussion of potential systemic implications of proposed transactions. The Board's traditionally microprudential approach, with its exclusive focus on individual institutions' risk exposure, prevented it from exploring how the proposed transactions fit into, and reflected, the broader dynamics of the financial market. The Board's persistent failure to raise that issue before permitting some of the country's largest commercial banks to engage in high-volume securities lending and borrowing with their affiliated securities broker-dealers, themselves major players in capital markets, was a striking omission.

It may be unrealistic to expect the Board to foresee the far-reaching systemic implications of its day-to-day decision making. However, situating specific banks' exemption requests in the context of broader market developments might have altered the Board's risk calculus. The emphasis on section 23B and the fact that affiliates, either as lenders or as borrowers of securities from the affiliated banks, did not get any direct cost advantage and were subject to industry-wide standards obscures the possibility of indirect advantages inherent in such arrangements. Thus, the in-house securities lending programs provide securities firms with continuous and reliable access to a ready pipeline of securities available for

173. *See* 2007 Wachovia Letter, *supra* note 161, at 6; 2005 BAC Letter, *supra* note 161.

174. *See* 2007 Wachovia Letter, *supra* note 161, at 6; 2007 BAC Letter, *supra* note 160, at 4; 2006 Wachovia Letter, *supra* note 160, at 4; 2005 BAC Letter, *supra* note 161.

borrowing. Such access may be more important than the pricing, especially for financial firms actively engaged in securities trading and dealing.

Although the Board's letters did not specify the purposes for which the broker-dealers needed to borrow securities from the affiliated banks on a scale large enough to potentially trigger the quantitative limits of section 23A, securities firms typically borrow securities to cover short sales in the course of proprietary trading or dealing in equity and derivatives instruments.[175] Broker-dealers also often relend borrowed securities to their customers, including hedge funds and arbitrageurs, enabling them to engage in short selling and other complex trading strategies.[176] Having assured access to securities held by BNY or Chase Manhattan put their affiliated broker-dealers in a position to grow both their own proprietary trading and dealing operations and increase their clients' trading abilities.[177] Direct links between availability of securities for borrowing and the potential rise in the volume and complexity of speculative market activities involving short selling, as well as a potential increase in hidden leverage throughout the financial system, are important factors that should have at least been acknowledged as the Board deliberated on its decisions.[178]

Similarly, permitting large commercial banks like BANA and Wachovia Bank access to their affiliated broker-dealers' securities borrowing pipeline gave these banks a potential opportunity to expand their equity derivatives operations. By the time of the Board's decisions, U.S. commercial banks had already developed an active business trading and dealing in OTC derivatives.[179] Over the past

175. *See* McCaffrey, *supra* note 149, at 483.

176. *See* ASS'N OF BRITISH INSURERS ET AL., *supra* note 143, at 2.

177. This was particularly relevant because BNY and Chase Manhattan were the two largest clearing banks in the U.S. and the key trust and custodian institutions on Wall Street holding huge amounts of customers' securities.

178. It is possible that the Board was fully aware of these potential systemic consequences of allowing such expanded in-house securities lending and borrowing programs. However, without access to behind-the-scenes discussion and deliberations, documented or verbal, it is difficult to ascertain whether the Board took these systemic considerations into account and made fully informed decisions. One would expect that, if the Board considered these issues, it would have included at least some references to its conclusions in the text of the interpretive letters.

179. Thus, in the first quarter of 2005, the total notional amount of derivatives contracts held by U.S. commercial banks was $91.1 trillion. COMPTROLLER OF THE CURRENCY, OCC BANK DERIVATIVES REPORT, FIRST QUARTER 2005, at 1 (2005), *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq105.pdf. In the first quarter of 2007, that same total notional amount was $144.8 trillion. COMPTROLLER OF THE CURRENCY, OCC'S QUARTERLY REPORT ON

three decades, U.S. bank regulators, whose decisions gradually empowered commercial banks to enter the OTC derivatives market, have been notoriously oblivious to potential systemic consequences of this fundamental shift in the U.S. banking industry's business and risk profile.[180] The Board's decisions show that, as late as mid-2007, regulators still failed to recognize the significance of this trend for increasing the levels of risk, complexity, leverage, and interconnectedness in the financial system. In fact, the Board viewed increasing the ability of two of the largest depository institutions in the United States[181] to expand their derivatives trading and dealing activities as the key public benefit of granting the requested exemptions.[182]

Of course, it is not the purpose of this Article to argue that the Board's use of its exemptive power under section 23A was the direct cause of the global financial crisis. Making that assertion, especially with the benefit of hindsight, would be quite a stretch. It is difficult, if not impossible, to prove that allowing affiliated banks and broker-dealers to borrow securities from one another did, in fact, lead to significantly increased volume of short selling and speculative trading in the financial system, which ultimately contributed to the market meltdown.[183] It is important to keep in mind that the Board's actions under section 23A are only a small piece in a complex and multi-faceted puzzle. However, a closer look at these obscure and seemingly mundane administrative actions reveals certain deeply seated tensions in the operation of the statute.

C. *Summary*

After the passage of the GLB Act, section 23A gained new prominence as the principal statutory provision keeping depository institutions safe from excessive exposure to potentially risky activities

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BANK DERIVATIVES ACTIVITIES, FIRST QUARTER 2007, at 1 (2007), *available at* http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq107.pdf.

180. *See generally* Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking,"* 63 U. MIAMI L. REV. 1041 (2009) (examining the evolution of the OCC's decisions allowing national banks to conduct derivatives activities).

181. By 2007, BANA, JPMorgan Chase, and Wachovia Bank were the three largest deposit holders in the United States. Eric Dash, *Big Bank Stops Effort to Change Law Limiting Growth*, N.Y. TIMES, Jan. 24, 2007, at C3.

182. *See* 2007 Wachovia Letter, *supra* note 161, at 6; 2007 BAC Letter, *supra* note 160, at 4.

183. Of course, it is equally hard to prove the absence of any causal link between these phenomena.

of nonbank financial institutions. Not surprisingly, the volume of banks' requests for exemptions from the limitations of section 23A, and the spectrum of transactions for which exemptions were requested, increased significantly in comparison to the pre-GLB Act years.

However, an examination of the Board's decisions shows that, even on the very eve of a major crisis, the U.S. bank regulators did not seem to fully appreciate the fundamental changes in the dynamics of the financial system. The Board's over-reliance on prior precedent, exclusive focus on entity-level risk, and failure to place proposed transactions in the broader context limited its ability to identify and assess potential effects of such transactions on the accumulation of risk in the financial system. Perhaps, by placing these strategies in the broader context and by using its review of proposed transactions as the window into the complex dynamics of the financial market, the Board might have seen some warning signs of the looming disaster. And, perhaps, by being more conservative in lifting the restrictions of section 23A, the Board might have prevented banks from being saddled with toxic subprime mortgage assets or even curbed the disastrous overgrowth of shadow banking.

Yet, regulatory nearsightedness is only part of the story. To a great extent, the Board's approach was a product of an inherently nonsystemic focus of the statute itself. Systemic risk prevention is not an explicit purpose of section 23A, which is concerned primarily with the safety and soundness of individual banks. As the GLB Act changed the broader context in which section 23A operates, it created a fundamental mismatch between the statute's entity-centric approach and the increasing dependence of individual banks' safety and soundness on systemic factors. It is much more difficult to maintain the fiction of complete separateness of a commercial bank from the affiliated nonbank entities within a single financial conglomerate.[184] As the methods of potential transfer of federal subsidy from banks to their affiliates become more complex and sophisticated, and the risks of such transfer are amplified, policing the section 23A firewall becomes a far more complicated task for the regulators. Performing that task effectively requires a more explicitly systemic approach that reflects growing interdependence among

184. *See* Kera Ritter, *Systemic Risk: Task of Prying Apart Interconnected Firms Daunting Part of "Wind-Down" Rulemaking*, BANKING DAILY (Nov. 8, 2010), http://news.bna.com/bdln/BDLNWB/split_display.adp?fedfid=18383932&vname=bbdbulallissues&fn=18383932&jd=a0c4u4d3c0&split=0 (stating that the lines between banks and the rest of the holding company are blurred and intentionally intertwined).

depository institutions and the rest of today's vast and dynamic financial system.

As this Part has demonstrated, in the years preceding the latest global financial crisis, the Board fell short of developing such an approach. By relaxing statutory constraints in response to exemption requests, the Board failed to utilize the potential ability of the section 23A regime to reduce incentives for excessive conglomeration and the growth of the shadow banking system, which were important contributing factors behind the latest financial crisis.

III. BANKS TO THE RESCUE: THE BOARD'S USE OF EXEMPTIVE POWER UNDER SECTION 23A DURING THE GLOBAL FINANCIAL CRISIS

The inherent weakness of the statutory wall between depository institutions and their nondepository affiliates became particularly visible during the recent financial crisis that put intense pressure on financial conglomerates to use their deposit-taking subsidiaries as a source of emergency financing for other entities within their corporate structure.

This Part examines the Board's interpretations issued in the three-year period between mid-June 2007 (the eruption of the subprime mortgage crisis in the United States) and mid-2010 (the passage of the Dodd-Frank Act). In these interpretations, the Board granted numerous financial institutions exemptions from the quantitative and qualitative requirements of section 23A in order to prevent the failure of their nonbank businesses and to avert broader market dislocations, even though such emergency measures contradicted the fundamental policy goals behind section 23A. This Part argues that, during the crisis, the Board effectively dismantled the statutory wall by aggressively using its exemptive authority under section 23A to make massive infusions of funds from and through the depository system into the shadow banking sector.

A. *Saving the Shadow Banking System*

The global financial crisis began in June of 2007, when the U.S. subprime mortgage markets suddenly collapsed, spreading panic among investors in a variety of mortgage-related assets and other financial instruments. An effective creditor run on the shadow

banking system created an unprecedented liquidity shortage in various segments of the global financial market.[185]

1. Saving Mortgage-Backed and Asset-Backed Securities Markets

On August 20, 2007, the Board issued three nearly identical interpretive letters granting Citigroup, BAC, and JPMCC exemptions from the quantitative and qualitative limitations of section 23A to allow their flagship bank subsidiaries (Citibank, BANA, and JPMorgan Chase Bank, respectively) to engage in certain "securities financing transactions" ("SFTs") with their affiliated securities broker-dealers (Citigroup Global Markets, Bank of America Securities, and JPMorgan Securities, respectively).[186] In these letters, the Board allowed each of these three largest U.S. banks to extend credit in the form of reverse securities repurchase (reverse repo)[187] and securities borrowing transactions to their securities affiliates, which would then enter into mirror image transactions with unaffiliated third parties. The purpose of these back-to-back transactions was to inject short-term liquidity into the markets for mortgage-backed and other asset-backed securities, gripped by sudden liquidity shock in the wake of the subprime fallout,[188] by

185. For a comprehensive examination of the causes and key lessons of the financial crisis of 2007–2009, see generally FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011) [hereinafter FCIC FINAL REPORT], *available at* www.gpoaccess.gov/fcic/fcic.pdf.

186. *See* Letter from Robert deV. Frierson, Sec'y of the Bd., Fed. Reserve Bd., to Patrick S. Antrim, Assistant Gen. Counsel, Bank of Am. Corp. 1–5 (Aug. 20, 2007) [hereinafter BAC SFT Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070820a/20070820a.pdf; Letter from Robert deV. Frierson, Sec'y of the Bd., Fed. Reserve Bd., to Carl Howard, Gen. Counsel, Citigroup Inc. 1–5 (Aug. 20, 2007) [hereinafter Citigroup SFT Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070820b/20070820b.pdf; Letter from Robert deV. Frierson, Sec'y of the Bd., Fed. Reserve Bd., to Kathleen A. Juhase, JPMorgan Chase & Co. 1–5 (Aug. 20, 2007) [hereinafter JPMCC SFT Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070820c/20070820c.pdf.

187. A reverse repo is a regular securities repo transaction but from the viewpoint of the buyer of securities (or the lender of cash) rather than the seller (or the borrower of cash). *See* Gabilondo, *supra* note 151, at 458 (stating that a reverse repo is a repo viewed from the other side of the transaction). Thus, the seller of securities would characterize the transaction as a repo, while the buyer of securities would characterize it as a reverse repo. For a definition of a securities repo, see *supra* note 151.

188. Thus, according to one commentator,

> The repo market virtually disappeared in August 2007 and the drought has lasted for months. The repo market dried up because dealer banks would not accept collateral because they rightly believed that if they had to seize the collateral,

enabling the three major securities broker-dealers to continue trading and dealing in these illiquid assets.[189]

In each case, the exemption was granted for SFTs in the aggregate amount of up to $25 billion, which constituted less than thirty percent of each of the three banks' total regulatory capital and, therefore, was far above the quantitative limit of section 23A for extensions of credit to a single affiliate.[190] Within the next few months, the Board granted substantively identical exemptions from section 23A to Deutsche Bank,[191] Barclays Bank,[192] and Royal Bank of Scotland,[193] allowing these banks' U.S. branches to engage in the

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> there would be no market in which to sell it. This is due to the absence of prices. The amount lent depends on the perceived market value of the asset offered as security. If that value cannot be determined, because there is no market—no liquidity—, or there is the concern that if the asset is seized by the lender, it will not be saleable at all, then lender will not engage in repo.

Gary B. Gorton, *The Panic of 2007*, at 67 (Yale Sch. of Mgmt. & Nat'l Bureau of Econ. Research, Working Paper No. 08-24, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1255362.

189. This arrangement allowed the broker-dealers to extend financing to market participants against illiquid collateral (mortgage-backed and asset-backed securities, possibly interests in CDOs and other structured products), while funding their obligations by simultaneous borrowing from their affiliated banks against that same collateral. In the shadow banking system, large volumes of trading in various types of asset-backed securities and structured products, including CDO tranches, were financed through repos and securities borrowing. Large securities broker-dealers were central players in these markets, intermediating the complex flows of funds and assets. Once the U.S. subprime mortgage market collapsed and the market value of mortgage-backed and other asset-backed securities fell, such short-term secured financing quickly disappeared. Using commercial banks as a source of liquidity was meant to support these major dealer-firms' ability to maintain the market by continuing trading and dealing in these assets. For a detailed discussion of the causes and mechanics of the subprime mortgage crisis, see generally the FCIC FINAL REPORT, *supra* note 185; Wilmarth, *supra* note 135; Gorton, *supra* note 188.

190. Section 23A limits extensions of credit to a single affiliate to ten percent of the bank's capital stock and surplus. 12 U.S.C. § 371c(a)(1) (2006) (amended 2010).

191. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Michael L. Kadish, Deutsche Bank AG 3–5 (Sept. 12, 2007), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070912/20070912.pdf. The exemption was granted for up to $13 billion, which constituted less than thirty percent of the bank's total regulatory capital. *Id.* at 3.

192. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Alan B. Kaplan, Deputy Gen. Counsel, Ams., Barclays Bank PLC 3–5 (Oct. 11, 2007), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20071011/20071011.pdf. The exemption was granted for up to $20 billion, which constituted less than thirty percent of the bank's total regulatory capital. *Id.* at 3.

193. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Jay Levine, Head of RBS Global Banking & Mkts., N. Am., Royal Bank of Scotland PLC 3–5 (Oct. 12, 2007), *available at* http://www.federal reserve.gov/boarddocs/legalint/FederalReserveAct/2007/20071012/20071012.pdf. The exemption was granted for up to

same types of securities financing transactions with their affiliated U.S. securities broker-dealers. These decisions unlocked an additional $43 billion in potential short-term liquidity, bringing the total amount of exempt SFTs to $118 billion.[194]

This was an extraordinary set of decisions. Never before had the Board removed the quantitative and qualitative requirements of section 23A, on such a massive scale, in order to prop up broader markets in distress—a systemic concern that goes far beyond the specific purposes of the statute. In fact, the effect of these exemptions was directly contrary to the twin statutory purposes of protecting depository institutions from losses in transactions with affiliates and limiting the ability of depository institutions to transfer to affiliates the subsidy arising from the institutions' access to the federal safety net.[195] In these transactions, the risks associated with lending against illiquid collateral, such as mortgage-backed securities and other potentially "toxic" assets, were shifted to depository institutions, including the three largest commercial banks in the country. Moreover, these exemptions were granted in conjunction with the Board establishing a special discount window lending facility that gave depository institutions access to term loans (instead of the typical overnight loans) at the discount window and lowered the discount rate for such loans.[196] The Board specifically made these exemptions temporary, to stay in effect only for as long as that special discount window lending facility was outstanding.[197] The removal of

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$10 billion, which constituted less than thirty percent of the bank's total regulatory capital. *Id.* at 3.

194. Of course, this amount represents only the aggregate capacity of the six banks to engage in the SFTs under the exemption. In practice, the banks might not have used the total capacity and might have extended less credit to their affiliated broker-dealers under the exempt SFTs.

195. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560, 76,560 (Dec. 12, 2002).

196. The Board's first order of business in responding to the financial crisis was making it easier for banks to borrow money. *See* Press Release, Fed. Reserve Bd., Federal Reserve Approves Modifications to the Terms of Its Discount Window Lending Program (Feb. 18, 2010), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20100218a.htm. On August 17, 2007, the Board reduced the spread of the primary credit rate (or the discount rate) over the federal funds target rate from 1% to 0.5% and lengthened the typical maximum maturity of discount loans from overnight to thirty days. *Id.* On December 12, 2007, the Board established the Term Auction Facility ("TAF") to provide additional liquidity to depository institutions. On March 16, 2008, the Board further lowered the spread of the discount rate over the target federal funds rate to 0.25% and extended the maximum maturity of discount window loans to ninety days. *Id.*

197. All six exemptions were terminated on March 18, 2010, when the typical maximum maturity for banks' discount window borrowing returned to overnight. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Patrick

the statutory restrictions enabled precisely the kind of a large-scale transfer of the federal subsidy from depository institutions to their securities affiliates and their counterparties in capital markets that the statute sought to minimize.

To bolster its claim that the exemptions were consistent with the purposes of section 23A, the Board stressed that the proposed transactions were meant explicitly to extend credit to unaffiliated third-party participants in the liquidity-starved markets for mortgage-backed securities, CDOs, and other structured products, and that the broker-dealer affiliates were mere conduits for this substantial injection of liquidity into these markets.[198] Thus, the Board concluded, granting an exemption from section 23A would have significant public benefits.[199] However, it is hard to deny that these extraordinary liquidity backup programs also functioned to prop up the banks' broker-dealer affiliates, which could not have continued to operate and possibly faced failure as a result of market collapse.[200]

S. Antrim, Assistant Gen. Counsel, Bank of Ams. Corp. 1 (Mar. 18, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100318/20100318a.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Alan B. Kaplan, Deputy Gen. Counsel, Americas, Barclays Bank PLC 1 (Mar. 18, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100318/20100318e.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Carl Howard, Gen. Counsel, Citigroup Inc. 1 (Mar. 18, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100318/20100318b.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Michael L. Kadish, Dir. & Senior Counsel, Deutsche Bank AG 1 (Mar. 18, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100318/20100318d.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Kathleen A. Juhase, Senior Vice President & Assoc. Gen. Counsel, JPMorgan Chase & Co. 1 (Mar. 18, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100318/20100318c.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Jay Levine, Head of RBS Global Banking & Mkts., Royal Bank of Scotland PLC 1 (Mar. 18, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100318/20100318f.pdf.

198. The Board somewhat euphemistically refers to "operational reasons" for back-to-back transactions instead of direct extension of bank credit to market participants. *See* BAC SFT Letter, *supra* note 186, at 1; Citigroup SFT Letter, *supra* note 186, at 1; JPMCC SFT Letter, *supra* note 186, at 1. According to the Board, using the affiliated broker-dealer as the conduit was "the most rapid and cost-effective" method of injecting liquidity into the market. BAC SFT Letter, *supra* note 186, at 4; Citigroup SFT Letter, *supra* note 186, at 4; JPMCC SFT Letter, *supra* note 186, at 4. As a practical matter, it was a product of the structure and operation of the market for these assets, and these dealer-firms' multiple roles in it. *See supra* note 189.

199. *See* BAC SFT Letter, *supra* note 186, at 4; Citigroup SFT Letter, *supra* note 186, at 4; JPMCC SFT Letter, *supra* note 186, at 4.

200. For an analysis of potential vulnerabilities of securities broker-dealers in the OTC markets, see Durrell Duffie, *The Failure Mechanics of Dealer Banks* 10–14 (Bank for Int'l

Their affiliated broker-dealers were the "conduits" for these emergency securities financing transactions because they were in the business of creating, trading, and dealing in securities that needed such financing and, as a result, had direct exposure to these highly unstable markets.[201]

The Board imposed several conditions on the exemptions similar to those found in its earlier exemptions for banks' securities borrowing from affiliates.[202] Thus, the proposed SFTs had to be over-collateralized at all times, marked to market on a daily basis, and remain subject to daily margin maintenance requirements.[203] To assure the banks' ability to promptly close out and liquidate the posted collateral in the event of the affiliated broker-dealers' bankruptcy, all SFTs had to qualify as "securities contracts" under the Bankruptcy Code.[204] The Board also required that each broker-dealer execute an SFT with an unaffiliated market participant contemporaneously and on the same terms as the SFT with its affiliated bank.[205] Finally, the SFTs remained "subject to the market-terms requirement of section 23B."[206]

One can reasonably question the practical significance of these conditions as effective mechanisms for limiting banks' risk, given the illiquid nature of the collateral securing the broker-dealers' obligations. The very purpose of exempting the SFTs was to provide secured financing for assets whose market value was negatively affected by the subprime mortgage crisis.[207] Conditionality based on

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Settlements, BIS Working Paper No. 301, 2010), *available at* http://www.bis.org/publ/work301.pdf.

201. *See* Greg Ip, *Fed's Credit Window Does Brisk Business*, WALL ST. J., Aug. 24, 2007, at A2 (explaining that, in Citigroup's case, the exemption was granted in order to facilitate the financing of mortgage-related assets). More than half of Citigroup's losses in the crisis came from mortgage-related securities created in-house. *See* Eric Dash & Julie Creswell, *Citigroup Pays for Rush to Risk*, N.Y. TIMES, Nov. 23, 2008, at N1.

202. *See supra* notes 166–74 and accompanying text.

203. *See* BAC SFT Letter, *supra* note 186, at 3; Citigroup SFT Letter, *supra* note 186, at 3; JPMCC SFT Letter, *supra* note 186, at 3.

204. BAC SFT Letter, *supra* note 186, at 3 n.7 (quoting 11 U.S.C. § 555 (2006)); Citigroup SFT Letter, *supra* note 186, at 3 n.7 (quoting 11 U.S.C. § 555 (2006)); JPMCC SFT Letter, *supra* note 186, at 3 n.7 (quoting 11 U.S.C. § 555 (2006)).

205. BAC SFT Letter, *supra* note 186, at 3; Citigroup SFT Letter, *supra* note 186, at 3; JPMCC SFT Letter, *supra* note 186, at 3.

206. BAC SFT Letter, *supra* note 186, at 4; Citigroup SFT Letter, *supra* note 186, at 4; JPMCC SFT Letter, *supra* note 186, at 4.

207. For these reasons, the Board did not subject the proposed SFTs to all of the conditions typical for securities borrowing transactions previously exempted from section 23A. Thus, under the Board's previous exemptions for banks borrowing securities from affiliated broker-dealers, such securities had to have a "ready market" and the amount of

pre-crisis precedent appears to be largely a cosmetic device in the context of the financial crisis that had just begun to unfold.

2. Auction-Rate Securities and Other Consumer Finance Markets

The Board used a similar approach to grant exemptions from the requirements of section 23A for transactions whereby depository institutions were allowed to purchase assets from their affiliates in order to inject liquidity into the markets for auction-rate securities ("ARS") and similar instruments. ARS are long-term debt securities with an interest rate that resets periodically in an auction process, effectively turning it into short-term debt.[208] Before the crisis, ARS were widely used to finance municipal bonds, student loans, and a variety of other debt.[209] Investment banks and brokerages that sold ARS and managed auctions often provided liquidity support for the securities by submitting bids in the absence of sufficient investor interest and committing to repurchase ARS from their holders on short notice.[210] In early 2008, as institutional investors withdrew from the ARS market and mounting financial difficulties forced securities firms to stop supporting ARS auctions, the ARS market came under severe liquidity strain.[211]

In December 2008 and January 2009, the Board issued four interpretations exempting bank purchases of ARS from their securities affiliates from the requirements of section 23A and

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the bank's unsecured credit exposure (which is inversely related to the market value of borrowed securities) was not exempt from the quantitative limits of section 23A. *See* 2007 Wachovia Letter, *supra* note 161, at 4–5 (quoting 17 C.F.R. § 240.15c3-1(c)(11)(i) (2007)); 2005 BAC Letter, *supra* note 161.

208. *See* Gretchen Morgenson, *The Investors Who Can't Come in from the Cold*, N.Y. TIMES, Nov. 30, 2008, at BU1. Thus, auctions resetting ARS rates could be held as frequently as every seven, twenty-eight, or thirty-five days. *See, e.g.*, WELLS FARGO SEC., AUCTION RATE SECURITIES: OVERVIEW, FEATURES, AND RISK 2–3 (2009), *available at* https://saf.wellsfargoadvisors.com/emx/dctm/Marketing/Marketing_Materials/Fixed_Income_Bonds/E6581.pdf.

209. *See* FCIC SHADOW BANKING REPORT, *supra* note 136, at 22. The ARS issuers benefitted from being able to issue long-term debt at short-term rates and the investors viewed them as liquid and near risk-free assets.

210. *Id.*

211. *See* Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, Feb. 15, 2008, at C6. As a result of massive auction failures, the issuers were contractually forced to pay interest on their securities at high penalty rates. *See* Gretchen Morgenson, *If You Can't Sell, Good Luck*, N.Y. TIMES, Mar. 30, 2008, at BU1. Securities firms that underwrote and sold ARS became targets of investor lawsuits and government investigations into their sales practices. *See* Eric Dash & Louise Story, *2 Big Banks Buying Back Securities*, N.Y. TIMES, Aug. 8, 2008, at C1 (discussing settlements by Citigroup and Merrill Lynch).

Regulation W.[212] From the outset, the Board stressed that the proposals for which exemptions were requested arose directly "out of ongoing dislocations in the ARS market."[213] In all cases, the banks' securities affiliates were active participants in ARS markets, underwriting, selling, and purchasing the ARS through trusts and other special purpose entities set up specifically for that purpose.[214] Because of a contractual obligation or as an accommodation to their clients seeking to liquidate their ARS holdings in the illiquid market, the banks' securities affiliates had to repurchase the ARS from their current holders.[215] Transferring these ARS to commercial banks was meant to provide financing for these purchases.

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212. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to William E. Stern, Goodwin Procter LLP (Fifth Third Bank) 4–5 (Jan. 30, 2009) [hereinafter Fifth Third Bank Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090130/20090130.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Charles M. Horn, Mayer Brown LLP (BB&T Corp.) 5 (Jan. 9, 2009) [hereinafter BB&T Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090109/20090109_1.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Jennifer M. Dirkin, Senior Attorney, N. Trust Corp. 3 (Jan. 9, 2009) [hereinafter Northern Trust Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090109/20090109_2.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to H. Rodgin Cohen, Sullivan & Cromwell LLP (Wachovia Bank) 4–5 (Dec. 29, 2008) [hereinafter 2008 Wachovia Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081229/20081229.pdf (granting exemption allowing Wachovia Bank to purchase up to $7 billion of ARS from two affiliated securities broker-dealers).

213. 2008 Wachovia Letter, *supra* note 212, at 1.

214. Technically speaking, both BB&T Corporation and the Fifth Third Bancorp requested exemptions for purchases of variable rate demand notes ("VRDNs") and tender option bonds ("TOBs"). *See* Fifth Third Bank Letter, *supra* note 212, at 1 (requesting exemption for purchases of VRDNs only); BB&T Letter, *supra* note 212, at 1 (requesting exemption for purchases of both VRDNs and TOBs). VRDNs are very similar to ARS; interest rates on VRDNs are reset either weekly or daily through an auction-like process that is similar to the ARS auction. *Municipal Bond Turmoil: Impact on Cities, Towns, and States: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 5 (2008) (statement of Martin Vogtsberger, Regional Bond Dealers Ass'n), *available at* http://financialservices.house.gov/hearing110/vogtsberger031208.pdf. However, unlike ARS, VRDNs have an explicit contractual liquidity support (so-called "hard put") from the remarketing agent (the securities firm that underwrites and markets VRDNs) and a liquidity credit line from a bank. Thus, both BB&T Corporation and the Fifth Third Bank provided such liquidity facility for the VRDNs sold and remarketed by their securities affiliates. TOBs are essentially securitizations of long-term fixed-rate municipal bonds, which pay variable interest at rates reset periodically in a remarketing process. *Id.* Like VRDNS, TOBs have a "hard put" that assures liquidity support. For a more detailed description of these instruments, see *id.* For the sake of simplicity, the following discussion includes VRDNs and TOBs in the general category of ARS.

215. Thus, the Northern Trust Corporation ("NTC"), the parent company of the Northern Trust Company, offered, as an accommodation to its customers, to purchase at par the ARS that its securities subsidiary sold to them. *See* Northern Trust Letter, *supra*

Wachovia Bank's request for an exemption presents a particularly interesting case. In August 2008, two of Wachovia Bank's securities affiliates, Wachovia Securities, LLC, and Wachovia Capital Markets, LLC (collectively, "Wachovia Securities"), reached a preliminary agreement to settle the charges that the Securities and Exchange Commission ("SEC") and various state regulators had brought against them for alleged misrepresentations Wachovia Securities made to its customers about the liquidity risk of the ARS it underwrote, marketed, and sold.[216] As part of the settlement, Wachovia Securities agreed to purchase, at par, certain ARS sold to their retail and institutional customers before February 14, 2008.[217] In December 2008, the Board granted Wachovia Bank's request for an exemption from the quantitative and qualitative limitations of section 23A to permit it to purchase up to $7 billion of ARS from Wachovia Securities.[218]

The Board indicated that granting the exemption was in the public interest because "it would facilitate the provision of liquidity by Wachovia to customers holding unexpectedly illiquid securities as a result of dislocation in the ARS market."[219] To protect the bank from excessive risk of loss, the Board imposed a long list of conditions.[220] Some of these conditions were the familiar ones from the long line of the Board's precedent: the parent company's commitment to "repurchase from the bank, on a quarterly basis" the

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note 212, at 1. In the cases of BB&T Corporation and the Fifth Third Bank, the holders of the ARS had a contractual right, in the event of a failed remarketing, to sell those ARS back to the remarketing agents (the banks' securities affiliates) or the trusts that issued them. The trusts had the right to draw on the banks' credit support facility to finance those repurchases. *See* Fifth Third Bank Letter, *supra* note 212, at 1–2; BB&T Letter, *supra* note 212, at 1–2.

216. *See* Press Release, SEC, Wachovia Agrees to Preliminary Auction Rate Securities Settlement that Would Offer Approximately $9 Billion to Investors (Aug. 15, 2008), *available at* http://www.sec.gov/news/press/2008/2008-176.htm. Specifically, it was alleged that Wachovia Securities falsely represented to investors that ARS were essentially cash equivalents and failed to disclose to them that the liquidity of these securities depended on Wachovia Securities' support for the auctions, and that Wachovia Securities was not obligated to continue providing such liquidity support. *Id.*

217. *Id.* Wachovia Securities was one of several major investment banks that settled similar charges with the SEC and state regulators. The list included JPMCC, Morgan Stanley, Citigroup, UBS, and other firms. *See* Patrick Temple-West & Yvette Shields, *Wachovia to Buy Back $8.8 Billion of ARS*, BOND BUYER, Aug. 18, 2008, at 1, *available at* http://www.bondbuyer.com/issues/117_157/-293538-1.html?zkPrintable=true.

218. 2008 Wachovia Letter, *supra* note 212, at 4–5. That amount represented approximately eleven percent of the bank's total capital stock and surplus, which exceeded the statutory limit on transactions with any single affiliate. *Id.* at 4.

219. *Id.* at 3.

220. *Id.* at 4.

transferred assets "that become low-quality assets"; the requirement that both the bank and the parent remain "well-capitalized" after the transfer; and the prerequisite that assets are purchased at fair market value.[221] In addition, the Board required that all purchased ARS be highly-rated[222] and that Wachovia Bank and its parent company (initially, Wachovia and then Wells Fargo & Company ("WFC") as its successor entity) enter into a repurchase agreement giving the bank the right to sell the ARS to the parent, by July 31, 2010, at the full purchase price plus interest.[223]

The Board imposed similar conditions and limits on other exemptions for bank purchases of ARS from their securities affiliates. In each of those cases, the Board also imposed some temporal limits on the exemption, which highlighted the emergency nature of these transactions designed explicitly for the purpose of alleviating the ongoing disruptions in the ARS market. Thus, the Board either mandated that all ARS had to be repurchased from the bank by the bank's parent company by a certain future date[224] or limited the ARS eligible for the exemption to those repurchased by the securities affiliate from its customers before a certain date.[225]

Much like in the SFT exemptions discussed above, the Board's conditions, designed on their face to satisfy the statutory requirement that the exemptions it grants be consistent with the purposes of section 23A, may fall short of achieving that goal in practice. For instance, the requirements that banks purchase only ARS with a high investment grade rating and purchase them at their fair market value seem less meaningful when placed in the context of the almost completely illiquid ARS market.[226] Similarly, in the midst of the

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221. *Id.* On October 3, 2008, Wells Fargo & Company ("WFC") entered into an agreement to acquire Wachovia Corporation ("Wachovia"), so the Board's conditions applied specifically to both WFC and Wachovia. *Id.* at 2. One of the conditions of the exemption was the requirement that WFC succeed to Wachovia's obligations and commitments made in connection with this exemption. *Id.* at 4.

222. Specifically, the Board required that all ARS be externally rated investment grade, and the majority be rated in the two highest categories of investment grade debt. *Id.*

223. *Id.*

224. *See, e.g.*, Northern Trust Letter, *supra* note 212, at 3 (stating that NTC had to repurchase the transferred ARS from the bank by July 31, 2010, at the price the bank paid plus any accrued interest).

225. *See, e.g.*, Fifth Third Bank Letter, *supra* note 212, at 4 (stating that "the exemption appli[ed] only to covered transactions [involving securities] purchased by [the bank's affiliated broker-dealer] from customers on or before December 31, 2009"); BB&T Letter, *supra* note 212, at 4 (same).

226. Of course, the assumption behind this requirement was that the relevant ARS were fundamentally sound financial investments, which was reflected in their high credit

financial crisis, the BHCs' commitments to protect their subsidiary banks from losses on the purchased assets are considerably less reliable protective devices than they might be under normal circumstances. The Board's pre-crisis precedent is of limited value where the explicit purpose of the exemption is to allow financial conglomerates to use depository institutions' access to federal subsidy and emergency government support not only to inject liquidity into specific markets but to alleviate the significant financial strain on their securities subsidiaries. After all, it was that logic that guided the Board's decision to permit Wachovia to shift up to $7 billion in illiquid ARS from its securities subsidiaries to Wachovia Bank, one of the largest U.S. commercial banks.[227]

As the crisis deepened, the Board granted a series of exemptions from section 23A and Regulation W for various transactions that allowed banks to directly support markets for consumer and student loans, which were severely affected by the near complete halt in securitization financing.[228] These cases exhibited the same pattern in

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ratings, and thus were likely to regain their value once the temporary liquidity squeeze was over.

227. Wachovia Securities fulfilled its obligations to repurchase ARS from customers under its settlement with the SEC. *See* Litigation Release, SEC, SEC Completes Review of Performance by Citigroup, RBC and Wachovia Under Auction Rate Securities Settlements (June 30, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/lr21585.htm. According to the SEC, Wachovia purchased $7.45 billion of ARS from its retail and institutional customers. *Id.*

228. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to William J. Sweet, Jr., Skadden, Arps, Slate, Meagher & Flom LLP (CIT Bank) 4 (Apr. 13, 2009), *available at* http://www.federalreserve.gov/boarddocs/legalint/Federal ReserveAct/2009/20090413/20090413.pdf (allowing the newly converted CIT Bank to acquire all the shares of three nonbank affiliates engaged in student loan financing and securitization as part of consolidation of the consumer lending operations of the CIT Corporation); Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to John G. Holinka, HSBC Bank USA, N.A. 4–5 (Jan. 14, 2009), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090114/2009 0114.pdf (allowing HSBC Bank USA to acquire from its affiliate a portfolio of subprime and near-prime automobile loans, credit card loans, and related securitized interests); Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to William S. Eckland, Sidley Austin LLP (GE Money Bank) 4 (Jan. 12, 2009), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090112/2009 0112.pdf (allowing GE Money Bank to purchase consumer loan receivables from affiliates as part of the consolidation of the consumer lending business of GE Capital Corporation); Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Daniel F. Kaplan, Perry, Guthery, Haase & Gessford, P.C., L.L.O (Union Bank & Trust Co.) 3 (Nov. 24, 2008) [hereinafter Union Bank Letter], *available at* http://www.federal reserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081126/20081126.pdf (exempting a purchase by Union Bank & Trust Company of federally guaranteed student loans from its affiliate, Nelnet, Inc., one of the country's largest originators, holders, and servicers of student loans).

the Board's approach: in times of extreme distress in financial markets, the limitations of section 23A were lifted to allow banks to come to the rescue of their nonbank affiliates. And, again, the Board got around that sensitive issue by stressing the public benefits of maintaining liquidity in consumer markets.[229]

3. Exemptions by Regulation: Saving Money Market Funds and Tri-Party Repo Markets

While the majority of the Board's exemptions were issued "by order," or in an individualized action upon a specific request from a financial institution, in two instances the Board felt it was necessary to grant broad-based exemptions from the requirements of section 23A, albeit on a temporary basis. These cases involved two critically important sources of short-term funding: the money markets and the tri-party repo markets.[230]

Money market funds, which were major investors in the commercial paper, short-term bond, and securities repo markets, experienced serious turmoil in the fall of 2008.[231] On September 16, 2008, the oldest money market fund in the United States, Reserve Primary Fund, which was heavily exposed to bankrupt Lehman Brothers Holdings Inc. ("Lehman Brothers"), "broke the buck" and set off an investor run on money market funds.[232] Faced with mounting redemption requests, money market funds were forced to liquidate assets and withdraw from buying corporate commercial paper, which caused serious concerns about companies' ability to roll over their debt used to fund their day-to-day operations.[233]

229. *See, e.g.*, Union Bank Letter, *supra* note 228, at 3.

230. For a definition of tri-party repos and a description of how tri-party repo markets operate, see *infra* note 241.

231. As of the end of 2008, money market funds had approximately $3.8 trillion in assets under management. They held 40% of all outstanding commercial paper (which made them by far the largest investor in that vital market), 23% of all repurchase agreements, 65% of state and local government short-term debt, 24% of short-term treasury securities, and 44% of short-term agency securities. Money Market Fund Reform, Exchange Act Release No. IC-28807, 74 Fed. Reg. 32,688, 32,689 (proposed June 30, 2009).

232. *See* Christopher Condon, *Reserve Primary Money Fund Falls Below $1 a Share*, BLOOMBERG (Sept. 16, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a5O2ylgo1GRU. The term "breaking the buck" refers to a fall in the money market fund's net asset value ("NAV") of $1.00 per share. *Id.* The fall in the NAV of the Reserve Primary Fund to ninety-seven cents per share was only the second such instance in the nearly four-decade long history of U.S. money market mutual funds, with the first case occurring in 1994. *Id.*

233. *See* Money Market Fund Reform, Exchange Act Release No. IC-28807, 74 Fed. Reg. at 32,692. Thus, in the final two weeks of September 2008, money market funds

Within three days, the federal government staged an unprecedented market intervention in order to stabilize money market funds and provide liquidity to the short-term debt markets. On September 19, 2008, the Treasury Department introduced a temporary guarantee program for certain investments in participating money market funds.[234] At the same time, the Board established the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"), which provided nonrecourse loans at the discount window rate to U.S. depository institutions and BHC to finance their purchases of highly-rated asset-backed commercial paper ("ABCP") from money market mutual funds.[235] The purpose of the AMLF was to enable money market funds to sell some of their secured assets at amortized cost, and to use the proceeds to meet requests for redemptions by investors, as well as to foster liquidity in the commercial paper markets.[236]

To enable banks to take full advantage of the AMLF, the Board amended Regulation W to grant a temporary exemption from the quantitative and qualitative requirements of section 23A for member banks' purchases of the ABCP from affiliated money market funds, if (1) the purchases were made on or after September 19, 2008; (2) the bank used the purchased ABCP as collateral securing the loan from the AMLF; and (3) the Board had not specifically informed the bank

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reduced their holdings of top-rated commercial paper by $200.3 billion, or twenty-nine percent. *Id.*

234. *See* Press Release, U.S. Dep't of the Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1147.aspx. The Treasury's guarantee program expired on September 19, 2009. *See* Press Release, U.S. Dep't of the Treasury, Treasury Announces Expiration of the Guarantee Program for Money Market Funds (Sept. 19, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg293.aspx.

235. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board Announces Two Enhancements to Its Programs to Provide Liquidity to Markets (Sept. 19, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20080919a.htm.

236. *Id.* The AMLF program was originally scheduled to expire on January 31, 2009, but was extended and eventually expired on February 1, 2010. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board Announces Extensions of and Modifications to a Number of Liquidity Programs (June 25, 2009), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20090625a.htm. In addition to the AMLF, the Board also established a separate Commercial Paper Funding Facility ("CPFF"), to provide liquidity directly to commercial paper markets. *See Commercial Paper Funding Facility*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/cpff.htm (last updated Feb. 5, 2010). For more detailed information on the AMLF, see *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/abcpmmmf.htm (last updated Feb. 5, 2010).

that it could not use the exemption.[237] The exemption was to remain in effect until the expiration of the AMLF. In the preamble to the final rule, the Board stressed that granting this exemption was in the public interest because it facilitated usage of the AMLF and thus helped to resolve liquidity problems in the money markets.[238] The Board also reasoned that the exemption was "consistent with the purposes of section[] 23A," because the nonrecourse financing provided under the AMLF effectively protected the banks from risk associated with holding the ABCP and "largely mitigate[d] the safety-and-soundness concerns that sections 23A and 23B were designed to address."[239] Characteristically, however, the Board neglected to mention the second, equally important, purpose of the statute: to prevent the transfer of the federal subsidy from depository institutions to their affiliates. In fact, this exemption was adopted precisely to enable the transfer of such special federal subsidy, available to banks through the AMLF, to affiliated money market funds.[240]

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237. 12 C.F.R. § 223.42(o) (2010). The Board adopted an interim final rule, bypassing the more typical "peacetime" process of issuing a proposed rule and soliciting comments, granting this exemption on the same day as it established the AMLF. *See* Transactions Between Member Banks and Their Affiliates, 73 Fed. Reg. 55,708, 55,708 (Sept. 26, 2008). The final rule, adopted on January 30, 2009, essentially restated the exemption in the interim rule but reflected an extension of the AMLF program past the originally scheduled expiration date. Transactions Between Member Banks and Their Affiliates, 74 Fed. Reg. 6,226, 6,227 (Feb. 6, 2009) (stating that the AMLF was extended until April 30, 2009).

238. Transactions Between Member Banks and Their Affiliates, 74 Fed. Reg. at 6,227.

239. *Id.*

240. Although the Board granted a general exemption for banks' purchases of ABCP from affiliated money market funds by regulation, it also granted two specific exemptions upon request by individual banking institutions. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to [Redacted] 2–3 (Dec. 1, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081201/2008 1201.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to [Redacted] 2–3 (Oct. 6, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081006/20081006.pdf.

It is not entirely clear why these institutions had to request exemptions, but it appears that the purchases involved money market funds' assets other than the ABCP and were not financed through the AMLF. The Board based its decisions on the same public interest rationale. The Board reasoned that granting such exemptions would have significant public benefit because they would enable the funds to meet redemption requests without having to sell their assets into the fragile and illiquid money markets. Letter from Robert deV. Frierson to [Redacted] (Dec. 1, 2008), *supra*, at 2; Letter from Robert deV. Frierson to [Redacted] (Oct. 6, 2008), *supra*, at 2. In both cases, the Board imposed a number of familiar conditions on the exemptions: the assets had to be externally rated at A-1/P-1 and purchased by the bank at fair market value, the parent company had to reimburse the bank for any losses sustained by the bank in connection with the purchased assets, and both the bank and its parent company had to remain well-

The same need to save short-term funding markets from collapse drove another amendment to Regulation W, which provided a temporary exemption from the requirements of section 23A for certain securities financing transactions in order to provide emergency liquidity support to the U.S. tri-party repo market.[241]

It is difficult to overestimate the significance of the U.S. tri-party repo market, in which two government securities clearing banks, JPMorgan Chase Bank ("JPMC Bank") and Bank of New York Mellon ("BNYM"), serve as the tri-party repo agents.[242] Securities broker-dealers obtain a significant portion of financing for their own and their clients' inventories through tri-party repos, making it a huge and vitally important market.[243] At its peak in early 2008, the tri-party repo market reached about $2.8 trillion, which declined to about $1.7 trillion in early 2010.[244] Collateral used to secure tri-party repos typically consists of U.S. Treasury securities and agency mortgage-backed securities.[245] In early 2008, at the market's peak, about thirty percent of the collateral securing tri-party repos consisted of various

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capitalized for as long as the exemption was in effect. Letter from Robert deV. Frierson to [Redacted] (Dec. 1, 2008), *supra*, at 2–3; Letter from Robert deV. Frierson to [Redacted] (Oct. 6, 2008), *supra*, at 2–3. In both cases, the exemptions were granted for a specified period of time and limited to the amount necessary to cover redemption requests by investors in the affiliated money market funds.

241. Tri-party repos are securities repos in which a third party, the tri-party agent, participates in the transaction along with the cash lender (typically, money market funds and mutual funds, custodial banks investing cash collateral on behalf of their securities lending customers, government entities, and other investors seeking relatively stable short-term secured lending opportunities) and the cash borrower (typically, securities broker-dealers, hedge funds, and other leveraged investors). FED. RESERVE BANK OF N.Y., TRI-PARTY REPO INFRASTRUCTURE REFORM 6 (2010) [hereinafter FRBNY WHITE PAPER], *available at* http://www.ny.frb.org/banking/nyfrb_triparty_whitepaper.pdf. The agent facilitates the transaction by providing operational services, including custody of securities, valuation of collateral, and settlement of cash and securities. *Id.*

242. PAYMENTS RISK COMM. TASK FORCE ON TRI-PARTY REPO INFRASTRUCTURE, REPORT 3 (2010) [hereinafter TASK FORCE REPORT], *available at* http://www.newyorkfed.org/prc/report_100517.pdf.

243. *Id.* ("The importance of the U.S. [tri-party] repo market is underscored by the fact that it is the market in which the Federal Reserve operationally implements U.S. monetary policy.").

244. FRBNY WHITE PAPER, *supra* note 241, at 6. Tri-party repos offered a variety of benefits for securities broker-dealers and other cash borrowers, including a preferential treatment under the Bankruptcy Code. *See id.* at 11–12 (discussing the general benefits of tri-party repos); TASK FORCE REPORT, *supra*, note 242, at 3 (explaining the bankruptcy treatment).

245. FRBNY WHITE PAPER, *supra* note 241, at 8. "Agency" securities are securities issued by the Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"), and securities guaranteed by the Government National Mortgage Association ("Ginnie Mae"). *Id.* at n.6.

corporate debt and equity securities, some of which were considerably less liquid than the traditional government and agency securities.[246]

However, as the financial crisis deepened, securities broker-dealers' financial condition deteriorated, the valuation of collateral became less certain, and cash lenders became increasingly reluctant to lend against nongovernment securities. This exposed the two tri-party repo agents, or clearing banks, which routinely extended intraday credit to broker-dealers as cash borrowers, to extremely high levels of risk.[247] Several times during the financial crisis, the tri-party repo market came dangerously close to collapsing, most notoriously in connection with the near-failure of Bear Stearns Companies Inc. ("Bear Stearns") and the failure of Lehman Brothers, both of which were major dealer-participants in the tri-party repo markets.[248] To preserve stability in the vitally important tri-party repo market, the federal government took a series of extraordinary measures.[249] On March 16, 2008, in the wake of the emergency acquisition of Bear Stearns by JPMCC, the Board established the Primary Dealer Credit Facility ("PDCF"), which allowed securities broker-dealers to obtain short-term secured financing directly from the Federal Reserve Bank of New York ("FRBNY").[250] On September 14, 2008, the day before Lehman Brothers declared bankruptcy, the Board expanded the

246. *Id.* at 8. Such securities were rated primarily investment-grade and included corporate bonds, asset-backed securities, money market instruments, collateralized mortgage obligations and municipal bonds. *Id.* at n.7. According to the Task Force Report:

> Tri-party repo grew from its origin as a funding instrument for U.S. Treasuries to include nearly all securities held by Dealers. The growth of the tri-party repo market mirrored the growth of Dealer balance sheets. The market evolved from a strictly overnight market to include significant term trading.

TASK FORCE REPORT, *supra* note 242, at 14.

247. For a detailed explanation of the mechanics of the clearing banks' intraday exposure, see FRBNY WHITE PAPER, *supra* note 241, at 9–11.

248. *See* TASK FORCE REPORT, *supra* note 242, at 4.

249. For detailed information on the special facilities established to provide liquidity to securities broker-dealers, see *Credit and Liquidity Programs and the Balance Sheet*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/bst_lendingprimary.htm (last updated Feb. 5, 2010).

250. FIN. CRISIS INQUIRY COMM'N, PRELIMINARY STAFF REPORT: GOVERNMENTAL RESCUES OF "TOO-BIG-TO-FAIL" FINANCIAL INSTITUTIONS 21–23 (2010) [hereinafter FCIC "TBTF" REPORT]. Expanding access to liquidity backup facilities of the Federal Reserve System beyond depository institutions was an unprecedented step. *See id.* at 22. To establish the PDCF, the Board used its authority under section 13(3) of the Federal Reserve Act, which required the Board to make a finding of "unusual and exigent circumstances." 12 U.S.C. § 343 (2006) (amended 2010).

PDCF by broadening the acceptable collateral to include all forms of collateral accepted in the tri-party repo market.[251]

Simultaneously with the expansion of the PDCF, the Board amended Regulation W to provide a temporary exemption from the requirements of section 23A to allow banks to provide their affiliates (primarily securities broker-dealers) with short-term financing for "securities or other assets that the affiliate ordinarily would have financed through the U.S. tri-party repurchase agreement market."[252] This exemption was designed to facilitate the ability of securities broker-dealers to continue financing their securities inventories despite the liquidity shortage in the tri-party repo market. To protect the safety and soundness of the banks, the Board imposed several conditions on the exemption, including the requirement that the banks could use the exemption to finance only those asset types that the affiliate financed in the tri-party repo market during the week preceding the establishment of the PDCF.[253] The Board also required that the transactions be "marked to market daily," be "subject to daily margin maintenance requirements," and that "the member bank [be] at least as over-collateralized . . . as the affiliate's clearing bank was" in its tri-party repo transaction with the affiliate on September 12, 2008.[254] To ensure that the banks used the exemption only to help provide liquidity to the U.S. tri-party repo market, the Board required that the aggregate risk profile of the exempt transactions not exceed the aggregate risk profile of the affiliate's tri-party repos on September 12, 2008.[255] The Board also conditioned the exemption on the bank's top BHC guaranteeing the affiliate's obligations to the bank.[256] Finally, the Board reserved the right to specifically prohibit

251. FCIC "TBTF" REPORT, *supra* note 250, at 24. Previously, only investment-grade debt securities were acceptable PDCF collateral.

252. Transactions Between Member Banks and Their Affiliates, 74 Fed. Reg. 6,225, 6,225 (Feb. 6, 2009). The Board initially adopted an interim rule granting this exemption. *See* Transactions Between Member Banks and Their Affiliates, 73 Fed. Reg. 54,307 (Sept. 19. 2008). The final rule, adopted on January 30, 2009, essentially restated the exemption in the interim rule but reflected an extension of the exemption past the originally scheduled expiration date. The final rule provided that the exemption expired on October 30, 2009. Transactions Between Member Banks and Their Affiliates, 74 Fed. Reg. at 6,225. The PDCF expired on February 1, 2010. *See Primary Dealer Credit Facility*, FED. RESERVE BANK OF N.Y., http://www.newyorkfed.org/markets/pdcf.html (last visited Apr. 29, 2011).

253. 12 C.F.R. § 223.42(n)(1)(i) (2010).

254. § 223.42(n)(1)(ii).

255. § 223.42(n)(1)(iii).

256. § 223.42(n)(1)(iv). Instead of the guarantee, the parent company could also post additional liquid, high-quality collateral. *See id.*

any bank from using this exemption or to impose additional conditions.[257] As the Board pointed out, the market-terms requirement of section 23B provided additional protection for banks' safety and soundness.[258]

All of the cases discussed above clearly illustrate the new crisis-driven decision making in the context of the Board's interpretation of section 23A. Faced with the sudden disappearance of credit and liquidity in various segments of capital markets, the Board found compelling public interest in lifting the statutory restrictions on affiliate transactions and allowing commercial banks to effectively finance rescue efforts. Despite the Board's efforts to include formal requirements and conditions ostensibly meant to ensure that the exemptions were consistent with the purposes of section 23A, the pressing need to prevent further market instability clearly outweighed the twin statutory purposes of protecting depository institutions from their affiliates' risk and, more importantly, preventing the transfer of federal subsidy outside the depository system.

B. *Saving Wall Street: Corporate Reorganizations on a New Scale*

A similar but conceptually separate trend in the Board's use of exemptive power under section 23A during the recent financial crisis involved removing the statutory limitations to allow or facilitate extraordinary corporate reorganizations that served to prevent potential systemic effects of the failure of major financial institutions.[259]

1. Exemptions Facilitating Emergency Mergers

The first big emergency merger of the crisis took place on March 16, 2008, when JPMCC agreed to acquire Bear Stearns, the fifth largest U.S. investment bank that experienced a sudden liquidity squeeze related to its large exposure to toxic mortgage assets.[260] To

257. § 223.42(n)(1)(v) ("[T]he member bank has not been specifically informed by the Board ... that the member bank may not use this exemption.").

258. Transactions Between Member Banks and Their Affiliates, 74 Fed. Reg. at 6,227.

259. For an insightful analysis of these extraordinary reorganizations, see generally Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009) (examining the U.S. government's actions during the financial crisis).

260. GARY SHORTER, CONG. RESEARCH SERV., RL 34420 BEAR STEARNS: CRISIS AND "RESCUE" FOR A MAJOR PROVIDER OF MORTGAGE-RELATED PRODUCTS 1 (2008), *available at* http://assets.opencrs.com/rpts/RL34420_20080326.pdf. For a detailed discussion of the events surrounding the failure of Bear Stearns and its acquisition, which was orchestrated and financed with unprecedented government assistance, see *id.*

facilitate the acquisition, the Board authorized the FRBNY to provide a $29-billion nonrecourse loan to JPMCC, at the discount rate, collateralized by $30 billion worth of Bear Stearns's assets.[261] JPMCC assumed exposure to the first $1 billion in losses on the assets, which were placed in a separate vehicle, Maiden Lane LLC.[262]

Merging Bear Stearns's operations into JPMCC's vast corporate structure presented a significant challenge, especially in the context of the worsening credit crisis. To accomplish this task, JPMCC repeatedly requested exemptions from the quantitative and qualitative requirements of section 23A. Thus, on April 1, 2008, the Board granted an exemption to allow JPMC Bank to extend credit to, and issue guarantees on behalf of, the former Bear Stearns entities, up to an aggregate amount equal to fifty percent of JMPC Bank's capital stock and surplus.[263] The exemption was granted for eighteen months, with the initial exempt amount to be gradually reduced over that period.[264] Citing prior precedent, in which it granted exemptions from section 23A for corporate reorganizations and securities financing transactions, the Board stressed that this exemption was necessary to facilitate the orderly integration of Bear Stearns with and into JPMCC and, therefore, had "substantial public benefits."[265] The Board's list of conditions appears quite short: all exempt transactions had to be fully collateralized and were subject to daily mark-to-market and remargining, and JPMCC had to guarantee the affiliates' obligations to JPMC Bank.[266]

That initial exemption was largely replaced by another exemption, granted to JPMCC on July 1, 2008, which allowed JPMC Bank to purchase from JPMCC the derivatives portfolio, along with

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261. *Id.* at 7. The assets were marked to market at the time of the transfer. The majority of the assets were mortgage-backed securities and related products. *Id.*

262. *Id.* The transaction was structured so that, technically, Maiden Lane LLC borrowed approximately $28.8 billion from the FRBNY in the form of a senior loan, which, together with $1.15 billion borrowed from JPMCC in the form of a subordinated loan, was used by Maiden Lane LLC to purchase the portfolio of assets from Bear Stearns, with an estimated market value, as of March 14, 2008, of approximately $30 billion. *See Maiden Lane Transactions*, FED. RESERVE BANK OF N.Y., http://www.ny.frb.org/markets/maidenlane.html (last visited Apr. 29, 2011).

263. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Kathleen A. Juhase, Senior Vice President and Assoc. Gen. Counsel, JPMorgan Chase & Co. 3 (Apr. 1, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20080403/20080403.pdf.

264. *Id.*

265. *Id.*

266. *Id.* at 2–3. The Board also stressed that the transactions would remain subject to the requirements of section 23B. *Id.* at 3.

associated hedges, acquired from Bear Stearns.[267] The total value of the exempt transaction was approximately $44 billion.[268] The Board reasoned that this exemption would increase the profitability and efficiency of JPMC Bank's existing derivatives business and benefit derivatives markets at large by increasing their overall liquidity.[269] The Board conditioned the exemption on several commitments, generally similar to typical commitments in precedent dealing with ordinary corporate reorganizations.[270]

The third exemption from the requirements of section 23A permitted JPMC Bank to enter into back-to-back swaps with JPMCC and Maiden Lane, designed to transfer synthetically risky positions embedded in a portfolio of hedging transactions related to mortgage-backed securities and other assets purchased by Maiden Lane from Bear Stearns.[271] The Board concluded that granting this exemption was in the public interest because it would "facilitate the consummation of the FRBNY facility" supporting JPMCC's acquisition of Bear Stearns.[272] The Board's interpretation was short and scarce on details, and essentially based on the fact that JPMC Bank was merely passing risk directly from JPMCC to Maiden Lane and that its exposure to JPMCC would be fully collateralized by cash.[273] The Board stressed that, in effect, the risk would be passed on to the FRBNY, which had the predominant economic interest in Maiden Lane.[274]

267. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Kathryn V. McCulloch, Senior Vice President & Assoc. Gen. Counsel, JPMorgan Chase & Co. 5 (July 1, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20080701/20080701.pdf.

268. *Id.* at 3. The derivatives portfolio included, among other types, foreign exchange and credit derivatives. *See id.* at n.2.

269. *Id.* at 4.

270. *See id.* at 4–6. Thus, JPMCC committed not to transfer any low-quality assets to JPMC Bank, to make a cash capital infusion to ensure that the bank's capital ratios were not affected as a result of the transaction, and to protect the bank from losses in connection with deterioration in the creditworthiness of the portfolio derivatives counterparties for a period of five years after the date of the exemption. *Id.* at 4–5.

271. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Kathleen A. Juhase, Senior Vice President & Assoc. Gen. Counsel, JPMorgan Chase & Co. 1 (June 26, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20080626/20080626.pdf.

272. *Id.* at 3.

273. *Id.* It is unclear from the Board's letter why the transfer had to be structured as a back-to-back series of swaps, with the bank being an intermediary passing on the risk. Most likely, this was due to regulatory and capital arbitrage.

274. *Id.*

The Board also granted exemptions from the limits of section 23A and Regulation W to both WFC and BAC to facilitate their internal reorganization efforts aimed at integrating the newly acquired businesses of Wachovia and Merrill Lynch & Company, Inc. ("Merrill Lynch"), respectively. In October 2008, WFC acquired deeply troubled Wachovia, whose flagship Wachovia Bank was the fourth-largest U.S. depository institution at the time, in a dramatic saga aptly described elsewhere.[275] On November 20, 2008, the Board lifted the statutory restrictions to allow Wells Fargo Bank, N.A. ("Wells Fargo Bank"), to extend up to $17 billion in credit to Wachovia Bank, to help it meet its short-term funding obligations during the transition period until the merger was completed.[276] Although the amount of the proposed extensions of credit was close to forty percent of Wells Fargo Bank's capital stock and surplus, the Board reasoned that these were transactions between two depository institutions and that imposing certain conditions would provide sufficient protection to Wells Fargo Bank.[277] The Board concluded that, in light of the fragility in the financial markets, allowing Wells Fargo Bank to provide liquidity to Wachovia Bank would have significant public benefits.[278]

275. *See, e.g.*, Too Big to Fail: Expectations and Impacts of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm'n (Sept. 1, 2010), http://fcic.law.stanford.edu/hearings/testimony/too-big-to-fail-expectations-and-financial-crisis. Wachovia sustained heavy losses in 2008 as a result of its exposure to subprime residential mortgages, commercial mortgages, and CDOs. Robert K. Steel, former President & Chief Exec. Officer, Wachovia Corporation, Statement Before the Fin. Crisis Inquiry Comm'n 1 (Sept. 1, 2010), http://fcic.law.stanford.edu/hearings/testimony/too-big-to-fail-expectations-and-financial-crisis. The bulk of that risk was associated with a portfolio of mortgage assets Wachovia inherited from Golden West, a large California-based thrift it acquired in 2006. *Id.*

276. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to John David Wright, Chief Regulatory Counsel, Wells Fargo Bank, N.A. 3 (Nov. 20, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081120/20081120.pdf.

277. *Id.* at 3. One of the most interesting conditions in this letter was the requirement that all extensions of credit under the exemption had to be secured by collateral with the current market value of at least 200% of the extension of credit, and that such collateral would not include any low-quality assets. In addition, Wells Fargo Bank agreed to other, more typical, conditions, such as the commitment that all extensions of credit would be marked to market on a daily basis and be subject to daily margin maintenance requirements. WFC committed to reimburse Wells Fargo Bank for any losses in connection with the proposed transactions and to ensure that both entities remained well capitalized at all times. As usual, the extensions of credit would be subject to requirements of section 23B. *See id.*

278. *Id.* The exemption was set to expire upon the completion of the acquisition of Wachovia by WFC. *See id.*

On September 3, 2010, the Board granted an exemption to BAC to allow the transfer of certain credit facilities originated by Merrill Lynch to BANA, as part of its efforts to consolidate and integrate its operations.[279] Even though the amount of the transfer was within the limits of section 23A,[280] BANA sought the exemption "to preserve all of its capacity under the 20 percent limit to engage in transactions with all its affiliates" so it could "use bank resources to meet its overnight funding requirements and other contingency needs."[281] The Board treated this request as a routine internal reorganization matter and conditioned the exemption on compliance with typical commitments, consistent with its precedent.[282]

2. Facilitating Conversions to Bank Holding Companies: New Regulatory Arbitrage

A different kind of corporate reorganization that emerged during the financial crisis involved radical changes in the regulatory status of certain large financial institutions that voluntarily sought to become subject to the full panoply of U.S. banking laws and regulations—a result they took pains to avoid in prior decades.[283]

On September 21, 2008, the Board approved expedited applications by Goldman Sachs and Morgan Stanley, the last two free-standing Wall Street investment banks, to convert into BHCs.[284]

279. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Phillip A. Wertz, Assistant Gen. Counsel, Bank of Am. Corp. 4 (Sept. 3, 2010), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2010/20100903/20100903a.pdf.

280. At the time, BANA's quantitative limit for covered transactions with any single affiliate was approximately $15 billion. *Id.* at 2.

281. *Id.*

282. *Id.* Thus, BAC committed (1) not to transfer any low-quality assets as part of the transaction; (2) for a period of four years, to reimburse BANA for losses on the assets that become low-quality; (3) to ensure that BANA holds capital cushion in the amount equal to 100% of the value of any transferred assets that become low-quality; and (4) to maintain the "well capitalized" status of both BANA and BAC. The transaction was also subject to prior approval by BANA's directors. *Id.* at 3–4.

283. Under the BHC Act, any entity that owns or controls a U.S. bank becomes subject to certain strict limitations on its direct and indirect activities and investments, designed to maintain the principle of separation of banking and commerce central to the U.S. system of bank regulation. 12 U.S.C.A. § 1841(a) (West 2001 & Supp. 2011) (defining the term "bank holding company"); 12 U.S.C.A. §§ 1842–1843 (West 2001 & Supp. 2011) (setting forth the limitations on the activities and investments of U.S. BHCs). Investment banks and other financial companies that did not own or control a U.S. bank, within the meaning of the statute, were free of such activity restrictions, which gave them a significant competitive advantage.

284. *See* Order Approving Formation of Bank Holding Companies, 94 FED. RES. BULL. C101, C102 (2008), *available at* 2008 WL 7861871, at *4 (order approving Goldman

These events were both shockingly unexpected and foreseeable. Immediately after Lehman Brothers had filed for bankruptcy, Morgan Stanley came under intense pressure not only from its trading counterparties and short-term creditors but also from short-sellers.[285] Federal regulators felt increasingly concerned that Morgan Stanley's failure at that critical moment would have potentially devastating effects on the fragile market and bring down one of its main trading partners, Goldman Sachs.[286] The announcement of the Board's simultaneous approval of the BHC status for both of these institutions was widely interpreted as a clear signal that the federal government would not let either of them fail.[287] Conversion to BHCs, and the concomitant conversion of their existing thrifts and industrial banks[288] into commercial banks, gave Morgan Stanley and Goldman Sachs assured access to the discount window and other government support programs, including the Treasury Department's Troubled Asset Relief Program ("TARP").[289]

On April 22, 2009, the Board granted both Goldman Sachs and Morgan Stanley exemptions from the requirements of section 23A, to facilitate their internal reorganization as part of the conversion into

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Sachs Group's request to become a BHC on conversion of Goldman Bank to a state-chartered bank); Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities, 94 FED. RES. BULL. C103, C105 (2008), *available at* 2008 WL 7861872, at *5 (order approving Morgan Stanley's request to become a BHC on conversion of Morgan Stanley Bank to a bank).

285. FCIC "TBTF" REPORT, *supra* note 250, at 28.

286. *Id.*

287. *See, e.g.*, DAVID WESSEL, IN FED WE TRUST 217–18 (2009) (stating that the conversion into BHCs gave both Goldman Sachs and Morgan Stanley "the Fed's public promise of protection and a permanent source of lending in a crisis").

288. An industrial bank (or an industrial loan company) is a state-chartered depository institution that is not considered a "bank" for the purposes of the BHC Act and, therefore, does not subject its parent company to federal regulation and supervision as a BHC. *See* 12 U.S.C.A. § 1841(c)(2)(H); *see also* Kenneth Spong & Eric Robbins, *Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate*, ECON. REV., 4th Quarter 2007, at 41, 44, *available at* www.kc.frb.org/Publicat/Econrev/PDF/4Q07Spong.pdf (describing the rapid growth of industrial loan companies and public policy issues associated with industrial loan companies).

289. The Emergency Economic Stabilization Act of 2008 ("EESA"), which Congress passed on October 3, 2008, authorized $700 billion in TARP funds to be used in tranches to purchase troubled assets from financial institutions. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765. TARP officially expired on October 3, 2010. For complete information on the operation and impact of TARP, see *Financial Stability*, U.S. DEP'T OF THE TREASURY, http://www.financialstability.gov/ (last visited Apr. 29, 2011); *see also* Lissa L. Broome, *Government Investment in Banks: Creeping Nationalization or Prudent, Temporary Aid?*, 4 FLA. INT'L U. L. REV. 409, 410–21 (2009) (detailing the early evolution and analyzing the effects of TARP).

BHCs.[290] In these nearly identical letters, the Board allowed the newly converted banks, Goldman Sachs Bank USA ("Goldman Bank") and Morgan Stanley Bank, N.A. ("MS Bank"), to acquire certain entities and assets from their parent companies and to provide short-term financing (through repos, securities borrowing, and other transactions) to their nonbank affiliates on a transitional basis, in the amounts exceeding the quantitative limits of section 23A.[291]

With respect to the purchase of assets,[292] the Board likened them to other one-time asset transfers routinely approved in the past and, in each case, granted a temporary exemption for such purchases, subject to certain conditions.[293] However, in addition to typical conditions imposed in similar situations, the exemption was conditioned on the requirement that the parent company must, at the request of the Board or the OCC (in the case of MS Bank), repurchase the transferred assets from the bank at the bank's original purchase price.[294] The Board also required the parent to secure its obligations by pledging to the bank collateral that was acceptable to the Board and in an amount equal to a certain percentage of the aggregate covered-transaction amount for the life of the transferred assets.[295] The parent's commitment to reimburse the bank for the

290. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Michael Civitella, Chief Exec. Officer & President, Goldman Sachs Bank USA 7 (Apr. 22, 2009) [hereinafter GS Reorganization Letter], *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2009/20090422/20090422b.pdf; Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Paul E. Glotzer, Cleary Gottlieb Steen & Hamilton LLP (Morgan Stanley Bank) 7 (Apr. 22, 2009) [hereinafter MS Reorganization Letter], *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserveAct/2009/20090422/20090422.pdf.

291. GS Reorganization Letter, *supra* note 290, at 6; MS Reorganization Letter, *supra* note 290, at 7. The proposed extensions of credit were designed to provide financing to the banks' affiliates during the transitional period before the parent company completed the transfer of the assets to the bank. These financing transactions were to be secured by the assets subject to such transfer. *See* GS Reorganization Letter, *supra* note 290, at 5.

292. These assets included, among other things, loan assets, various securities, mortgage servicing rights, and derivatives. Goldman Bank also acquired several operating subsidiaries, including a multipurpose OTC derivatives dealer, a mortgage lending company, and several other specialized lending entities. *See id.* app. A.

293. *See id.* at 3; MS Reorganization Letter, *supra* note 290, at 3. Under the Board's exemptions, both Goldman Bank and MS Bank had to complete the purchases within a specified period, which in the case of MS Bank was approximately five months from the date the exemption was granted. *See* GS Reorganization Letter, *supra* note 290, at 5; MS Reorganization Letter, *supra* note 290, at 4.

294. *See* GS Reorganization Letter, *supra* note 290, at 4; MS Reorganization Letter, *supra* note 290, at 4.

295. *See* GS Reorganization Letter, *supra* note 290, at 4; MS Reorganization Letter, *supra* note 290, at 4. The exact percentage requirement for this parent guarantee collateral was redacted in the public version of each letter.

losses associated with deterioration in the quality of any transferred assets was also extended for the lifetime of the transferred assets, as opposed to the more typical two-to-five-year period.[296] Finally, the bank had to maintain specified capital ratios that were higher than the legally required minimum.[297]

With respect to extensions of credit to affiliates, the Board also imposed several conditions.[298] In addition, the parent company committed to fully guarantee the affiliates' repayment obligations and post collateral supporting such guarantee in an amount equal to a specified percentage of each financing transaction.[299] These unusual additional conditions were clearly meant to provide stronger protection for the safety and soundness of the newly formed banks than was typically the case in the Board's prior precedent. Subject to these conditions, the Board reasoned that the exemptions were in the public interest because the reorganization would enhance the banks' profitability and allow them to extend additional credit into the markets still embroiled in a severe credit crisis.[300]

Although Goldman Sachs and Morgan Stanley were by far the most high-profile cases of this peculiarly crisis-driven kind of regulatory arbitrage, a number of other large financial institutions

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296. *See* GS Reorganization Letter, *supra* note 290, at 4; MS Reorganization Letter, *supra* note 290, at 3–4.

297. *See* GS Reorganization Letter, *supra* note 290, at 4; MS Reorganization Letter, *supra* note 290, at 4. Thus, Goldman Bank committed to maintain a leverage ratio of at least six percent, a Tier 1 risk-based capital ratio of at least eight percent, and a total risk-based capital ratio of at least eleven percent. GS Reorganization Letter, *supra* note 290, at 5. The ratios applicable to MS Bank were redacted in the public version of the letter.

298. *See* GS Reorganization Letter, *supra* note 290, at 5–6; MS Reorganization Letter, *supra* note 290, at 5. These conditions included the requirement that all such extensions of credit had to be overnight financing transactions, fully secured, marked to market daily, subject to daily margin maintenance, and that the collateral securing the loans was of sufficient credit quality. GS Reorganization Letter, *supra* note 290, at 5–6; MS Reorganization Letter, *supra* note 290, at 5.

299. *See* GS Reorganization Letter, *supra* note 290, at 5–6; MS Reorganization Letter, *supra* note 290, at 5. Morgan Stanley committed that all of the proposed financing transactions were qualified securities contracts, so that MS Bank would be able to promptly liquidate them in the event of bankruptcy of the borrowing affiliate. Since Goldman Bank was not able to give such assurance, it agreed to cap the total amount of the exempted financing transactions and to conduct such transactions only until a specific cut-off date. GS Reorganization Letter, *supra* note 290, at 6.

300. GS Reorganization Letter, *supra* note 290, at 6; MS Reorganization Letter, *supra* note 290, at 6. The Board also stressed that, in each case, the exempt transactions remained subject to the market-terms requirements of section 23B and that, consistent with previous exemption requests, the proposed transactions had been approved by the directors of the bank. *Id.*

converted into BHCs.[301] Thus, CIT Group, Inc. ("CIT"), one of the largest U.S. commercial lending companies, received its BHC status in December 2008.[302] On April 13, 2009, CIT also received an exemption from the quantitative and qualitative limits of section 23A, allowing its newly converted CIT Bank to acquire all of the shares of three affiliates engaged primarily in holding and securitizing federally guaranteed student loans in the aggregate amount of $5.66 billion.[303] The Board emphasized that the government guarantee of the transferred student loans effectively eliminated the risk to CIT Bank but, nevertheless, made the exemption subject to standard conditions for one-time asset transfers in corporate reorganizations.[304]

Ironically, however, it is the relatively uncomplicated and low-risk CIT case that illustrates the limited efficacy of the Board's standard conditions to exemptions of asset transfers from the requirements of section 23A. Despite the $2.33 billion capital injection from TARP, CIT filed for bankruptcy on November 1, 2009.[305] Although it emerged from bankruptcy in thirty-eight days, the

301. These included, for example, American Express and General Motors Assurance Corporation ("GMAC"). *See* Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities, 95 FED. RES. BULL. B20, B22 (2009), *available at* 2009 WL 6529111, at *5 (order approving American Express Company's request to become a BHC on conversion of American Express Centurion Bank to a bank); Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities, 95 FED. RES. BULL. B29, B33 (2009) [hereinafter GMAC BHC Order], *available at* 2009 WL 6529114, at *7 (order approving GMAC's request to become BHCs on conversion of GMAC to a commercial bank).

302. *See* Order Approving Formation of a Bank Holding Company and Notice to Engage in Certain Nonbanking Activities, 95 FED. RES. BULL. B26, B29 (2009), *available at* 2009 WL 6529113, at *5 (order approving CIT Group, Inc.'s request to become a BHC on conversion of CIT Bank to a state bank).

303. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to William J. Sweet, Jr., Skadden, Arps, Slate, Meagher & Flom LLP 4 (CIT Group, Inc.) (Apr. 13, 2009), *available at* http://www.federalreserve.gov/boarddocs/legalint/Federal Reserve Act/2009/20090413/20090413.pdf.

304. *Id.* at 3. These conditions included a five-year commitment by CIT to reimburse CIT Bank for losses in connection with the deteriorating quality of the transferred assets, an agreement to make a cash capital contribution to CIT Bank in the amount equal to the book value of any low-quality assets transferred to the bank and to ensure the bank would hold a 100% capital cushion for all such low-quality assets. Both CIT and CIT Bank committed to stay well-capitalized, and the board of directors of CIT Bank had to approve the transactions. *Id.* at 5–6.

305. Press Release, CIT Group, Inc., CIT Board of Directors Approves Proceeding with Prepackaged Plan with Overwhelming Support of Debtholders (Nov. 1, 2009), *available at* http://ir.cit.com/phoenix.zhtml?c=99314&p=irol-newsArticle&ID=1349179 &highlight.

restructuring took a serious toll on the company.[306] In granting exemptions from section 23A, the Board tends to rely heavily on the BHCs' commitments to protect the bank from losses and to maintain the "safe" level of capital. This assumption may not be free of doubt even in the best of circumstances, and in periods of market turmoil it becomes largely indefensible, as the CIT example has clearly shown. Making a determination that a specific bank is duly protected from assuming excessive risk through transactions with affiliates requires more than a formalistic requirement of a parent company's guarantee. Instead, it may require a more substantive examination of the parent company's overall risk profile and financial stability.

It is clear that, in all of these cases of crisis-driven corporate reorganizations, the grant of exemptions from the quantitative and qualitative limits of section 23A played an ancillary role. Substantive policy decisions to allow, and even facilitate, mega-mergers and emergency conversions were made in a different regulatory context and on the basis of different considerations. Exemptions from the statutory limits on affiliate transactions were necessary to successfully carry out these internal reorganizations.

Nevertheless, these transactions were far from ordinary and had serious implications for broadening access to the federal safety net and further exacerbating the problem of moral hazard. Although preventing excessive consolidation and concentration in the financial industry was not originally part of the legislative intent, restrictions on bank affiliate transactions under section 23A can potentially serve as a check on that process, an opportunity for subjecting these trends to additional regulatory scrutiny. The Board's decisions to remove such restrictions contributed, albeit only indirectly, to the increasing concentration of economic power in a small number of financial institutions that became too big, or too important, to fail.

C. *Saving the U.S. Automotive Industry: The Curious Case of GMAC*

Without a doubt, the most extraordinary and unprecedented expansion of the federal safety net in direct contravention of the

306. *See* Michael J. de la Merced, *CIT Leaves Bankruptcy, with Questions*, N.Y. TIMES, Dec. 10, 2009, at B7.

underlying purposes of section 23A was the Board's treatment of General Motors Assurance Corporation ("GMAC").[307]

GMAC was established in 1919 as a captive financing arm of General Motors ("GM"), one of the largest automakers in the United States.[308] In accordance with industry practice, GMAC provided the bulk of consumer financing for buyers of GM vehicles and wholesale floorplan financing for GM dealers.[309] Although GM spun off GMAC in 2006,[310] the company remained the principal source of credit supporting retail and wholesale sales of GM's automobiles.[311] During the pre-crisis asset and credit boom, GMAC moved away from its core mission of providing auto-financing and became heavily involved in the origination and securitization of subprime residential mortgages, relying principally on short-term funding markets.[312] The subprime mortgage crisis exposed GMAC to large losses and threatened the company's collapse.[313] To avoid bankruptcy, GMAC began negotiating a conversion into a BHC with the Board in November 2008.[314]

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307. In 2010, GMAC changed its name to Ally Financial Inc. ("Ally Financial"). *See Our History*, ALLY, http://www.ally.com/about/company-structure/history/index.html (last visited Apr. 29, 2011).

308. *See Who We Are*, ALLY, http://www.ally.com/about/ally-story/ (last visited Apr. 29, 2011).

309. COP REPORT, *supra* note 13, at 27–30. In the United States, nearly all automobile dealers, "which typically operate as independent franchises affiliated with one or more automobile manufacturer[s]," finance their wholesale purchases of automobiles through so-called floorplan financing. *Id.* at 6. According to a recent influential report,

> A floorplan loan is essentially a two-party contract between the automobile manufacturer and the dealer, with the lender serving as a third-party financier. In a typical floorplan loan, a dealer agrees to purchase a certain number of cars from a manufacturer for a set price. The lender will advance the amount of the purchase price of the automobiles to the dealer and, in turn, take a security interest in the automobiles as collateral for the loan.

Id. at 8.

310. *See id.* at 13. A consortium led by Cerberus Capital Management L.P., one of the largest U.S. private equity funds, acquired a 51% controlling interest in GMAC. *Id.* GM retained a 49% stake in the newly independent GMAC. *See id.* As a condition of the government rescue of GMAC in December 2008, both companies were forced to significantly reduce their ownership stakes in May 2009. *Id.* at 20–22.

311. After the spin-off, the historical relationship between GM and GMAC as its "captive financing arm" was effectively replicated on a contractual basis. *Id.* at 10.

312. *See id.* at 39, 41.

313. *Id.* at 17. Thus, during 2007, GMAC posted a $2.3 billion loss as a result of its exposure to troubled mortgage markets. *Id.*

314. According to the COP Report, the main reason behind GMAC's push to become a BHC was to gain access to federal bailout funds and other forms of government

In December 2008, the U.S. automotive industry was on the brink of bankruptcy.[315] On December 19, 2008, President Bush announced the administration's Automotive Industry Financing Program ("AIFP") that would use TARP to rescue the failing carmakers.[316] On December 24, 2008, the Board granted an expedited approval of GMAC's application to become a BHC.[317] Almost immediately upon its conversion to BHC, GMAC received its first $5.25 billion in TARP bailout funds.[318] In addition, GMAC Bank[319] received access to discount window borrowing and other special liquidity facilities available to depository institutions, including the Term Auction Facility ("TAF") administered by the Board.[320]

However, section 23A severely limited GMAC Bank's ability to extend credit to GM's customers and dealers, by virtue of the attribution rule.[321] Thus, on the same day that GMAC was approved to become a BHC, GMAC Bank received its first exemption from the quantitative and qualitative limits of section 23A for providing consumer credit to purchasers of GM cars.[322] The Board's justification

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assistance. *See id.* at 18. At the time, it was not clear whether TARP funds would be available to nonbanking financial institutions. *See id.* at 8–19.

315. *See* John D. Stoll et al., *Big Three Seek $34 Billion Aid—GM, Chrysler Warn of Collapse This Month as Lawmakers Explore Bankruptcy*, WALL ST. J., Dec. 3, 2008, at A1.

316. *See* Neil Irwin, *Treasury Maintains Leeway in Auto Aid*, WASH. POST, Jan. 1, 2009, at D1; David E. Sanger et al., *Bush Aids Detroit, But Hard Choices Wait for Obama*, N.Y. TIMES, Dec. 20, 2008, at A1.

317. GMAC BHC Order, *supra* note 301, at B29–B30. Ordinarily, section 3 of the BHC Act requires the Board to provide a notice of an application to the appropriate federal or state banking regulators and supervisors of the banks to be acquired and provide such regulators and supervisors with a certain period (usually thirty days) to submit their views and recommendations. Bank Holding Company Act, 12 U.S.C.A. § 1842(b)(1) (West 2001 & Supp. 2011). In the case of GMAC, the Board expedited the process and granted the approval without such waiting period. GMAC BHC Order, *supra* note 301, at B30.

318. *See* COP REPORT, *supra* note 13, at 44–45. The Board conditioned its approval of GMAC's BHC application on the company raising $7 billion in capital. *Id.* at 44. The Treasury Department's capital injection was meant to assist GMAC in meeting that goal. *Id.* at 44–46.

319. As part of its conversion into a BHC, GMAC converted its Utah-chartered industrial bank, GMAC Bank, into a national bank, which was later renamed Ally Bank. *Id.* at 21, 23.

320. *Id.* at 55. TAF was created in order to provide liquidity to depository institutions by allowing them to borrow funds against a broad range of collateral, to compensate for the severe contraction in interbank lending during the crisis. The last TAF auction was held on March 8, 2010. For details, see *Term Auction Facility*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/monetarypolicy/taf.htm (last visited Apr. 29, 2011).

321. *See supra* note 35 and accompanying text.

322. Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Richard K. Kim, Wachtell, Lipton, Rosen & Katz (GMAC Bank) 4 (Dec. 24, 2008)

for the exemption was clear: allowing GMAC Bank to extend credit beyond the statutory limit would benefit the public by providing "an important source of financing for U.S. retail purchases of GM vehicles from independent dealers and avoid further disruption in the credit market for such purchases."[323] The exemption was, as always, subject to several conditions. One set of conditions aimed at ensuring that GMAC Bank used the exemption to provide consumer credit only to customers of GM dealers not affiliated with GM and that it did not extend high-risk consumer loans.[324] The Board also imposed a set of standard conditions based on its long-standing precedent. These included a specific limit on the aggregate amount of the exempt transactions, a commitment by GMAC to reimburse GMAC Bank on a quarterly basis for losses on the loans that become low-quality assets, and a commitment by GMAC Bank to hold a dollar-for-dollar risk-based capital against any such loans.[325]

In addition to these typical commitments, the Board mandated that GMAC pledge to GMAC Bank collateral acceptable to the Board, in the "amount equal to 10% of the aggregate covered transactions amount, for the life of the exemption."[326] This collateral was meant to secure GMAC's obligations under its parent guarantee.[327] On its face, this additional commitment seems to convey the Board's resolve to ensure that GMAC, as the parent company, bears the credit risk associated with GMAC Bank's retail auto-financing beyond statutory limits. However, placing this decision in the context of GMAC's ongoing saga highlights how little these commitments meant in reality.

In May 2009, at the conclusion of the series of "stress tests" of the nation's largest BHCs, the Board announced that GMAC needed

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[hereinafter 2008 GMAC Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081224/20081224.pdf.

323. *Id.* at 4.

324. *Id.* at 3. Thus, the exemption required that loans were to be extended only to retail customers with a certain credit bureau risk score and imposed limits on the maturity, amount, and loan-to-value ratio of each individual loan. *Id.*

325. *Id.* at 3–4.

326. *Id.* at 4. This commitment is similar to the Board's requirements that Goldman Sachs and Morgan Stanley collateralize parent guarantees in the exemptions from section 23A granted to those institutions to facilitate their conversion into BHCs. *See supra* note 299 and accompanying text.

327. *See* 2008 GMAC Letter, *supra* note 322, at 4. If at any point, the value of GMAC's collateral fell below the mandated ten percent level, it had to pledge additional collateral to the bank in order to stay in compliance with the Board's requirement. *Id.*

to raise an additional $11.5 billion in capital.[328] However, GMAC was unsure of its ability to raise the needed amount in private markets, particularly in light of the pending bankruptcy of GM and Chrysler.[329] On May 21, 2009, the Treasury Department made another capital injection of $7.5 billion, part of which was meant to finance GMAC's acquisition of Chrysler Financial's auto-lending assets.[330] As a result of acquiring the financing business of Chrysler Financial, GMAC became even more important as the principal source of credit for auto dealers and retail customers of both GM and Chrysler. The auto makers were particularly dependent on GMAC for their floorplan financing.[331] However, the original exemption from the requirements of section 23A applied only to the extension of consumer credit by Ally Bank.[332]

On May 21, 2009, the Board granted the second request by the renamed Ally Bank for an exemption from the requirements of section 23A to permit it to extend both retail and wholesale loans for new purchases of GM automobiles.[333] With respect to retail loans, this exemption was subject essentially to the same conditions as the original December 2008 exemption.[334] With respect to dealer loans, the Board imposed a similar set of conditions aimed to ensure that

328. COP REPORT, *supra* note 13, at 47. The "stress tests" were part of the Supervisory Capital Assessment Program ("SCAP") conducted by the U.S. bank regulators in early 2009, to ensure that largest U.S. BHCs had enough capital to withstand further worsening of market conditions. *Id.*

329. *Id.* As Treasury officials realized, GMAC was the only BHC included in the SCAP that could not meet the new capital buffer requirements on its own, because its ties to GM, moving toward inevitable bankruptcy, put it in a uniquely difficult situation. *See id.* at 50 (quoting Treasury Secretary Timothy Geithner).

330. *Id.* at 48. On April 30, 2009, when Chrysler filed for bankruptcy, Ally Bank entered into an agreement to provide retail and wholesale financing for the Chrysler dealer network, effectively assuming the auto lending business of Chrysler Financial. *See* Ally Financial Inc., Current Report (Form 8-K) (Aug. 12, 2010).

331. *See* COP REPORT, *supra* note 13, at 66. Unlike consumer financing for individual car purchases, the market for floorplan financing has historically been dominated by a few captive automotive financing companies. *See id.* In late 2008 to early 2009, the floorplan financing market came to a virtual halt. *Id.* at 66–68. Under those circumstances, GMAC's withdrawal from that market could have had catastrophic consequences for the entire automotive industry. *See id.* at 66–72.

332. *See* 2008 GMAC Letter, *supra* note 322, at 1, 5.

333. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Richard K. Kim, Wachtell, Lipton, Rosen & Katz (Ally Bank) 5 (May 21, 2009) [hereinafter 2009 GMAC Letter], *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/20090521/20090521.pdf. Because Ally Bank was not an affiliate of Chrysler, no exemption was necessary for the financing of purchases of Chrysler automobiles. *Id.* at 1.

334. *See id.* at 3; *see also* 2008 GMAC Letter, *supra* note 322, at 3–4 (detailing conditions imposed to limit riskiness and protect GMAC Bank).

the exemption was used to provide floorplan financing only to independent dealers with good credit standing, which were not likely to present an unacceptably high credit risk.[335] In addition, the Board conditioned both retail and dealer loans on the same typical commitments as those included in the original 2008 exemption: the limit on the aggregate amount of the exempt covered transactions, GMAC's commitment to reimburse Ally Bank for losses on any loans that became low-quality assets, the requirement of dollar-for-dollar capital cushion for all low-quality assets, and the mandatory approval of the exemption by a majority of the bank's directors.[336]

However, in contrast to the 2008 exemption, the Board did not require GMAC to post collateral securing its parent guarantee.[337] The Board explained that decision bluntly by referencing the fact that the federal government's support provided sufficient protection for Ally Bank. As the Board stressed, "GMAC's financial position will be strengthened by an additional equity investment by the Treasury. Treasury's support helps ensure that GMAC will be in a position to honor its obligations under the guarantee."[338] In effect, this was an admission that GMAC's parent obligations by themselves were irrelevant, given its financial condition.

Importantly, the Board did not impose any limits on the duration of this extraordinary exemption, which authorized a U.S. federally insured commercial bank to continue funding the business of its affiliated automotive companies far in excess of the statutory and regulatory limits on bank affiliate transactions. In effect, this decision made it clear that the macro-economic goal of saving the U.S. automotive industry justified a complete override of section 23A.

As the Board explicitly acknowledged in the very beginning of its interpretive letter, the Treasury Department was strongly committed to providing substantial financial support for GMAC as the lifeline that was indispensable to the government's efforts to restructure GM and Chrysler.[339] Although GMAC was not considered a systemically important financial institution, Treasury's belief in GMAC's vital role

335. 2009 GMAC Letter, *supra* note 333, at 3–4. Thus, the exemption was available for financing only independent dealers who were current on their existing floorplan loans and who would use it only for new purchases of cars from GM. *Id.* In addition, all dealer loans had to conform to the bank's underwriting standards, be limited to the normal factory invoice amount, and be repaid once the inventory securing it was sold by the dealer. *Id.*

336. *Id.* at 4–5.

337. *Id.* at 3–5.

338. *Id.* at 4.

339. *Id.* at 1.

in keeping the automotive industry alive explains the extraordinary amount of government assistance provided to it,[340] including the Board's expedited approval of its BHC application and successive infusions of TARP funds.[341] The Board's grant of what appeared to be a permanent exemption from the quantitative and qualitative limits of section 23A for Ally Bank's financing of GM's automobile sales was just one of many such forms of extraordinary assistance, driven ultimately by the overarching policy goal of saving the automaker.[342] However, from a bank regulatory perspective, this decision marked an unprecedented change. The Board, the principal guardian of the statutory wall between depository institutions and their affiliates, established a precedent allowing U.S. commercial banks to transfer federal subsidy not only to nonbank financial institutions, but also to nonfinancial, industrial companies affiliated with them.[343]

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340. *See* COP REPORT, *supra* note 13, at 79–82. The COP Report discusses the differences in treatment of GMAC and CIT and argues that the Treasury Department's far greater willingness to use public funds to assist GMAC, rather than CIT, was rooted in the government's view of the GMAC rescue as the rescue of the automotive industry. *See id.*

341. GMAC BHC Order, *supra* note 301, at B30. Thus, as a result of the $17.2 billion public bailout, the U.S. government came to own 56.3% of GMAC's voting equity. *See* Dakin Campbell, *GM's IPO Shows Ally Could Afford to Repay Bailout*, BLOOMBERG BUS. WK. (Sept. 15, 2010), http://www.businessweek.com/news/2010-09-15/gm-s-ipo-shows-ally-could-afford-to-repay-bailout.html.

342. GMAC BHC Order, *supra* note 301, at B30–B31. GM filed for bankruptcy on June 1, 2009, and entered the process of government-assisted restructuring. *See* Linda Sandler et al., *GM Files Bankruptcy to Spin Off More Competitive Firm*, BLOOMBERG (June 1, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4brqCWwvYXY. GM opted for a pre-packaged Chapter 11 restructuring. *Id.* On July 10, 2009, the process was completed and GM's profitable assets were officially sold to its successor-entity, which assumed the name of General Motors Company. *See, e.g.*, John D. Stoll & Sharon Terlep, *GM Takes New Direction*, WALL ST. J., July 11, 2009, at B1. The U.S. government, which provided $50 billion to finance that purchase, ended up owning over sixty percent of the equity in the new GM, and announced its plans to divest its stake through a series of public securities offerings starting in 2010. *Id.* In 2010, GM and Chrysler started showing signs of returning to profitability and began repaying TARP funds, which positively affected GMAC's financial condition and outlook. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-933T, TROUBLED ASSET RELIEF PROGRAM: CONTINUED ATTENTION NEEDED TO ENSURE THE TRANSPARENCY AND ACCOUNTABILITY OF ONGOING PROGRAMS 7–9 (2010). Nevertheless, it remains to be seen whether GMAC will be able to achieve true financial stability and independence in the near future. *Id.*

343. On December 23, 2010, the Board granted the request by Ally Financial not to treat GM as an affiliate of Ally Bank for the purposes of sections 23A and 23B, once the planned restructuring and conversion of preferred stock of Ally Financial held by the Treasury Department and other third parties brings GM's ownership stake in Ally Financial below ten percent of all voting shares. *See* Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd., to Jeffrey Brown, Ally Financial, Inc. 3 (Dec. 23, 2010), *available at* http://www.federalreserve.gov/BoardDocs/LegalInt/FederalReserve

D. *Summary*

This Part detailed how a severe financial crisis, which quickly spread to the broader economy, led the Board to effectively dismantle the section 23A firewall. There may be many different explanations for the Board's choices. In some respects, this may be viewed as a case of regulatory failure. One approach to explaining the Board's failure to safeguard the integrity of the statute may point to some form of regulatory capture, either in its traditional sense or in the more subtle form of ideological capture.[344] Another potential explanation is regulatory incompetence and the inability, or reluctance, of the regulators to recognize and address potential systemic consequences of discrete administrative actions. Yet, the whole picture is far more complex than the familiar interplay of regulatory incompetence, complacency, and complicity.

The Board's use of its exemptive authority under section 23A to permit massive transfers of funds and federal subsidy from depository institutions to the rest of the crisis-ridden financial system was driven primarily by its fear of a total systemic collapse.[345] Whereas the Board's pre-crisis reasoning focused entirely on individual banks' safety and soundness and ignored the systemic aspect of proposed transactions, its crisis-era decision making aimed first and foremost at preserving systemic stability. Under the circumstances, the Board's chosen course of action may have been well justified, if not inevitable.[346] It is hard to deny that lifting statutory restrictions on banks' transactions with affiliates, in order to increase the flow of badly needed credit and liquidity in the markets, served the public interest. However, in order to provide that urgently needed public benefit, the Board had to sacrifice the competing public interest in maintaining separation between banking and commerce. Despite the Board's rhetoric, the crisis-driven exemptions from section 23A, which purposely exposed banks to risks associated with their affiliates' nonbanking business and transferred federal subsidy

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Act/2010/20101223/20101223a.pdf (modifying the conditions of GMAC BHC Order that required Ally Bank to treat GM as an affiliate for the purposes of sections 23A and 23B).

344. For a discussion of regulatory capture in the banking industry, see generally Daniel Hardy, *Regulatory Capture in Banking* (Int'l Monetary Fund, Working Paper No. 06/34, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892925.

345. *See generally* Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1051 (2009) (examining the use of "extraordinary measures to stop the spread of financial distress" during financial crisis containment).

346. *See id.* at 1057.

outside the depository system, were not, and could not have been, consistent with the fundamental purposes of that statute.

If this story, as incomplete and oversimplified as it may be, nevertheless captures the essence of what happened, it raises an important set of questions. What should be done to address this internal conflict in the practical application of section 23A? And what are the broader implications of this phenomenon for the future of financial regulation in the United States?

IV. FIXING THE WALL: POLICY IMPLICATIONS FOR REGULATORY REFORM

In the Dodd-Frank Act, conceived as a major overhaul of the U.S. system of financial regulation, Congress attempted to strengthen the existing section 23A regime by tightening certain statutory requirements. In general, the Act embraces the concept of statutory walls protecting banks from certain risky institutions and activities, such as proprietary trading[347] or certain types of derivatives dealing.[348] However, it does not provide sufficient details on how these arrangements would work in practice, leaving much of that decision making to regulatory agencies.[349] The recent history of section 23A, which illustrates the difficulties associated with maintaining and policing statutory firewalls and the dangers of giving too much discretion to regulators, is very instructive in this respect.

This Part examines the amendments to section 23A enacted as part of the Dodd-Frank Act. It argues that these amendments fail to address the fundamental tensions in the operation of section 23A that were so clearly exposed during the latest crisis. This Part discusses a number of broad issues in financial regulation reform that remain unresolved under the Dodd-Frank Act.

A. *The Dodd-Frank Act Amendments: Patches and Guards*

The Dodd-Frank Act made several important changes to the requirements of section 23A. These amendments significantly expanded the scope of section 23A and seek to tighten its application. There are five key areas in which the revisions were made.

347. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 619, § 13, 124 Stat. 1376, 1620–31 (2010) (codified at 12 U.S.C.A. § 1851 (West Supp. 2011)) (adding section 13 to the BHC Act).

348. § 716, 124 Stat. at 1648–51 (codified at 15 U.S.C.A. § 8305 (West Supp. 2011)).

349. *See* Eric Lichtblau, *Ex-Regulators Lobby to Shape Overhaul*, N.Y. TIMES, July 28, 2010, at B1.

First, the Act eliminated the exception from the quantitative limits for covered transactions between a bank and its financial subsidiary.[350] Second, the Volcker Rule, which imposed prohibitions and restrictions on banking organizations and systemically important nonbanking organizations with respect to proprietary trading and investing in hedge funds and private equity funds, also extended section 23A and 23B limits to cover banking entities' permitted fund activities.[351] The Act prohibited any banking organization that serves, directly or indirectly, as an investment manager, adviser, or sponsor of a hedge fund or private equity fund, or that organizes or offers shares in such fund, and any affiliate of such banking organization, from entering into covered transactions with such hedge or private equity fund, as well as with any other fund controlled by such fund, as if they were affiliates.[352]

Third, the Dodd-Frank Act amended the definition of "covered transactions" to explicitly include derivatives and securities lending and borrowing transactions that cause a bank to have credit exposure to an affiliate.[353] It is difficult to overestimate the importance of this amendment, especially given the volume of bank derivatives business with affiliates.[354] By subjecting derivatives to the requirements of

350. § 609(a), 124 Stat. at 1611 (codified at 12 U.S.C.A. § 371c(e) (West Supp. 2011)). Previously, section 23A(e)(3) exempted covered transactions between a bank and any single financial subsidiary of that bank from the ten percent limitation. *See* 12 C.F.R. § 223.32 (2010).

351. Sec. 619, § 13(d), 124 Stat. at 1623–1627. As enacted, the Volcker Rule provides that banking and systemically important nonbanking organizations may engage in certain "permitted" fund activities. *Id.*; *see supra* note 3 and accompanying text.

352. Sec. 619, § 13(f)(1)–(2), 124 Stat. at 1628. The Act provides, however, that the Board may permit the banking entities to offer prime brokerage services to certain hedge and private equity funds, subject to certain conditions. Sec. 619, § 13(f)(3), 124 Stat. at 1628. The Act's prohibition on covered transactions becomes effective on the earlier of one year after the date of adoption of the final rules implementing the Volcker Rule or two years after the date of the enactment of the Dodd-Frank Act. Sec. 619, § 13(c)(1), 124 Stat. at 1622.

353. § 608(a)(1)(B), 124 Stat. at 1608 (codified at 12 U.S.C.A. § 371c(b)(7) (West Supp. 2011)). The Act does not define "credit exposure" as used in this context.

354. With respect to securities lending and borrowing, however, the Dodd-Frank Act's mandate may not be such a radical change. As discussed in Part III, the Board has been treating credit exposure under securities lending and borrowing as an "extension of credit" within the meaning of section 23A and explicitly recognized that securities lending and borrowing are "covered transactions" under the statute and Regulation W. *See* 2007 BAC Letter, *supra* note 160, at 3; 2005 BAC Letter, *supra* note 161. Nevertheless, an explicit inclusion of these types of transactions in the statutory definition of a "covered transaction" signals the significance of controlling their potential implications both for the safety and soundness of depository institutions (especially those affiliated with securities broker-dealers) and for systemic stability.

section 23A, Congress reversed the decade-long prior policy of giving derivatives preferential treatment and leaving the task of managing the risk of such transactions to the financial institutions' internal risk management.[355] This change of heart was clearly a result of the recent financial crisis, which demonstrated the dangers of relying entirely on Wall Street executives' prudence and technical sophistication. Not surprisingly, the industry lobbied especially hard to prevent this particular amendment from passing, arguing that it would amount to an outright prohibition on derivatives transactions between banks and their affiliates and diminish the ability of large financial institutions to manage risk on a consolidated basis.[356]

However, despite its potentially harsh tenor, the practical impact of this change on banking organizations' derivatives business depends on how the regulators implement it. For instance, the Dodd-Frank Act specifically allows the Board to issue regulations or interpretations with respect to the manner in which a bank may take any netting agreements into account in calculating the amount of a covered transaction or determining whether the transaction is fully collateralized.[357] This gives the Board an important ability to substantially reduce the portion of derivatives that would be subject to the limits of section 23A. In addition, the Board, along with the FDIC and OCC, may significantly curtail potentially restrictive effects of this provision by using their authority to exempt certain derivatives transactions from the quantitative and qualitative limits of section 23A.[358] Thus, agency action will ultimately determine whether this provision of the Dodd-Frank Act affects any real change in large banking organizations' derivatives dealing and trading.

Fourth, the Act tightened the collateral requirements of section 23A by mandating that banks maintain the appropriate level of collateral at all times for covered transactions subject to collateralization.[359] Prior to the enactment of the Act, section 23A required collateral only at the time the bank entered into the relevant

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355. *See supra* note 63 and accompanying text.

356. Stacy Kaper, *Obscure Provision in Reg Reform May Have Big Impact*, AM. BANKER (Mar. 5, 2010), http://www.americanbanker.com/news/obscure-provision-in-reg-reform-1015476-1.html (detailing the debate on the positive and negative effects of adopting this amendment).

357. § 608(a)(4)(B), 124 Stat. at 1608–11. As a general matter, a "netting agreement" is a contract that allows the parties to aggregate their mutual payment and settlement obligations across various transactions and to offset payables against receivables. 12 U.S.C. § 4402(14)(A) (2006).

358. *See infra* notes 362–68 and accompanying text.

359. § 608(a), 124 Stat. at 1608–10.

covered transaction.[360] The new requirement aims to strengthen the protection afforded to banks extending credit to their affiliates, by ensuring that the value of collateral remains at the statutory level and shielding the bank's security interest from fluctuations in market prices of the assets used as collateral. The Act also expanded the scope of covered transactions required to be collateralized to include derivatives, securities borrowing and lending, and securities repurchase agreements, to the extent such transactions create credit exposure to affiliates.[361]

Finally, the Dodd-Frank Act imposed certain limitations on the Board's previously broad authority to grant exemptions from the requirements of section 23A.[362] Under the new law, the OCC and the FDIC are for the first time given statutory power to grant exemptions from the requirements of section 23A to institutions under their respective supervision.[363] The Act explicitly prohibits the Board, the OCC, and the FDIC from exempting any transaction or relationship from section 23A, if the FDIC determines that such exemption presents an unacceptable risk to the federal deposit insurance fund.[364] Both the Board and the OCC are required to notify the FDIC of the proposed exemption and give the FDIC sixty days to object in writing, if it finds that the proposed exemption presents an unacceptable risk to the federal deposit insurance fund.[365]

360. *See* 12 U.S.C. § 371c(c)(1) (2006) (amended 2010).

361. § 608(a), 124 Stat. at 1608–10. However, as noted above, the Act gives the Board discretion to determine the manner in which a bank may take into account netting agreements with its affiliates in calculating collateral requirements applicable to covered derivatives transactions. *See supra* note 357 and accompanying text.

362. § 608 (a), 124 Stat. at 1608–10.

363. 12 U.S.C.A. § 371c(f)(2) (West Supp. 2011). The OCC is the primary federal regulator and supervisor of federally chartered banks and, upon dissolution of the OTS mandated by the Dodd-Frank Act, savings associations. *See* 12 U.S.C.A. § 5412 (West Supp. 2011) (detailing the transfer of powers to the OCC); Heidi M. Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 1005 n.45 (2010). The FDIC is the primary federal regulator and supervisor of state chartered banks that are not members of the Federal Reserve System. *See Who is the FDIC?*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/about/learn/symbol/index.html (last updated Aug. 11, 2010).

364. § 608(a)(4)(A), 124 Stat. at 1609.

365. *Id.* The Dodd-Frank Act also amended section 23B of the Federal Reserve Act to make the Board's authority to grant exemptions from that section's requirements subject to the FDIC's determination that such exemptions do not present unacceptable risk to the deposit insurance fund. *See* § 608(b), 124 Stat. at 1610.

The Board still retains direct exemptive authority under section 23A with respect to member banks.[366] In addition, the Act specifically allows the Board to "issue regulations or interpretations" with respect to certain aspects of the amended statute.[367] However, in issuing interpretations with respect to specific entities, the Board must act jointly with the federal banking agency, either the OCC or the FDIC, which directly regulates and supervises such entities.[368]

Thus, the Dodd-Frank Act has not eliminated the Board's ability to grant exemptions from the requirements of section 23A, even though it made those requirements more pervasive and stricter. The Act merely divided the existing exemptive authority among three federal banking agencies and put the FDIC at the center of the exemption process by giving it an effective veto right over the Board's and the OCC's decisions. On the one hand, this step dilutes the Board's power and creates, at least potentially, structural checks and balances designed to ensure the exemptions are more thoroughly vetted. On the other hand, whether this more decentralized exemptive process makes it more difficult for financial conglomerates to pierce through the statutory wall in practice depends greatly on how these agencies approach the issue and how independently, or how uniformly, they make decisions in this area. One may easily imagine a situation in which the FDIC fails to exercise its veto right as assertively as it should, perhaps as a result of certain power dynamics among the three agencies. Or, in the alternative, all three banking agencies may share the same permissive approach to granting exemptions from section 23A, driven by various ideological or pragmatic reasons. It is worth noting, for instance, that the FDIC concurred with most, if not all, of the Board's prior decisions to exempt individual transactions from the quantitative and qualitative limits of section 23A.[369] Formalizing the FDIC's participation in the process of granting exemptions from the statutory provision

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366. § 608(a)(4)(A), 124 Stat. 1609–10. Any grant of exemption by the Board remains subject to the requirement that the Board must find the proposed exemption to be "in the public interest and consistent with the purposes of" section 23A. *Id.*

367. *See, e.g.*, § 608(a)(4)(B), 124 Stat. at 1608–11 (giving the Board the authority to make rules and issue interpretations with respect to the manner in which "netting agreement[s] may be taken into account" when banks calculate various amounts in order to determine whether their derivatives transactions with affiliates comply with the statutory limits).

368. § 608(a)(4)(A), 124 Stat. at 1609–10.

369. Of course, it may be the case that the FDIC's concurrence with the Board's exemption decisions was a mere formality and that the Board did not give the FDIC a meaningful opportunity to weigh in on any of those decisions.

traditionally administered and implemented by the Board may or may not have the desired effect.

B. Searching for Alternatives: Rebuild on a New Foundation?

An examination of the Board's use of exemptive authority under section 23A shows how often this venerable statutory firewall came down in order to accommodate the business needs, or sheer survival, of large financial conglomerates.[370] It also provides important context both for assessing the Dodd-Frank Act's approach to fixing the statutory wall and for discussing broader regulatory design issues the Act failed to address.

During the recent crisis, the Board's strategy of dismantling the section 23A wall was a pragmatic and largely unavoidable response to severe market dislocation. As with most crisis containment measures, the Board's actions operated to suspend peacetime regulation of bank affiliate transactions.[371] However, such suspension inevitably creates a serious moral hazard issue and threatens to undermine the legitimacy and efficacy of the regulatory regime after the crisis, unless followed by regulatory reforms aimed at preventing future crises and redesigning peacetime regulation to address the causes of the prior failure.[372] This is a particularly salient issue with respect to section 23A, given the massive nature of its "suspension" during the latest crisis. If a fundamental expectation built into the operation of section 23A is that regulators always remove the statutory limitations on bank affiliate transactions in crises, that expectation will shape the long-term incentives for financial institutions' risk-taking in ways

370. One could argue that focusing on the exemptions from section 23A tends to downplay the fact that, in the majority of cases, the statute may be successfully operating to prevent risky affiliate transactions. A relatively low number of exemptions in this area, given the high volumes of affiliate transactions, may be viewed as proof of such success. There may be some validity to this counterargument, especially since it is impossible to ascertain whether, and under what circumstances, the Board actually denied any requests for exemptions. However, the fact that there have not been more exemptions during the period under examination may also be a sign of successful regulatory arbitrage on the part of financial institutions. For instance, the fact that Regulation W excluded derivatives from "covered transactions" allowed banks to provide a great deal of leverage to their affiliates without regard to the quantitative limits of section 23A. In addition, as some observers note, the limitations on affiliate transactions are generally easy to evade and "difficult to enforce." *See* Wilmarth, *supra* note 55, at 456.

371. *See* Gelpern, *supra* note 345, at 1057 (arguing that "suspending regulations" in the crisis containment stage "is neither good, nor bad, but [simply] unavoidable").

372. *Id.* at 1051 (arguing that "regulation, prevention and resolution" measures in times of calm seek to establish long-term incentives for market actors).

contrary to the legislative intent. It is also highly likely to become a self-fulfilling prophecy.

The Dodd-Frank Act misses the target in this respect. It purports to expand the scope of the existing limitations on bank affiliate transactions but does not change the fundamental dynamics of the regulatory decision making in times of crisis.[373] Even assuming that the Act's provisions will technically strengthen the statutory firewall in times of calm, nothing in the Act guarantees that this newly enhanced firewall will withstand the next systemic crisis.[374] Dispersing the exemptive authority among several agencies is not likely to provide such a guarantee. In times of crisis, when systemic risk concerns drive all policy choices, it would not matter which agency actually makes the individual decision or whether that decision is made by a single agency or collectively. Moreover, since the Dodd-Frank Act expanded and reinforced the Board's authority and responsibility for systemic risk regulation,[375] the Board may be even more likely to prioritize that regulatory duty, even if it involves dismantling the new and improved section 23A firewall. In addition, the Dodd-Frank Act makes the heads of the OCC, FDIC, and the Board the members of the Financial Stability Oversight Council

373. One could potentially counter that point by arguing that other provisions of the Dodd-Frank Act—such as the creation of the new systemic risk regulatory structure or new comprehensive resolution regime—would operate to minimize the possibility of such a situation arising in the first place. However, whether or not these or any other reforms are effective in minimizing the risk of a major systemic failure remains to be seen.

374. It is also doubtful that the Dodd-Frank Act amendments to section 23A can make the statutory provisions more resilient and effective during ordinary times. As recent experience shows, in periods of economic growth, when the financial industry is generating steady profits and financial innovation seems to have only positive effects, regulators tend to be less vigilant and more inclined to lift statutory restrictions to accommodate financial institutions' quest for higher profits. *See* Jeffery N. Gordon & Christopher Muller, *Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management* 25–26 (European Corporate Governance Grp., Working Paper No. 277, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1553880#%23. There is little basis to think that this pro-cyclical pattern will change in the near future. *See id.* at 25. Devising truly effective counter-cyclical regulatory and supervisory mechanisms is notoriously difficult, and it is unclear whether the current efforts to come up with such techniques will succeed. *See, e.g.*, Raghuram Rajan, Eric Gleacher Distinguished Serv. Professor of Fin., Univ. of Chi. Booth Sch. of Bus., Address at the Credit Markets Symposium: Cycle Proof Regulation (Apr. 2–3, 2009), *available at* http://www.richmondfed.org/conferences_and_events/banking/2009/pdf/cms_2009_rajan.pdf (citing the ability of firms to avoid complying with regulatory requirements).

375. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 161(a)–(b), 124 Stat. 1376, 1420–21 (codified at 12 U.S.C.A. § 5361 (West Supp. 2011)) (granting the Board the authority to regulate and supervise systemically important nonbank financial companies).

("FSOC"), the new systemic risk regulator.[376] Charged with this regulatory task, all of these agencies may be more inclined to place systemic stability concerns above the more narrow purposes of section 23A. The Act's purported solutions to the fundamental problem of redefining the regulators' exemptive authority under section 23A do not provide much guidance in this respect.

Given the inherently unsettling dynamics of crisis containment, it may be far more important and realistic to focus on ensuring effective functioning of the section 23A firewall during peacetime, before a crisis inevitably alters regulatory calculus. This is precisely what the Dodd-Frank Act aims to accomplish. As discussed above, the practical impact of the amendments to section 23A is difficult to ascertain. However, the Act also raises broader potential issues with respect to the operation and enforcement of section 23A.

Thus, the passage of the Dodd-Frank Act may lead to a spike in financial institutions' requests for exemptions from the limitations of section 23A. The inclusion of derivatives as "covered transactions" is the most obvious potential reason for large financial conglomerates to seek individual exemptions from the revamped requirements of section 23A.[377] New statutory and regulatory restrictions on banks' ability to engage in proprietary trading, deal in OTC derivatives, or conduct certain other activities are likely to force FHCs to move most of their high-margin, high-risk operations into nonbank subsidiaries.[378] By forcing financial conglomerates to relocate the riskiest business activities from banks to nonbanking entities, the new financial regulation framework may further elevate the profile and legal significance of section 23A and, in particular, increase the importance of individualized exemptions from its operation for a variety of affiliate transactions.

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376. § 111, 124 Stat. at 1392–94 (codified at 12 U.S.C.A. § 5321 (West Supp. 2011)) (establishing the FSOC).

377. In fact, there is strong reason to believe that the Board's decision in Regulation W not to include derivatives in the definition of a "covered transaction" was one of the main reasons why the Board did not get inundated with requests for exemptions from section 23A limitations in the pre-crisis period.

378. Stricter capital adequacy rules under the new Basel III regime may create further incentive for such internal risk arbitrage, although it is extremely difficult to predict how that regime would operate in practice. *See International Regulatory Framework for Banks (Basel III)*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/bcbs/basel3.htm (last visited Apr. 29, 2011); N.M., *Third Time's the Charm?*, ECONOMIST (Sept. 13, 2010), http://www.economist.com/blogs/freeexchange/2010/09/basel_iii (arguing that Basel III may increase the incentive for banks to engage in capital arbitrage).

In this context, it becomes even more crucial to address the fundamental questions that the Dodd-Frank Act failed to address. In light of our post-crisis wisdom, what is the proper role of section 23A in the U.S. system of financial regulation? How important are the underlying policy goals of section 23A? Is section 23A well-suited to achieve these policy goals, or are there more effective mechanisms for accomplishing them in today's complex financial system? In other words, it is necessary to revisit the normative foundation on which the entire section 23A regime rests and to reevaluate our policy priorities in light of what we have learned about the operation and the failings of that regime in the past decade.

If the twin purposes of section 23A—protecting U.S. banks from excessive risk exposure to affiliates and preventing transfer of federal subsidy outside the depository system[379]—are still important, or arguably even more important today, it is vital to resolve the key tension in the operation of the statute, which, despite its high profile and substantive importance, is so often and so easily overridden by the regulatory exercise of exemptive authority.

One potential solution to resolving this tension would be to eliminate, or severely restrict, the regulators' authority to grant exemptions from the requirements of section 23A. As discussed above, the Dodd-Frank Act purports to do that by eliminating the Board's monopoly on granting exemptions from section 23A and giving the FDIC a veto power.[380] However, overcoming powerful incentives to suspend the operation of the statute, both in moments of systemic instability and in the midst of market boom, requires much stricter limits on regulatory discretion. To be meaningful, the agencies' ability to grant exemptions, by order or regulation, would have to be confined to a very narrow spectrum of situations clearly defined in the statute. The vague current standard—that the agency must determine that granting an exemption would serve public interest and be consistent with the purposes of section 23A[381]—would have to be replaced by a more specific set of conditions under which the agencies would be allowed to grant exemptions.

Despite its attractiveness, this approach has a serious potential drawback: it may be unfeasible and even counterproductive, especially in situations where regulators are faced with difficult and very important substantive choices between competing policy goals.

379. *See supra* note 8 and accompanying text.
380. *See supra* notes 362–68 and accompanying text.
381. *See* Federal Reserve Act, 12 U.S.C.A. § 371c(f)(2) (West 2001 & Supp. 2011).

When the purposes of section 23A conflict with other more pressing goals such as containment of a rapidly escalating credit crisis, it may be vital for the regulators to have sufficient flexibility to relax or even remove statutory limits in specific situations. Thus, in the end, the ultimate question is one of substance rather than procedure. Striking the right balance with respect to regulators' exemptive authority under section 23A involves weighing the relative significance of various substantive policy objectives, which is an inherently difficult task.[382]

An alternative approach to resolving the tension in the operation of section 23A is to redefine its role in the U.S. system of bank regulation. This solution would require renouncing the notion that section 23A is the "Magna Carta" of U.S. banking law,[383] the principal statute that protects the safety and integrity of the entire U.S. depository system, and recalibrating our view of what it can, and cannot, achieve.

If strictly applied and enforced, the quantitative and qualitative requirements of section 23A can limit banks' potential exposure to their affiliates' credit risk and limit the transfer of federal subsidy outside the depository system. Limitations on affiliate transactions can also significantly curtail potential conflicts of interest in credit allocation. Minimizing the danger of unfair allocation of credit as a result of banks steering funds toward their affiliates has always been an important element of the statutory design.[384] Moreover, by restricting the ability of nonbank entities to benefit from affiliation with insured depository institutions, section 23A can potentially help to control the unlimited growth of the shadow banking system. Diligent enforcement of section 23A can have a meaningful impact on firms' decisions to affiliate in the first place, as fewer opportunities for regulatory arbitrage and indirect access to federal subsidy would make such affiliation potentially less attractive. From this perspective, the real promise of section 23A in the post-GLB Act world is its

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382. It is worth emphasizing that this is a difficult, if not impossible, choice to make in the abstract. It also raises legitimate questions about the specific quantitative thresholds enshrined in section 23A: Why are ten and twenty percent of a bank's capital and surplus the magic limits that cannot be sacrificed easily, even in a crisis? Assuming there is a strong basis for reiterating the importance of the main purposes of section 23A, it may be much more difficult to justify these specific numerical criteria. Eliminating these thresholds, by simply prohibiting all extensions of credit by banks to their nonbank affiliates, would remove this difficulty but would not resolve the problem of regulatory discretion.

383. *See* COP REPORT, *supra* note 13, at 24.

384. *See* CARNELL ET AL., *supra* note 8, at 427.

potential ability to serve as a key mechanism in reducing incentives for excessive conglomeration in the financial services sector.

However, as this Article shows, the Board consistently failed to recognize and realize this hidden potential of the section 23A regime. The Board's extensive use of its exemptive authority, especially during the years preceding the recent financial crisis, effectively undermined the statute's ability to restrict the growth of shadow banking and discourage arbitrage-driven conglomeration.

Ironically, in the post-GLB Act world, this permissive regulatory approach was combined with the grand notion of section 23A as the principal firewall keeping banks safe from risks generated by their nonbank affiliates. The story this Article has laid out strongly suggests that this notion helped to create a false sense of security with respect to broader systemic risk issues. In reality, section 23A has not been very effective in meeting its officially stated policy objectives primarily because of a fundamental design flaw. The statute relies exclusively on imposing quantitative and qualitative limitations on bank transactions with affiliates as the method of achieving its objectives. As the prior discussion shows, such limitations are relatively easily and frequently lifted by regulatory action. In addition, on its face, the statute conspicuously lacks systemic focus and operates purely on a microprudential, individual entity level, which undermines its ability to safeguard the U.S. depository system in today's complex and interconnected financial marketplace.

The key to understanding why section 23A was designed this way, and why it largely failed to deliver on its alleged promise, is the fact that it was never supposed to promise that much. At the time of its enactment in 1933, the statute's approach was based on the key premise that none of banks' nonbank affiliates would actually engage in securities dealing or other financial activities that Congress viewed at the time as unacceptably risky for federally insured commercial banks.[385] Originally, section 23A was not designed to be the single most important statutory mechanism keeping banks, and federal deposit insurance funds, safe from risky capital markets activities. Neither was it meant to be the main statutory provision safeguarding the fundamental principle of separation of banking and commerce. In 1933, Congress assigned those functions primarily to the Glass-Steagall Act.[386] Section 23A of the Federal Reserve Act was an

385. *See supra* notes 40–43 and accompanying text.

386. Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.), *repealed in part by* Financial Services

ancillary provision, an additional protection applicable to a much narrower set of transactions between banks and their *permissible* affiliates, which at the time excluded investment banks, hedge funds, derivatives dealers, and most of the rest of the financial world. It was the interplay between these statutes that created a coherent legal regime. After the partial repeal of Glass-Steagall in 1999, section 23A was propelled to new prominence as its "successor" statute, in the sense of preserving the integrity of a federally insured depository system.[387] The problem is that, if quantitative limits on bank affiliate transactions were not designed to fulfill such a complex and important policy objective back in 1933, they certainly could not be expected to meet that challenge in the twenty-first century.

And that leaves us facing another dilemma. If we scale back our expectations of section 23A and stop relying on it as the centerpiece legislation protecting banks from externally generated risks and preventing the leakage of public subsidy outside the banking system, we need to look for other, more viable alternatives. We also have to admit that U.S. bank regulation does not currently provide a functioning mechanism for preserving the wall between federally insured commercial banks and "shadow banks" or, more broadly, between banking and commerce.

Acknowledging this sobering reality is the necessary first step toward a potential solution. One such potential solution may be returning to the old Glass-Steagall principle of institutional separation among different classes of financial institutions, based on their business and risk profile. In the run-up to the enactment of the Dodd-Frank Act, the idea of resurrecting the Glass-Steagall Act in its original form had gained significant popularity.[388] Of course, a complete reconstitution of the old regulatory regime may not be the most desirable choice in the context of the twenty-first century financial marketplace. Nevertheless, that does not preclude us from thinking about devising an alternative regulatory system, in which certain financial institutions (including federally insured banks), whose safety and soundness are critical for ensuring a steady supply of credit to support productive functioning of the national economy, are expressly disallowed from affiliating with other classes of

Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12 and 15 U.S.C.).

387. *See supra* notes 45–49 and accompanying text.

388. *See, e.g.*, Allison Vekshin & James Sterngold, *War on Wall Street as Congress Sees Returning to Glass-Steagall*, BLOOMBERG (Dec. 27, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aeQNTmo2vHpo.

institutions engaged in potentially high-risk and complex financial dealings. After all, if it is so difficult to ensure effective policing of affiliate transactions, it makes perfect sense to prohibit publicly subsidized depository institutions from affiliating with any entities whose potentially risky activities endanger their safety and soundness. Choosing how and where to draw the line between acceptable and unacceptable risks would require serious deliberation and analysis, which goes far beyond the scope of this Article.

Of course, this approach rests on a fundamental assumption that building statutory firewalls to protect depository institutions from the rest of the financial system remains a relevant and critically important policy goal in today's financial markets. However, one can challenge that assumption and argue for a radically different approach to safeguarding the depository system. For instance, it may be more effective to manage the safety and soundness of depository institutions through legal and regulatory mechanisms aimed at ensuring stability of the entire financial system. Technology-driven innovation, complexity, and the global interconnectedness of today's financial markets elevate systemic risk prevention to the very top of regulatory priorities. These factors also make it increasingly difficult to maintain the fiction that the safety and soundness of the banking system are neatly separable from the safety and soundness of the nonbanking financial sector. Taking this approach one step further, one could advocate adopting the universal banking model, which would allow commercial banks to engage in an unlimited variety of financial, and even commercial, activities.[389] Legalizing universal banking, among other things, would render section 23A irrelevant and would have to rely instead on a conceptually different set of legal and regulatory safeguards against systemic risk.

There may be a broad range of potential regulatory design options that fall between the revival of the Glass-Steagall principle of organizational separation, on the one hand, and the acceptance of universal banking, on the other. However, regardless of the merits of any particular proposal, the most important first step toward a solution is to face the complex reality of the existing section 23A regime and its unfulfilled promise.

389. It may be argued that, in reality, both the industry and the regulators have already accepted the existence of de facto universal banks in the United States.

CONCLUSION

As this Article has demonstrated, section 23A of the Federal Reserve Act largely failed to fulfill its stated purposes. Since the partial repeal of the Glass-Steagall Act in 1999, it has been officially portrayed as the principal statutory firewall keeping banks safe and preventing them from being used as a cheap, publicly subsidized source of financing for potentially high-risk business activities of their nonbank affiliates. However, an examination of the Board's use of exemptive power under section 23A in recent years exposes serious cracks in this statutory firewall and calls into question the efficacy of the current regime governing bank affiliate transactions. Furthermore, by creating a false sense of security with respect to the safety and soundness of the depository system in the face of financial conglomeration, the section 23A firewall potentially hinders the much needed debate on the future of financial regulation reform in the United States.