The retreat from systemic risk regulation: what explains it? (and why it was predictable)

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Financial crises usually trigger a predictable cycle: first, a populist outburst that produces dramatic legislative and regulatory changes and, then, a slower counter-reaction as the financial industry gradually subjects the new reforms to a death by a thousand cuts, often with the result that little remains. This cycle – here called the "Regulatory Sine Curve" – can be traced back to the South Sea Bubble in 1720. In the aftermath of 2008, this cycle seems to be again in progress in the United States, as many of the Dodd-Frank Act's reforms have either gone unimplemented or have been partially repealed. But the same cycle does not appear to be occurring in Europe. This brief essay analyzes these differing responses and seeks to explain why Europe seems better insulated against counter-reaction.

Introduction

The 10th anniversary of anything (even a financial crisis) usually presents an opportunity for celebration. Regulators will recall how they redesigned policies to foil the "bad guys", to protect victims, and to prevent future crises. Enforcement victories will be recalled (with more than a hint of self-satisfaction), and legislators will proclaim their courageous opposition to "special interests". The problem with such a self-congratulatory retelling of the decade since the financial crisis of 2008 is that it would be largely fictional. Yes, to be sure, there was a prompt response in the U.S., and the Dodd-Frank Act of 2010 did address most of the critical gaps in U.S. financial regulation (1). Even if it was imperfect (as human efforts usually are), it contained important reforms, such as the Volcker rule, curbs on incentive compensation, special rules for "Systemically Important Financial Institutions" (or "SIFIs"), and the Consumer Financial Protection Bureau (or "CFPB") (2).

But unfortunately one cannot stop the story at this point. Since 2012 and the passage of the JOBS Act, regulatory and legislative movement in the United States has been almost entirely in the direction of deregulation. So far, this has involved repeal of some provisions of the Dodd-Frank Act, the relaxation of many rules adopted by federal regulators (including the Volcker Rule), the dismantling or muting of some agencies (most notably the CFPB), and a sharp reduction in enforcement directed at public companies by the SEC. The old practices that caused or contributed to the 2008 crisis are resurfacing: complex securitizations are re-appearing; the repo market is heating up; "interest only" mortgage loans (on which no amortization of principal is charged) have returned; and banks are actively trading securities-based swaps through unregulated offshore subsidiaries (3).

Although it would overstate to say that the Dodd-Frank Act has been erased or gutted, it has been significantly

(1) Technically, the Act is more properly identified as the Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). For purposes of this non-technical article, I will shorten this title to the "Dodd-Frank Act".

(2) For an overview of the Dodd-Frank Act and the pushback that it generated from the outset, see COFFEE John C., Jr., The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 Cornell L. Rev. 1019 (2012). Beyond the subparts of the Dodd-Frank Act noted in the text, its provision on stress testing may have proved the most useful (and it predictably has been rolled back, as later discussed).*

(3) Some of the Dodd-Frank Act's rules appear to have been evaded simply by moving transactions offshore. See LEVINSON Charles, Vanishing Act: U.S. Banks Moved Billions of Dollars in Trades Beyond Washington's Reach*, Reuters Investigates, August 21, 2015. Essentially if U.S. banks trade through foreign subsidiaries and the parent bank does not guarantee the transaction, the Commodities Futures Trading Commission takes the position that these transactions are beyond its jurisdiction. More generally, with respect to the re-appearance of risky securitizations and overly leveraged lending, the Bank of England has just "sounded the alarm", focusing particularly on the U.S. market. See DOUGLAS Jason, "U.K. Central Bank Warns On Debt Risk",* The Wall Street Journal*, June 28, 2018 at B10. For fuller details, see infra at note 45.*

crippled. One can express shock at this ("How soon they forget!"), but it was also predictable. Why? A recurrent regulatory cycle has characterized most major financial crises and the reaction to them. The cycle begins (at least in Democracies) with a swift (and often punitive) political reaction [(4)], and significant reform legislation is enacted. Only at such moments can democratic majorities, enraged and demanding action, overcome the entrenched financial establishment. This tendency can be traced back to the South Sea Bubble, which burst in 1720 and caused an infuriated Parliament to overreact and prohibit the private chartering of corporations [(5)]. But at some later point, the second phase of this cycle begins. Once the crisis cools and the public's attention turns elsewhere, powerful institutions can quietly lobby to unwind much of the regulation to which they have been subjected. Sometimes, this may take a substantial period. For example, Parliament's ban enacted after the South Sea Bubble on privately chartered corporations (which are universal today) lasted (in both the U.K. and the U.S.) until the advent of the Industrial Revolution and the appearance of the railroads (which needed to raise capital on a massive scale and whose promoters wanted to utilize limited liability to do so). Similarly, the federal securities laws and the Glass-Steagall Act in the United States were a direct response to the 1929 Stock Market Crash, and they lasted (largely untouched) until the 1980's when deregulation gradually pruned away many of their original (and arguably outdated) provisions [(6)]. All that is different and unique in the case of the Dodd-Frank Act is the speed with which it has been eclipsed. While the federal securities laws and Glass-Steagall remained impregnable for a half century at least, Dodd-Frank has enjoyed at most a window of a few years (and more trimming may yet come).

In earlier work, I have termed this phenomenon the "Regulatory Sine Curve" [(7)]. To the extent that this cycle is apparent again, two notable differences stand out: First, the speed of the retreat has been much faster in the U.S. Indeed, the Dodd-Frank Act has experienced a much quicker counterattack than had been seen in the aftermath of earlier financial crises. Second, Congress and regulators moved quickly in the United States, both in initially enacting comprehensive legislation and later in cutting it back. In contrast, Europe moved more slowly, but it has seen no

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Caricature about the failure of the South Sea Company, in "Extraordinary Popular Delusions and the Madness of Crowds", by Charles Mackay, England, 1720.

« Parliament's ban enacted after the South Sea Bubble on privately chartered corporations (which are universal today) lasted (in both the U.K. and the U.S.) until the advent of the Industrial Revolution and the appearance of the railroads. »

(4) For a fuller description of this cycle, see COFFEE, supra note 2, at 1020 to 1021; BANNER Stuart, What Causes New Securities Regulation? 300 Years of Evidence*, 75 Wash. U. L. Q. 849, 849-851 (1997); DOWNS Anthony,* Up and Down with Ecology – The "Issue Attention" Cycle*, 28 Pub. Int. 38. pp. 38-41 (1972) (arguing that legislative inertia and interest group veto power can only be overcome after a crisis that captivates the public's attention). Others argue that the same phenomena apply to the passage of environmental laws. See SCHROEDER Christopher H.,* Rational Choice Versus the Republican Moment – Explanations for Environmental Laws*, 1969-1973, 9 Duke Energy L. & Policy F. 29, pp. 33-36 (1998).*

(5) The South Sea Company was a British joint-stock company, founded in 1711 as a public-private partnership to consolidate and reduce the national debt; it was granted a monopoly to trade with South America and nearby islands (which at the time remained under Spanish control). Because the South Sea Company had no access to South America, trading of governmental debt became its principal activity, and its stock price rose precipitously, before crashing in 1720. The scandal deepened when some members of the Royal Family were found to have engaged in significant self-dealing relating to the South Sea Company. In reaction, Parliament enacted The Bubble Act 1720 (6 Geo. I, c. 18), which prohibited the creation of joint stock companies without a royal charter. Ironically, this Act was supported by the South Sea Company, itself, which wanted to eliminate competition.

(6) The Glass-Steagall Act, passed in 1933, denied commercial banks the ability to underwrite securities, thus eliminating a source of both risk and conflicts of interest for banks. It was not formally repealed until the Gramm-Leach-Bliley Financial Modernization Act was enacted in 1999. But well before that point, the Federal Reserve Board had gradually loosened many of Glass-Steagall's prohibitions during the 1980s. Similarly, although the Securities Act of 1933 has never been repealed (nor is it likely to be), many of its restrictions were relaxed in the 1980s, with the introduction of integrated disclosure, shelf registration, and eased requirements for private placements (including both Regulation D and Rule 144).

(7) For a fuller description of this term, see COFFEE, supra note 2, at 1029-1031.

similar return to deregulation [8]. Brussels is not fighting the "barbarians at the gate" (as the U.S. is).

What explains both these differences? Let us begin with the faster pace in the United States. Why has it been easy to unwind Dodd-Frank? Here, it is much too simple to rely solely on the unexpected election of Donald Trump as President; he did not begin this process; nor was he closely involved in much of it. A deeper explanation requires that we start with the general public's indifference to the causes of the crisis. Basically, the public does not understand financial regulation, which is complex and arcane. Thus, it may not see its own stake in the survival of such legislation. Of course, that was arguably true with respect to the passage of the federal securities laws in the 1930's as well (and they survived much longer without serious change). Possibly, the U.S. public in the era after 1929 did understand that the Glass-Steagall Act was intended to keep banks small (and liked that). Put differently, the public (and Congress) had no more than a dim idea of who the villain was in the aftermath of the 2008 crisis. At best, systemic risk regulation is an abstract concept, focused less on fraud than on requiring lenders to be prudent on the obvious grounds that a large bank's collapse can set off a domino-like wave of failures. Still, such a goal requires prophylactic and seemingly rigid rules, which are predictably unpopular with consumers, borrowers and the industry.

Second, Dodd-Frank challenged very entrenched practices (such as incentive compensation), and the financial industry was strongly motivated to resist it. Third, virtually everyone – both on the Left and the Right – likes easy money. But reducing systemic risk requires that liberal, even reckless, lending be controlled and that is unpopular. Thus, quasi-public lenders, such as Fannie Mae and Freddie Mac, were able to escape potential death sentences, despite very culpable behavior on their part, because the vast majority in Congress wanted to assure the easy availability of mortgage funds. Hence, the industry had a powerful argument that they did not have after 1929: deregulation will mean more and easier lending.

To be sure, the U.S. public did know what it did not like – most notably, "bailouts". Unfortunately, the bailout of a large financial institution may be the soundest way to prevent its failure from triggering a financial contagion [9]. Consider, for example, what might have happened if the Federal Reserve and the Treasury had not bailed out AIG. In contrast, the exact point at which a large bank should be classified as a SIFI or the precise leverage ratio to which it should be subjected triggers no emotional or intuitive response from the public. To put this a different way, after a vivid scandal, such as Bernie Madoff's Ponzi scheme, no one could conceivably seek the repeal of mutual fund regulation, but the financial industry could easily (and did) lobby for the redefinition of "SIFI" and a loosening of "proprietary trading" restrictions under the Volcker Rule, arguing that their reforms would create jobs or ease credit. The Crash of 1929 both produced more vivid villains and ones that better aligned with the needed reforms; thus, the laws engendered by that Crash may have lasted longer.

Beyond these observations, there is a larger generalization about the asymmetry between the contending forces that explains why financial reforms tend to be watered down over time. It was first offered in an integrated fashion by Mancur Olson in his classic book, *The Logic of Collective Action: Public Goods and the Theory of Groups* [10]. Olson's central idea is that smaller, better-organized, and naturally cohesive groups will predictably outperform larger, citizen-based "latent" groups. Self-funded business lobbies – for example, the U.S. Chamber of Commerce or The Business Roundtable – will thus dominate broader, but less well-funded, groups seeking to represent diffuse groups, such as investors, bank depositors or the general public. Once the public's indignation subsides (as it eventually does), banks and other "inside" players will out lobby a broader, but loose-knit aggregation, such as the public. That is now happening.

These comments do not deny that necessarily rushed legislation can result in overregulation. For example, the Sarbanes-Oxley Act in 2002 indirectly created an obligation under Section 404(b) of that Act to verify a reporting company's internal controls, and this proved unduly costly for smaller companies [11]. Not surprisingly, this provision was quickly cut back by both legislative and regulatory action [12]. Similarly, the Dodd-Frank Act set the level at \$50 billion at which a financial institution became a closely regulated "SIFI". In retrospect, this level was probably too low (whereas the new legislatively set level of \$250 bil-

(8) This short piece cannot summarize the literature fully. Nonetheless, good summaries of changes in E.U. policy are available. See VERON Nicolas, "EU Financial Services Policy Since 2007: Crisis, Responses and Prospects", 9 Global Policy*, Supplement 1 (June 2018), and European Commission,* "*Coping with the international financial crisis at the national level in a European context*" *(November, 2017).*

(9) The idea of the central bank as the "lender of last resort" has long been a consensus proposition with which few financial economists disagreed and dates back to Walter Bagehot in the 19th Century. See BAGEHOT W., Lombard Street: A Description of the Money Market *(1873).*

(10) See OLSON Mancur, The Logic of Collective Action: Public Groups and the Theory of Groups *(2nd ed. 1992). A number of important scholars have followed in Olson's wake. See HARDING Russell,* Collective Action *(1982) and SANDLER Todd,* Collective Action: Theory and Application *(1992). For an application of Olson's ideas to the world of corporate governance, see PRENTICE Robert A. and SPENCE David B.,* Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 Geo. L. J. 1843, 1847-49 92007.*

(11) Section 404(b) of Sarbanes-Oxley Act did not actually require the auditor to "audit" the company's internal controls, but only to "attest to and report on" management's assessment of its internal controls (which assessment was required by Section 404(a)). However, the Public Company Accounting Oversight Board ("PCAOB"), adopted its Auditing Standard No. 2 in 2004, which required a full-scale audit of the issuer's internal controls, and industry reaction was swift and hostile. For the fuller statutory language, see infra at note 50.

(12) This audit requirement was costly, particularly for smaller companies, and the JOBS Act in 2012 exempted "emerging growth companies" from this requirement. Even earlier, in 2006, the PCAOB also relaxed its rule for smaller companies. See Auditing Standard No. 5. See COFFEE, supra note 2, at 1037-1039.

lion may be too high). This recognition of the potential for hasty overregulation reveals the problematic side to the Regulatory Sine Curve on which this article focuses. Simply put, it is never easy to identify the "Goldilocks point" at which the temperature is neither too hot nor too cold, but just right. In this light, this article will briefly survey in deliberately non-technical prose five areas where deregulation may have gone past the point of sensible adjustment. Its specific conclusions may be debatable, but not its central point about the accuracy of Mancur Olson's prediction that the better organized groups will win most regulatory contests, defeating larger, "latent" groups. That, in turn, frames the final question on which this article will focus: How, if at all, can we adjust or respond to the inevitable tendency of collective action to favor the better organized minority?

Still, what explains the much slower pace of reform and retreat in Europe? Arguably, less was done in Europe to curb systemic risk in the immediate aftermath of 2008, but clearly far less has been done in Europe than in the United States to undo these reforms over the last several years. This suggests that the more complex and fragmented political structure of Europe slows and retards both reform and the counter-reaction to reform. Once legislation is enacted within the European Union, Brussels appears to be fairly insulated from the lobbyists who wish to repeal or modify it. Why? Possibly, the key difference is that the American Congress can be dominated by a single political party. When that dominant party is liberal (i.e., the Democratic Party), reform sweeps in after a crisis. But when a conservative party (i.e., the Republican Party) takes control, the prior reforms can die a death by a thousand cuts. In contrast, no single political party is active across Europe. Similarly, no political leader seeks to aggregate dissident groups or disaffected persons across all Europe. Thus, no single election or transfer of power can fundamentally shift the attitudes of the European Commission (or its bureaucracy). As a result, there is no common agenda (or at least not one determined by the political process).

In turn, this relative fragmentation affects lobbyists as well. In the U.S., lobbyists need only to gain the support of the U.S. President or the leadership of the dominant political party. In Europe, gaining the support of the Prime Minister of France or Germany still does not mean that the lobbyists have captured the E.U. In short, because it is much harder to dominate the European political process, both reform and counter-reform move at a slower, less coordinated pace. For better or worse, the result is that the bureaucrats in Brussels cannot be easily overruled.

A Closer Look at the U.S. Experience: What Problems and Regulatory Gaps Have Re-emerged Post-Crisis?

If one contemporaneous statement made during the 2008 Crisis seems likely to survive and be remembered, it is the much quoted comment of Charles Prince, then the CEO of Citigroup, who was asked in 2007 what would happen now that securitizations were encountering resistance and recognition was growing that financial institutions were overleveraged. He responded, with a seemingly resigned shrug, acknowledging that there were problems, but still insisting:

"As long as the music is playing, you've got to get up and dance!" (13).

In short, even if problems are evident, one has to keep on closing deals. Ignore that they may later explode, producing litigation and bankruptcy. That is someone else's problem.

Behind this attitude lie two powerful forces: 1) financial competition, as banks dare not fall behind their rivals, for fear that their shareholders will revolt; and 2) incentive competition, as financial executives have come to be compensated under incentive formulas that give them both a short-term and risk-tolerant orientation. Ironically, the Dodd-Frank Act actually aggravated the first factor by authorizing "proxy access," a procedure that gave activist shareholders increased leverage over corporate managements (14). But the Business Roundtable sued and invalidated the SEC's rule adopted to implement proxy access (15), thus both ending this threat and again demonstrating the power of a well-organized group.

Not surprisingly, the Dodd-Frank Act specifically addressed incentive compensation and sought to limit its influence. But of all the areas in which Dodd-Frank has been cut back, this is the clearest (and most extreme) example, because, despite elaborate draft rules, nothing was ever adopted. The problem of incentive compensation has now been deemed a non-problem.

The 2008 crisis also demonstrated beyond argument that major banks were "too big to fail". Given also that Congress chose to limit the Federal Reserve's authority to bail out a major bank, it was blindingly obvious that banks had to be regulated so that they did not fail. The Dodd-Frank Act attempted to accomplish this in several ways, and for our purposes it will be sufficient to examine two such efforts: 1) the Volcker Rule, and 2) new controls on capital and leverage. In both cases, strong rules were imposed, but have already (as of mid-2018) been substantially cut back. The rules that remain in place are clearly an improvement over the pre-Dodd-Frank regulatory environment, but it is reasonable to conclude that they fall somewhere short of the "Goldilocks Point" at which the level of regulation is "just right".

Next, the Dodd-Frank Act created a new body to protect consumers in the financial sector: the Consumer Finan-

(13) See DEALBOOK, "Citi Chief on Buyouts: 'We're Still Dancing"', New York Times, July 10, 2007.

(14) Pursuant to authority granted by the Dodd-Frank Act, the SEC adopted Rule 14a-11, which would have permitted a specified level of shareholders under defined circumstances to nominate candidates for the issuer's board of directors and include them on the corporation's own proxy statement (thereby allowing dissident shareholders to economize on the costs of a proxy solicitation).

(15) In a controversial decision, this rule was struck down by the D.C. Circuit Court of Appeals for failure to conduct an adequate cost/benefit analysis. See Business Roundtable v. S.E.C., 647 F. 3d 114 (D.C. Cir. 2011).

cial Protection Bureau (or "CFPB") [16]. Its core priorities, according to its first director, Richard Cordray, were mortgages, credit cards, and student loans [17]. To this end, the CFPB promulgated rules seeking to reform mortgage lending, including by specifying income ratios for "qualified mortgages" – an obvious response to the decline in mortgage lending standards prior to the 2008 crisis.

Since its outset, the CFPB has been the subject of legal and legislative challenges. In 2018, Congress passed, and President Trump signed into law, legislation 1) repealing CFPB's automobile lending regulations, and 2) exempting smaller banks that had been subject to its regulations [18]. Here, the banking industry has clearly counter-attacked vigorously and effectively and left the CFPB today a weak and muted agency.

Finally, what has happened to financial enforcement? Here, the most active enforcer is the SEC, and as will be seen, the SEC has shifted its focus to the retail level and sued few public companies under President Trump. This is a major shift from the Obama Administration, which in its final years compelled the largest banks to pay massive settlements for their role in the 2008 crisis.

Each of these examples needs a fuller (but still brief) examination.

Incentive Compensation

A long list of authorities can be listed for the proposition that incentive compensation (and particularly stock options) induces corporate managers to accept increased risk [19]. Some studies show that this incentive may also incline executives to engage in financial misreporting [20]. Historically, executive compensation has shifted dramatically, beginning in the 1980's. Figure A below shows the sudden acceleration in the median compensation of CEOs and other top officers from 1940 to 2000 [21].

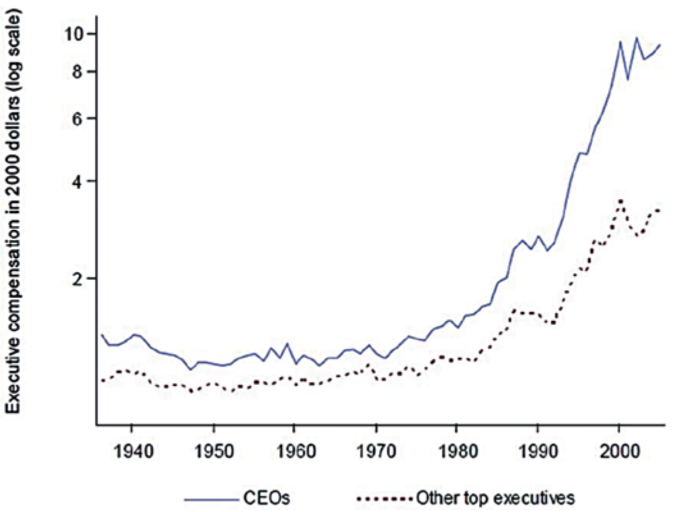

Figure 1: Median Compensation of CEOs and Other Top Officers from 1936 to 2005.

Clearly, there is a major inflection point in the 1990s. What caused it? Figure 2 below shows that a shift from cash to equity compensation bears the principal caused responsibility [22].

As of 2015, Equilar has reported that the share of total CEO compensation deriving from equity was 60% for companies in the S&P 500 [23].

The dangers of incentive compensation are particularly acute in the world of investment banking [24]. Suppose a bank realizes that securitizations have become toxic and the mortgages it has assembled into portfolios are likely to default. Should it halt their sale? If senior bank officials handling these deals stand to make bonuses of $10 to $20 million when these deals close this year, those officers will push back hard at any such suggestion. Some will leave for other jobs, and an executive revolt is predictable. Arguably, the bank just has to keep dancing "while the music was playing".

Figure 3 shows just how endemic such bonuses were at the major banks specializing in mortgage-backed securitizations. As Figure 3 shows, the major banks lost billions ($27.7 billion in the case of Citigroup), but still created enormous bonus pools even while heading towards insolvency ($5.33 billion at Citigroup in this worst year on record) [25]. Citigroup paid bonuses of over $3 million to 124 persons (and other similar banks paid such bonuses to over 200 persons).

(16) The CFPB is most easily defined as the federal agency charged by the Dodd-Frank Act with overseeing consumer protection in the financial sector. Much of its power was re-allocated from other federal agencies, including the Federal Reserve Board, which was thought to have underperformed in this area. Technically, it is housed within the Federal Reserve System, but it is independent of the Federal Reserve Board. The CFPB remains the subject of litigation challenging its constitutionality. The CFPB was clearly the brainchild of Senator Elizabeth Warren, who authored a law review article in 2007, calling for its creation. For her original conception, see WARREN Elizabeth, "Unsafe at Any Rate: If It's Good Enough For Microwaves, It's Good Enough For Mortgages", Democracy *(Summer 2007) at p. 8.*

(17) See EAGLESHAM Jean, "Warning Shot on Financial Protection", The Wall Street Journal, February 9, 2011 (quoting Richard Cordray, the CFPB's first director).

(18) See WARMBRODT Zachary, "Trump Signs Bill Blocking Consumer Bureau Auto-Lending Measure", Politico, *May 21, 2018. SHERMAN Erik, "Scaling Back Dodd-Frank Is Just the Beginning in Trump's Run On Deregulation", NBC News, May 24, 2018.*

(19) For an overview, see COLES J., DANIEL N. D. and NAYEEN L., "Managerial Incentives and Risk-Taking", 79 Journal of Financial Economics *413 (2006); LARCKER D., ORMAZABAL G., TAYLOR B. and TAYLOR D. J., Follow The Money: Compensation,* Risk and the Financial Crisis, *Stanford Closer Look Series, September 8, 2014.*

(20) See ARMSTRONG C. S., LARCKER D., ORMAZABAL G. and TAYLOR D. J., "The Relation Between Equity Incentives and Misreporting: The Role of Risk-Taking Incentives", 100 Journal of Financial Economics *327 (2013).*

(21) See FRYDMAN C. and JENTER D., "CEO Compensation", 2 Annual Review of Financial Economics *75 (2010).*

(22) Id.

(23) See Equilar, "2015 CEO Pay Strategies", at p. 90 (2016).

(24) BEBCHUK Lucian A. and SPAMANN Holger, Regulating Bankers' Pay, *98 Geo. L. J. 247, 255-274 (2010); BEBCHUK Lucian A.* et al., The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, *27 Yale J. on Reg. 257, pp. 273-276 (2010) (arguing that incentive compensation created moral hazard problems).*

(25) See CUOMO Andrew M., No Rhyme or Reason: The "Heads I Win, Tails You Lose" Bank Bonus Culture", *at 5 (2009); see also COFFEE, supra note 2, at 1068.*

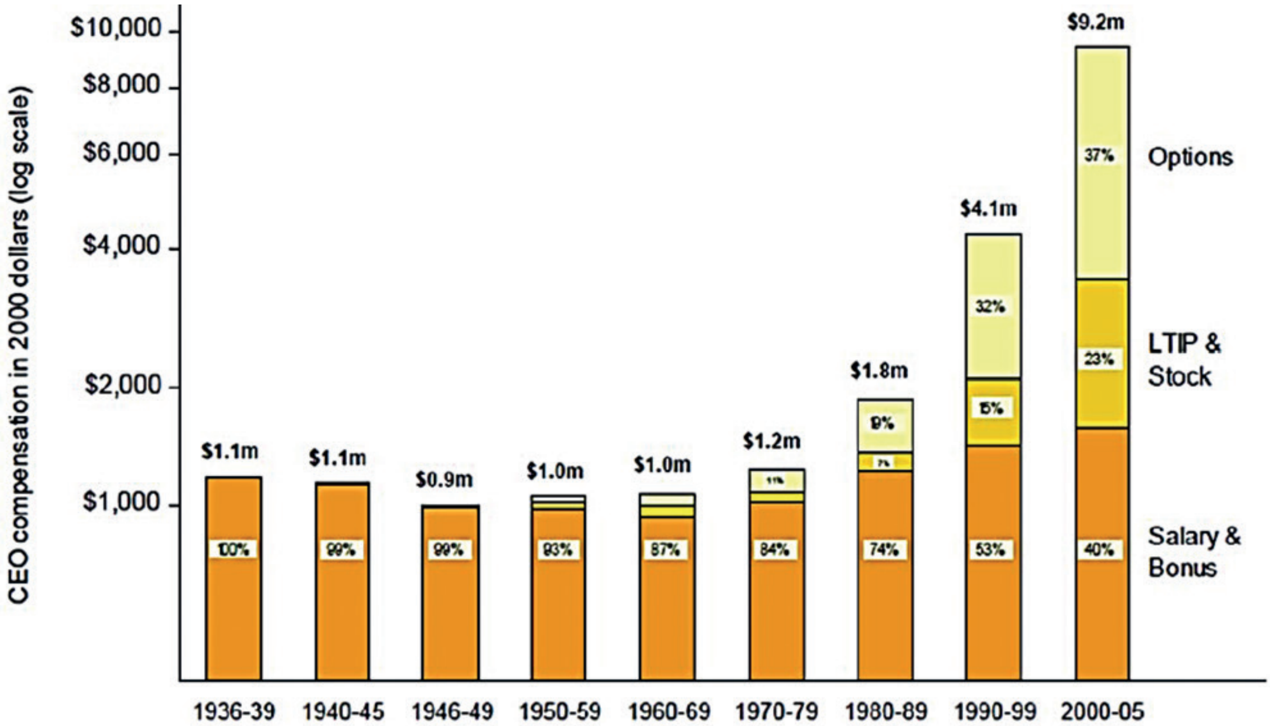

Figure 2: The Shifting Structure of CEO Compensation.

Institution	Earnings / (Losses)	Bonus Pool	No. of Employees Receiving Bonus ≥ $3 million	No. of Employees Receiving Bonus ≥ $1 million
Bank of America	$4 billion	$3.3 billion	28	172
Citigroup, Inc.	$(27.7 billion)	$5.33 billion	124	738
Goldman, Sachs Group	$2.322 billion	$4.823 billion	212	953
J.P. Morgan Chase & Co.	$5.6 billion	$8.693 billion	≥ 200	1,626
Merrill Lynch	$(27.6 billion)	$3.6 billion	149	696
Morgan Stanley	$1,707 billion	$4.475 billion	101	428

Figure 3: Selected TARP Recipients 2008 Bonus Compensation.

But these bonuses ensured that the bankers would be closing deals to earn them even at the brink of insolvency.

The draftsmen of the Dodd-Frank Act understood this problem and designed §956 to enable regulators to discourage inappropriate risk-taking at "covered financial institutions." In terms of its substantive commands, Section 956 did essentially three things: 1) it authorized financial regulators to prohibit "excessive compensation"; 2) it instructed them to discourage incentive compensation which, even if not "excessive", could lead to "material financial loss"; and 3) it required most "covered financial institutions" to disclose to their respective regulator "the structure of all incentive-based compensation" paid to officers, directors and employees, to enable the regulator to regulate compensation "that could lead to material financial loss to the covered financial institution" (26). This was vague, but it seemingly allowed regulators to request at least what was disclosed in Figure 3 above (which was disclosed by then New York State Attorney General Andrew Cuomo after an investigation of these banks).

Nothing like Figure 3 was ever disclosed (or even required in draft regulations to be disclosed). The various regulators (including the Federal Reserve, the SEC, and the FDIC) were simply faced down in negotiations by the banking community. In terms of disclosure, the regulators were convinced to accept only a generalized narrative description of the structure of executive compensation. This would have produced largely formalized boilerplate of limited value. Still, in the case of the larger banks in Levels One and Two (i.e. those with assets over $50 billion), the draft regulations did require more, including disclosure of specific details as to incentive compensation arrangements. More importantly, in these cases, the regulations proposed substantive requirements to mitigate the impact of incentive compensation, including deferrals of up to 60% of incentive compensation for up to four years (depending on the institution's size) plus clawbacks (27).

(26) Section 956 was codified at 12 U.S.C. § 5641. Still, it is the rules under Section 956 that are crucial. From early on in the implementation of the Dodd-Frank Act, it was contemplated that there would be three levels of "covered financial institutions": Level One would cover institutions with total consolidated assets of $250 billion or more; Level Two would cover institutions with total consolidated assets between $50 billion and $250 billion, and Level Three would cover institutions in the range of $1 billion to $50 billion in total consolidated assets. Institutions in Levels Two and Three were required to impose deferrals of payment, downward adjustments, and "clawback" provisions on senior executive officers and certain other employees engaged in risk-taking in order to reduce their incentives to enter transactions that could result in material losses. But institutions in all three levels were required (with some small exceptions) to comply with Section 956's disclosure provisions.

(27) Senior executive offers at Level One financial institutions were, under the proposed rules, to be subject to deferral of 60% of incentive compensation for four years (and significant risk takers at Level One institutions, who were not such executives, would face a deferral of 50% of such compensation for four years). Thus, traders, if covered at a Level One bank, would not receive half of their bonuses or other incentive payment for four years.

These were meaningful reforms, but they did not apply to many of the persons most likely to injure their institutions in pursuit of incentive compensation. Although the Dodd-Frank Act recognized that employees other than senior executives (whom it termed "significant risk-takers") might similarly cause material losses, it did not specify how persons in this latter category should be defined or identified. Logic and experience suggested that most traders can easily cause such a loss, possibly through unauthorized trading (Barings Bank had failed from such an experience and Societe Generale had had a very recent similar experience) (28). Although this expanded coverage was logical, it threatened banks and caused them to push back. If banks had to disclose their compensation levels for traders and then design rules that restricted or delayed their incentive compensation, these traders might migrate *en masse* to unregulated hedge funds (and indeed many did). Thus, the banking industry wanted a different standard under which the board (or a committee thereof) of each large bank would determine who could cause it a "material financial loss". Only these identified persons would then be subjected to restrictive policies (such as clawbacks). Obviously, banks had an incentive under this standard to under-identify those who could harm it.

Based on this weak compromise, the Obama Administration in 2011 implemented Section 956 to require only 1) a lengthy narrative on covered banks' executive compensation policies; 2) in the case of banks with assets over $50 billion, more specific rules on disclosure with respect to executive officers and those persons, if any, identified by the board as being capable of causing a "material loss;" and 3) deferral and clawback rules for the executive officers and other persons so identified (29). In short, each major bank could largely decide for itself to whom Section 956 would apply.

This was extreme deference to the industry, but it was only the start. The rules proposed in 2011 and published in the Federal Register were never adopted. Even these were resisted by the industry. By the end of the Obama Administration in 2016, new rules – tougher in some respects and softer in other respects – were widely circulated, but these too were never adopted (30). Then came the Trump Administration, and the entire project was quickly shelved. No rules are currently under consideration, and Section 956 has been quietly abandoned.

To sum up, the 2008 crisis was caused at least in substantial part by excessive risk-taking motivated in the view of most observers by excessive incentive compensation. Congress passed a broad grant of authority (Section 956) to curb excessive incentive compensation, but the entire project collapsed (in stages) in the face of industry opposition. To be sure, many major banks today do have "clawback" policies, but examples are few and far between in which compensation has been recovered pursuant to them (31). If this shows anything beyond political cowardice in Washington, it is that Mancur Olson was on to something important.

Who Is a SIFI?

Recognizing that major banks (and other financial institutions) were "too big to fail", the Dodd-Frank Act subjected them to additional oversights and imposed higher capital and more restrictive leverage requirements. At the time, this was relatively uncontroversial, as Lehman and AIG were very visible cases in point of poorly managed financial institutions (and they were not the only firms rendered insolvent in 2008). But when the Regulatory Sine Curve turns downward, lobbyists pursue deregulation incrementally. A first target was the level at which a bank must become a SIFI. Under the Dodd-Frank Act, this level was set at $50 billion. Almost everyone today concedes that that level was probably set too low. The "Economic Growth, Regulatory Relief and Consumer Protection Act," enacted by Congress and signed by President Trump in 2018, raised this level (in stages) to $250 billion (32). Is this level

(28) For example, Jerome Kerviel lost $7.2 billion for Societe Generale in 2008 through unauthorized trading as a relatively junior trader. See ISKYAN Kim, "Here's the story of how a guy making $66,000 a year lost $7.2 billion for one of Europe's biggest banks", Business Insider*, May 8, 2016. Ultimately, Mr. Kerviel was criminally convicted by a French court, but whether he was a "rogue trader" (as his employer characterized him) or only a fallible trader who responded to excessive incentives remains debatable.*

(29) See "Incentive-Based Compensation Arrangements", Exchange Act Release No. 64, 140, 76 Fed. Reg. 21,120 (April 14, 2011).

(30) No single proposed regulation was jointly released by all six agencies (The Federal Reserve Board, the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the National Credit Union Administration); nor were these rules filed in the Federal Register. Major law firms, however, wrote detailed memos to their clients about these changes. See Latham & Watkins, "Client Alert: Revised Rules on Dodd-Frank Incentive Compensation Requirements for Financial Institutions Proposed" (May 4, 2016 - Number 1963). One important change was to define "significant risk-taker" to include only persons at Level One and Two institutions who received at least one-third of their compensation in the form of incentive compensation and were "among the top five percent (for Level One covered institutions) or top two percent (for Level Two covered institutions) of highest compensated covered persons" and had "authority to commit or expose 0.5 percent or more of the capitals of the covered institution". Id at p. 6. Such a definition would likely exclude most traders at most institutions. But at least this provision would have ended total reliance on the board's (or committee's) identification of "significant risk-takers".

(31) To my knowledge, as of mid-2018, the only significant use of clawbacks subsequent to the 2008 crisis has been at Wells Fargo Bank, where the board clawed back $75 million from two executives (Chairman John G. Stumpf and Executive Vice President Carrie L. Tolstedt) in the wake of a scandal there that was unrelated to the 2008 crisis. See COWLEY Stacy and KINGSON A., "Dealbook: Wells Fargo to Claw Back $75 million from 2 former Executives", New York Times*, April 10, 2017.*

(32) This legislation, sponsored by Senator Michael Crapo of Idaho and known as S.2155, passed Congress in late May, 2018 when the House adopted the Senate bill. In both the House and the Senate, there was relatively bipartisan support for the legislation. Clearly, this legislation did not repeal the Dodd-Frank Act (and the House version, which would have repealed the Volcker Rule, did not pass the Senate, although S.2155 does exempt banks with less than $10 billion in assets from that rule). Title IV of S.2155 raises the SIFI threshold from $50 billion to $250 billion (but permits the Federal Reserve Board to determine that specific banks with assets greater than $100 billion should be subject to the same standards as a SIFI). Title IV further ends "company run" stress tests for banks with under $250 billion in assets. "Periodic" supervisory stress tests are still permitted for banks with assets from $100 billion to $250 billion.

too high? Here, one can quickly generate a spirited debate. Probably around two dozen banks were exempted from SIFI status by this change. It is unlikely that the failure of any one of these banks would have the same impact as Lehman's failure in 2008 (although Lehman's failure may have shocked the market because it showed that the market did not properly understand the vulnerability and exposure that financial institutions had, both in the "repo" market and in terms of the illiquidity of their holdings).

Still, even if the impact of raising the level of SIFI-hood is indeterminate, one example bears special emphasis. The 2008 crisis started in the market for residential mortgage-backed securities. Here, one villain does stand out: Countrywide Financial Corporation, the largest U.S. lender in sub-prime mortgages. By most accounts it was a "freewheeling mortgage machine" that led a general relaxation in mortgage lending standards, through such techniques as "exploding interest rates" and "interest only" mortgages (33). On the brink of insolvency, Countrywide was acquired (probably unwisely) by Bank of America, which has been forced to absorb billions in liabilities attributable on Countrywide's behavior. The relevant point here is that Countrywide (at the time of its acquisition) fell in the zone between $50 billion and $250 billion that has now been deregulated. Had Dodd-Frank existed in 2006, Countrywide would have been subject to leverage ratios, capital levels, and stress tests that might have identified it as a dangerously exposed bank at an earlier stage. Countrywide's example suggests that more supervision is needed over banks in this range, particularly because stress tests would reveal weaknesses that can later destabilize the market (34).

In addition to the "Economic Growth, Regulatory Relief, and Consumer Protection Act" discussed above, the Federal Reserve is currently rewriting and lowering its leverage-ratio rule (which require U.S. banks to maintain a minimum level of capital defined in terms of their total assets). Essentially, this reduction will be down to a level required by the Basel Committee on Banking Regulation; thus, it is unlikely to be a game-changing reduction. Nonetheless, this reduction should be measured against a contemporaneous marked change in banking behavior. In 2018, for the first time since 2008, U.S. banks will pay out in dividends and stock buybacks more capital than they are earning from their operations (35). In effect, capital is flowing out, just as deregulation is reducing the mandatory standards. If this trend continues, banks could return to their position in the pre-bubble era.

The Volcker Rule

If major banks are "too big to fail" and if Congress insists that bailouts are impermissible, then banks must be regulated so they do not fail by barring them from risky activities. The Volcker Rule is a means to this end (36). To be sure, the activities barred by the Volcker Rule did not cause the 2008 crash. But this concession means little, as all crashes come from the blind side. Restricting the risks that banks can run therefore makes sense.

In its core provision, the Volcker Rule barred banks from engaging in "proprietary trading" on the obvious premise that banks (which have thin equity) should not be able to bet on securities with effectively their depositors' money. But the term "proprietary trading" is not self-defining, and thus an important provision in the rule was its presumption that any position in a security held far less than 60 days was to be deemed a "proprietary" trade. That presumption would now be abandoned. In addition, the Volcker Rule contained exemptions for trading done as a part of hedging, market-making or underwriting activities by the bank. These exemptions will now be expanded, and the documentation necessary to justify them will be greatly relaxed. As others have phrased it, the result is to turn the Volcker Rule into "a 'we'll-take-your-word-for it' kind of a rule" (37). Depending on how the Volcker Rule is enforced, these changes will downsize it somewhere between moderately and greatly.

In all likelihood the level of speculative trading by banks in securities will not return to pre-2008 levels, largely because high-paid traders have migrated to hedge funds. This migration was partly caused by expected controls on incentive compensation at banks, but those rules were never adopted. Thus, over the long-run, it is unclear whether traders will return to banks, so that banks could again become major players in speculative trading.

To sum up, the Volcker Rule has not been abolished, but compliance with it is likely to vary significantly across banks, and ultimately this could produce a standard race to the bottom.

The Consumer Financial Protection Bureau

This agency, created by Dodd-Frank based on a 2007 proposal by now Senator (but then Professor) Elizabeth Warren, has always been controversial (38). Essentially, Dodd-Frank concentrated the consumer protection responsibilities of several federal agencies in the CFPB. From its outset, the CFPB made clear that its high-priority concerns were with mortgage lending, credit cards, and student loans (39).

Correspondingly, from its outset, the Trump Administration made clear its hostility to the agency, and the CFPB direc-

(33) See MORGENSON Gretchen, "Fair Game: Countrywide Mortgage Devastation Lingers on as Ex-Chief Moves On", N.Y. Times, *June 26, 2016 at B-1.*

(34) It should be added that even under the 2018 legislation, the Federal Reserve can still order banks with assets over $100 billion to undergo stress tests, but such authority is likely to be used by the Fed only sparingly.

(35) See GRAY Alistair and MCLANNAHAN Ben, "U.S. banks poised to hand out $170 bn", Financial Times, *June 18, 2018 at p. 13.*

(36) Essentially, the Volcker Rule bars commercial banks from "proprietary trading" or owning or sponsoring a hedge fund. Section 619 of the Dodd-Frank Act, which has been codified at 12 U.S.C. § 1851, expresses this prohibition. The rules implementing the Volcker Rule were delayed as the result of lobbying and did not go into effect until July 21, 2015.

(37) See ARNOLD Chris, "Fed Proposes Changes in Volcker Rule", NPR, May 21, 2018. Smaller banks with assets under $10 billion are now exempted from the Volcker Rule. See note 32 supra.

(38) For the article by then Professor Warren, see WARREN, supra note 15.

(39) See EAGLESHAM, supra note 16 (quoting CFPB's first director, Richard Cordray).

tor initially appointed by President Trump, Mick Mulvaney, once called the agency a "sick, sad joke" (40). In 2018, legislation supported by the Trump Administration was twice enacted, in the first case, exempting smaller banks from the CFPB's jurisdiction and, in the second case, repealing the CFPB's rules on automobile lending (41). Mulvaney also summarily dismissed the CFPB's Advisory Committee after they had criticized his failure to meet with them.

In short, in contrast to the more moderate reforms relating to SIFI status, the Volcker rule, or leverage ratios, the CFPB has been effectively placed in a deep freeze and rendered inactive. The impact of such a move on systemic risk regulation is, however, less clear. Although rules restricting "interest only" mortgages and overly liberal lending might have a salutary effect on systemic risk, this was never the CFPB's mission or priority. No agency in Washington is prepared to stand between borrowers and easy money. And that is one way to state the dilemma surrounding systemic risk regulation.

Financial Enforcement

Legal realism tells us that rules do not work unless they are enforced. Yet, enforcement with respect to financial regulations (including anti-fraud rules) appears to be on the wane. A 2018 study by Cornerstone Research and the NYU Pollack Center finds that SEC enforcement actions against public companies declined to the lowest level in five years, with only 15 new actions being filed in the first half of 2018 (42). This was a 67 percent decrease from the corresponding period in 2017. Of course, the SEC is only one agency, but it has the largest enforcement resources and capacity of any federal administrative agency and has traditionally been the leader. Add to this picture the forced muting of the CFPB and the extent to which revised rules (such as the revised Volcker Rule) depend upon voluntary compliance, and the prospect for undetected misbehavior looms large.

In contrast, in Europe, there is a new enthusiasm for financial enforcement. The European Commission is working on proposals to give the European Banking Authority greater enforcement powers and resources to investigate banks for money laundering and illicit financing (43). A new pan-European agency (created in the wake of the financial crisis) – the European Public Prosecutor's Office – may also receive enhanced authority, particularly to investigate terrorist financing (44). To be sure, these new powers are a response to a series of scandals that have shown the European banking system to have been exploited by Russian and other criminals to launder billions in illicit funds. But for Europe to be investing in enforcement, while the U.S. trims its efforts, is a unique phenomenon.

An Initial Summary

This tour has been brief and incomplete. One could alternatively have examined recent developments in swaps and derivative trading, or at money market funds, or at clearing and credit rating agencies. But the same picture would likely emerge: some deregulation may seem justifiable; other deregulatory efforts are harder to evaluate; and finally, some deregulation seems clearly unjustifiable, leaving us with a half-built regulatory fortress lacking a wall on at least one side. This does not mean that another financial crash is predictable in the short-run; indeed, realists must recognize that the banking industry is at the top of its business cycle and banks' stock prices have never been higher. The point is rather that the business cycle eventually turns downward (45), and our defenses against systemic risk remain incomplete and inadequate.

How to Moderate the Regulatory Sine Curve

To this point, this article has emphasized three themes: 1) incentive compensation and competitive pressure will continue to fuel excessive risk taking in the financial sector; 2) the forces favoring deregulation are better organized, better funded, and better able to fight longer and harder than the temporary coalitions that assemble to seek reform after a financial crisis; and 3) somehow Europe, perhaps because of its less centralized political economy, seems less subject to the Regulatory Sine Curve. Where do these themes lead? First, what should the U.S. do if we start with the necessary recognition that we cannot turn ourselves into Europe? Even if one can imagine ways in which Congress could write more mandatory legislation on incentive compensation and other topics, the real problem is that more rigid rules are even more likely to be repealed or watered down by a later Congress. For example, the central idea adopted by the original designers of Dodd-Frank's incentive compensation rules was to delay incentive compensation (or at least 50% of it) for a period of years in order to permit bonuses and options to be clawed back if the transaction justifying the bonus later soured. Conceptually, this seems sound, but its impact will be minimal if the clawback period is not long enough or if the "covered persons" do not include all those who could cause material loss to the company (such as "star" traders). Realistically, the Obama Administration's proposed rules (at least the 2011 version) were full of loopholes and inconsistencies. For example, the proposed holdback would have senselessly applied to the company's General Counsel (who is an "executive officer,"

(40) See O'DONNELL Katy, "Mick Mulvaney isn't blowing up the CFPB; it's more like a death by a thousand cuts, critics say", Politico *(April 30, 2018).*
(41) See sources cited supra at note 17.
(42) See Cornerstone Research, "SEC Enforcement Activity: Public Companies and Subsidiaries - Midyear FY 2018 Update".
(43) See KHAN Mehreen and BRUNSDEN Jim, "Bank Scandals spur EU to ramp up fight against cross-border crime", Financial Times, *September 10, 2018 at p. 1.*
(44) Id.
(45) Despite a healthy, even booming, stock market, there are already warning signals flashing of a crisis in global debt markets. In June 2018, the Bank of England released a highly critical report on global debt markets that (in the words of The Wall Street Journal*) "voiced particular concern about the U.S., where corporate borrowing has ballooned to 290% of first quarter earnings, according to BOE calculations" and has been "accompanied by looser lending standards, leading to a surge in high-risk lending…, a large share of which is being parceled into securitized assets sold to investors worldwide". See DOUGLAS Jason, supra note 3. This sounds like 2007 all over again.*

but seldom a key financial decision-maker), but not to its star traders. The statutory language in Section 956 was adequate, but the proposed rules were too compromised to be effective.

This example illustrates that the deeper problem here is how to minimize post-crisis backsliding when the lobbyists begin to pressure the regulator. Predictably, those doing this lobbying will be former regulators, themselves, and their approach will be friendly, helpful and well-informed. Nor will there be any organized group, ready, able and well-funded enough to counter their efforts.

In that light, this article will make two modest proposals: the first contemplates a special watchdog for systemic risk, and the second seeks to enlist existing gatekeepers to focus on systemic risk.

Creating A Watchdog for Systemic Risk

Financial reform legislation needs to create its own guardian. This guardian could not be part of the Government, itself, because shifting political tides would cause it to be staffed by the President and party in power. Rather, a permanent body, with an Inspector General-like authority, needs to be created, whose views would have to be solicited and which would publicly provide its evaluation. Its initial members would be persons with expertise in the field of systemic risk who would be Presidential appointees. Ideally, they would be appointed at (or immediately after) the time of the legislation's passage [46], but these initial members would appoint their own successors by majority vote. This self-perpetuating feature is intended to assure greater continuity and less political pressure. Suppose, for example, that the Dodd-Frank Act had required such a body, and President Obama had appointed to it persons such as Paul Volcker and Barney Frank. By now, some initial appointees might have retired, but to the extent their successors would have been appointed by the rest of this board, greater stability and consistency of outlook seems likely.

What powers would it have? First, rules and regulations (such as the Volcker Rule) adopted pursuant to the statute (and any amendments thereto) would have to be presented to it for its review and public comment. Possibly, this body could even require a delay (conceivably of up to a year) if it felt the proposed rules or regulations were inadequate or misguided [47]. Of course, this body would be constrained by the knowledge that Congress could at any time abolish it (or change its powers), and its members would be removable by the President for cause and could serve no more than a specified term of years. Its real power would lie in its prestige, as its criticism should embarrass the agencies it criticized. Essentially, the proposal is to create a counterweight to lobbying pressure, as this would be a small, cohesive, well-informed (and well paid) body.

Besides commenting on proposed rules, this body could also be asked to comment on proposed plans submitted pursuant to the statute by covered institutions. For example, if a bank were required to submit its executive compensation and clawback policies to the Federal Reserve, they would be passed onto this body for its public evaluation. It would not necessarily have the power to modify or delay, but its comments could help the regulator negotiate a stronger compromise (as the regulator could point to this body as insisting on a stronger policy). Often, regulators are being pushed only from one side and the proposal here is to ensure that there is counter-pressure when needed.

How powerful is prestige in a political world dominated by sound bites, 24-hour news cycles, and "alternative facts"? Skeptics can question this premise that prestige still counts, but this body's members would be nationally known, either for their expertise (think, Paul Volcker) or their commitment to the goals of the legislation (think, Barney Frank). The regulator – whether the Federal Reserve, the F.D.I.C. or the SEC – would not want to be in a public quarrel with it. Power also comes from financial resources, and this body could also be funded through industry assessments (much as FINRA or the F.D.I.C. are today), which all covered financial institutions would be required to pay. Thus, it would have adequate funding. This differentiates it from private groups. To be sure, private advocacy groups seeking to advocate strong systemic risk regulation are desirable and have arisen [48], but they have neither the prestige nor funding of this proposed body. Is this a panacea? By no means will such a body fully counter the power and impact of lobbyists, but it is a counterweight that could partially compensate.

Enlisting the Gatekeepers

The landscape of contemporary corporate governance is populated by a number of "gatekeepers," who are essentially reputational intermediaries who pledge their reputational capital to give credibility to their assessments to investors [49]. Auditors verify past earnings; securities analysts predict future earnings; and credit rating agencies assess the company's creditworthiness. But no gatekeeper evaluates a large financial institution's vulnerability to systemic risk. That omission can and should be rectified.

One means to this end would begin by recognizing that a large financial institution's internal controls should focus on the financial institution's exposure to systemic risk. Today, theses controls focus on the accuracy of its financial

(46) No position is here taken on whether senatorial confirmation should be necessary for the initial appointees. Obviously, many agencies have advisory boards whose members are not confirmed by the Senate, but this body would have power to delay the effectiveness of proposed agency rules and this might point to the need for Senate confirmation. Also, a requirement of senatorial confirmation might give this body greater prestige and visibility. To the extent that this body has any power, removal of its members for cause by the President (or perhaps the Federal Reserve Board) is probably constitutionally required. See Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd, 561 U.S. 477 (2010).

(47) In this light, the members of this body would have to be subject to some conflict of interest rules.

(48) One such example is Better Markets, a non-profit organization founded after the 2008 crisis "to promote the public interest in the financial markets".

(49) For an overview of gatekeepers in corporate governance, see COFFEE John C., Jr., Gatekeepers: The Professions and Corporate Governance *(Oxford University Press 2006).*

statements and its exposure to fraud and misappropriation. Since the Sarbanes-Oxley Act in 2002, public companies (with some modest exceptions for smaller companies) are required by Section 404 of that Act to report on the adequacy of their internal controls, and Section 404(b), as interpreted by the Public Company Accounting Oversight Board, requires the auditor to audit these controls, reporting on their adequacy [50].

The next step is the key one. A financial institution's internal controls should guard it not only from the overstatement of earnings or the misappropriation of assets, but from a systemic risk crisis. What would such internal controls look like? They might include constraints on "excessive compensation" and incentive compensation that could lead to "material losses" – just as Section 956 of the Dodd-Frank Act mandated. Although Section 956 has been ignored, a body such as the PCAOB could require the auditor to express its view on whether the financial institution had adequate policies and procedures to address systemic risk. To be sure, this will not happen during the Trump Administration, but our vision has to extend beyond that point. If the concept of internal controls is to make sense and be relevant, it has to encompass not only protections against small errors in financial reporting, but also major inadequacies (such as exposure to a systemic risk) that could ignite a major financial crisis. Ideally, future legislation could instruct the SEC and the PCAOB to insist that certain issuers (i.e., largely major financial institutions) design their internal controls to address this issue and that auditors assess and report on the adequacy of these controls. Even in the absence of new legislation however, a future PCAOB could focus auditors on this issue.

Conclusion

The last decade has seen the Regulatory Sine Curve follow its customary path in the U.S., and even more quickly than usual. This speed may be partially attributable to the appearance of Donald Trump – clearly a disruptive personality eager to junk existing law and favoring massive, even chaotic, deregulation. Nonetheless, it would overstate to accord him the primary role in the recent retreat from strong systemic risk regulation. The Economic Growth, Regulatory Relief and Consumer Protection Act, enacted by Congress in 2018 [51], was designed in Congress with little direct involvement by the President. Nor does that statute repeal the Dodd-Frank Act (or take other severe action of the kind that President Trump usually favors). At most, it represents the beginning of a death by one thousand cuts, which is the classic pattern.

Also, the most important defeat for systemic risk regulation came before President Trump's election: the failure to implement Section 956 of the Dodd-Frank Act and curb incentive compensation at major financial institutions. Absent such a reform, everything else may amount to little more than re-arranging the deck chairs on the Titanic. So long as financial executives are incentivized by the high octane fuel of high incentive compensation, they will focus on the short-run tactics that maximize that compensation. That best explains the 2008 crisis, and in time may explain the next crisis.

Europe, however, presents a different story. The Regulatory Sine Curve has not been as evident, and Europe seems interested today in developing a serious pan-European enforcement presence. Possibly, this is because Europe is better insulated from the power of the special interest groups that have pushed deregulation in the U.S. Alternatively, Europe may be too absorbed with the battle over Brexit to pay attention to other matters. Still a last possibility is that, although the pace of the Regulatory Sine Curve has been slower in Europe, it may not have yet run its full course. This is the most ominous possibility: the movement toward deregulation may just be beginning in Europe. If so, then systemic risk regulation could still be curbed or unwound in Europe also. The future is thus uncertain, and this story has not yet ended.

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(50) Under Section 404(a) of the Sarbanes-Oxley Act, management must first provide an "internal control report" as part of the company's Annual Report on Form 10-K, which must contain "an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting". Then, under Section 404(b), the auditor "shall attest to, and report on, the assessment made by the management of the issuer". Section 404(b) further provides that this assessment shall be "made in accordance with standards for attestation engagements issued by the" PCAOB (which required a full audit for this assessment). Section 404 of Sarbanes-Oxley has been codified at 15 U.S.C. Section 7262.

(51) See text and note supra at note 32.