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After Dodd-Frank:

The Post-Enactment Politics of Financial Reform in the United States

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## ABSTRACT [first revision]

The financial crisis of 2008 raised the politics of regulation to a new level of practical as well as scholarly attention. This paper argues that the post-enactment politics of implementation matter as much to the success of regulatory reform as the politics of passing legislation. In contrast to the prevailing concepts of regulatory capture and business power, we find that recent reforms in U.S. financial markets hinge on intellectual resources and new organizational actors that are missing from existing theories of regulatory change. In particular, small advocacy groups have proven significantly more successful in opposing the financial-services industry than the existing literature predicts. By maintaining the salience of reform goals, elaborating new analytic frameworks, and deploying specialized expertise in post-enactment debates, these small organizations have contributed to a diffuse but often decisive network of pro-reform actors. Using empirical material from the rule-writing process for macroprudential supervision and for derivatives trading, we show that these small organizations coalesce with other groups to form a new stability alliance that has prevented industry groups from dominating financial regulation to the degree that occurred in earlier cases of regulatory reform.

After Dodd-Frank:

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John T. Woolley

## **I. Introduction**

The financial crisis of 2008 elevated the analytic priority of the politics of financial regulation. The literature on regulation has been dominated by the concepts of business power and the possibility of regulatory capture. Contrary to previous cases of major reform, where public attention subsided quickly after the enactment of new laws, attention to the goals of the Dodd-Frank reforms has been sustained. Due to the emergence of a new network of interested organizations, the ability of incumbent firms to dominate the rule-making process has been blocked in important ways. As we show in this paper, the changing landscape of regulation is shaped above all by a consensus around a set of key ideas and policy objectives that stand in stark contrast to previously dominant views.

Passed in July 2010, the Dodd-Frank Act<sup>1</sup> was the outcome of the Obama Administration's primary effort to craft a thoroughgoing regulatory reform for financial markets after the emergency bailouts of late 2008. Even before taking office in January, 2009, the Obama team was under intense pressure to supplement the taxpayer-funded bailouts with more lasting regulatory reforms that would sharply reduce the likelihood of similar meltdowns in the future. Revamping existing financial regulatory institutions was second only to health care

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<sup>1</sup> Public Law 111-203, "Dodd-Frank Wall Street Reform and Consumer Protection Act," signed into law on July 21, 2010.

legislation as a priority for the new Administration. When signed by the President in July 2010, the Dodd-Frank Act was hailed as the most far-reaching overhaul of the country's financial structure since the Great Depression. Yet many observers – and much of the press – fear the reforms are being diluted in the regulatory implementation process through industry efforts—that is, they have been “captured” by the very interests the legislation was intended to constrain.<sup>2</sup>

Social scientists have also become attuned to the risk that general interest reforms can be eroded even after legislative passage.<sup>3</sup> Contrary to the image of Dodd-Frank as a well-intended reform that has been subverted by powerful business interests, we argue that the implementation of Dodd-Frank requires a different understanding of post-enactment politics based on a broadened view of business power. We do not claim – nor do the most optimistic observers we have encountered – that the Dodd-Frank reforms can assuredly prevent financial crises in the future. It is too early to gauge the success of the legislation in the broadest terms. Yet in the implementation process to date regulators have used their new statutory powers to take many actions contrary to the explicitly and strongly expressed preferences of the financial services industry. These actions have imposed significant new costs or limits on industry.

These developments do not mean the financial industry has been tamed.<sup>4</sup> Rather, they mean the post-enactment politics of financial reform are, like the politics of enactment, contingent on an evolving set of coalitions that exploit the procedural features of the rule-making process to advance their goals. To understand this process, we need a framework quite different from the stark images of regulatory capture and business power that have informed the literature so far.

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<sup>2</sup> For example, Haley Sweetland Edwards, “He Who Makes the Rules,” in *Washington Monthly*, March/April 2013.

<sup>3</sup> Eric Patashnik, *Reforms at Risk: What Happens after Major Policy Changes Are Enacted* (Princeton: Princeton University Press, 2008).

<sup>4</sup> Indeed, as former Treasury Secretary Geithner, writes, regulatory reform is a “forever war.” Geithner, *Stress Test: Reflection on Financial Crises* (NY: Random House, 2014), 505.

Toward this goal, we examine several types of resources including the ability to sustain an issue in the public eye, the articulation of coherent guiding ideas and principles, the capacity to find allied, if not formally coordinated actors, as well as to bring material resources or positional advantages to bear on key decision makers. This approach requires an altered understanding of capture. It further implies that business can activate sources of power beyond those described by the contrast between instrumental versus structural power. More specifically, the financial services industry provides not only discrete products for its customers but also produces a body of expert knowledge on which regulators depend as they seek to supervise market competitors. This sort of expert knowledge can itself, when uncontested in the post-enactment process of rulemaking, become a significant form of political power. Our argument for these underlying changes in the politics of financial reform relies on three main assertions.

*First*, the financial crisis was the culmination of a thirty-year period of deregulatory policy that fundamentally altered the underlying principles as well as the competitive boundaries of the finance industry. The deregulatory program from the 1970s to 2008 made financial services ever more central to the U.S. economy. This broad-ranging shift, often termed “financialization,”<sup>5</sup> had the effect of permitting more concentration in certain financial markets while encouraging more competition in others. As a result, the customary mechanisms of regulatory capture were slowly transformed. Instead of privileging incumbent firms by creating entry barriers that protected them from competition, federal regulatory agencies increasingly exposed firms to competition and accepted arguments from free-market principles, moving away from prescriptive rules toward greater reliance on industry self-regulation.

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<sup>5</sup> Greta Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge: Harvard University Press, 2011).

*Second*, by changing the basis of regulatory capture from entry-barrier mechanisms to a diffuse but pervasive sort of intellectual capture, the deregulatory interregnum from 1977 to 2007 had cross-cutting effects. It made the industry more dependent on widespread acceptance of its central role in the country's economic life. At the same time, the pervasive role of finance made the industry increasingly vulnerable to intellectual challenge and popular rejection. The shift to new forms of regulatory capture opened the door to policy entrepreneurs and activists who questioned the principles of market self-regulation in finance. Once the crisis of 2008 revealed the potentially disruptive fragility of core financial markets – in securitized mortgages, short-term commercial credit, and derivatives – the proponents of regulatory change gained an immediate forum for their views.

*Third*, the organizations and individuals that joined the debate over financial reform coalesced into identifiable formations that supplied the vocabulary and organizing concepts for legislators and regulators alike. We elsewhere characterize the pre-enactment debates as having a “two-tier” quality – elites in key institutions aligned themselves with powerful strands of popular, grass-roots support.<sup>6</sup> As reform moved from the legislative to the administrative arena, these formations looked less and less like traditional coalitions of constituents and interest groups. They instead took on the form of loose but influential advocacy networks that spanned individual firms, industry groups and their established lobbying organizations, academic experts, think tanks, policy entrepreneurs inside as well as outside government, grass-roots coalitions, and finance specialists turned activists. The advocacy network that emerged to champion more stringent reform we call the “stability alliance” – an interest formation not familiar in the existing literature on regulation or business power. The advocacy network that questioned the reform and

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<sup>6</sup> See John T. Woolley and J. Nicholas Ziegler, “The Two-Tiered Politics of Financial Reform in the United States,” in Renate Mayntz, ed., *Crisis and Control: Institutional Change in Financial Market Regulation* (Frankfurt/New York: Campus Verlag, 2012), 29-65.



instead promoted the industry's preference for continued policing of its own members we call the "self-regulation alliance."

To demonstrate the potentially decisive role of these advocacy networks, we examine the implementation of two far-reaching changes envisioned by the Dodd-Frank Act: (1) the creation of a new superordinate council of regulators, the Financial Stability Oversight Council (FSOC), to grapple with the problem of systemic or "macroprudential" risk, and (2) the dramatic expansion in the mission of one agency, the Commodity Futures Trading Commission (CFTC) for regulating derivatives. Both of these provisions implied major reductions in the autonomy and operating scope of the largest businesses in financial services. Both examples represent cases where we would expect the incumbent firms to exert maximum effort to maintain their positions, and are therefore good tests for our argument.

## **II. The Literature to Date: Regulatory Capture and Business Power**

In analyzing the post-enactment vulnerability of reform legislation, scholars have revived two key concepts from earlier debates: capture and business power. The notion of regulatory capture grew out of the public choice approach to regulation. As elucidated by George Stigler and Mancur Olson and applied to politics by scholars including James Q. Wilson, capture theory argued that concentrated industry groups were able to shape regulatory policies to their own advantage. In particular, concentrated industry groups could lobby for barriers to entry, thereby limiting competition and imposing higher costs across less well organized groups of consumers. This view informs much of the recent press coverage on Dodd-Frank and accentuates expert

concern that the reforms are being diluted so significantly that the legislation will not achieve its goal of preventing future financial crises.<sup>7</sup>

Despite its elegance, this rent-seeking approach to capture has been critiqued by a number of scholars. Daniel Carpenter and David Moss argue against the primacy of entry barriers as the one and only goal of incumbent firms in regulated industries. Rather than a question of “capture” or “no capture,” Carpenter and Moss show that industry influence takes a variety of forms and degrees. For example, James Kwak reviews the evidence for a type of “cultural” capture that rests on career patterns and world views shared by finance executives and regulatory staffs. Nolan McCarty argues that some industries possess a preponderance of specific expertise that makes a related form of “capture through complexity” predictable.<sup>8</sup> In a parallel vein, Gunnar Trumbull has documented cases where diffuse interest groups constrained industry influence far more effectively than the literature on capture predicts. He shows how effective politicking over regulatory policy hinges as much on the articulation of “legitimacy narratives” as on direct lobbying. On this view, industry groups have to compete with others – including consumers and regulators themselves – in defining alternative conceptions of the public interest. In different ways, these arguments all show how intellectual resources of several types can play a key role in debates over regulatory reform.<sup>9</sup>

In contrast to the literature on regulatory capture, the debates on business power grew out of a class-based view of politics. To be sure, in the 1960s, business provided important material

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<sup>7</sup> See, for example, Haley Sweetland Edwards, “He Who Makes ....” Among legal scholars, see especially Arthur E. Wilmarth, “Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street,” *Univ. of Cincinnati Law Review*, 81:4 (2013).

<sup>8</sup> Daniel Carpenter and David A. Moss, “Introduction,” in Carpenter and Moss, eds., *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (Cambridge University Press, 2014). See also the chapters by James Kwak and Nolan McCarty in the same volume.

<sup>9</sup> J. Gunnar Trumbull, *Strength in Numbers: The Political Power of Weak Interests* (Cambridge: Harvard University Press, 2012).

for the analysis of interest groups in American pluralism.<sup>10</sup> By the mid-1970s, however, scholars grew dissatisfied with the idealized view that saw business as no different in principle from other interests in a democratic policy.<sup>11</sup> Among the earlier proponents of pluralism, Charles Lindblom provided an especially notable reassessment in arguing that business occupied a structurally privileged position in capitalist societies. Because business provided the preponderance of investment capital and jobs,, it could extract anticipatory concessions from politicians by virtue of its positional advantage even without instrumental efforts such as explicit lobbying.<sup>12</sup>

Interestingly, as the pluralists were acknowledging the positional or structural power of business, neo-Marxist scholars began to question whether the decisions of state officials were invariably determined by the interests of capital owners. Fred Block showed that state officials often anticipated the long-term needs of the private sector even when owners lacked the insight necessary to articulate their own interests explicitly. At times of major crisis, such as war or economic collapse, however, Block argued that state officials were able to elevate emergency, society-wide goals over those of private capital owners.<sup>13</sup>

Subsequent authors have taken up Block's insights by analyzing how business power can vary between structural and instrumental forms.<sup>14</sup> One relevant strand of literature emphasizes

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<sup>10</sup> It is often forgotten, for example, that the widely-used distinction between distributive, regulatory, and redistributive policies was articulated in a review of research on business. See Theodore Lowi, "American Business, Public Policy, Case-Studies, and Political Theory" (a review of Raymond A. Bauer, Ithiel de Sola Pool, and Lewis A. Dexter, *American Business and Public Policy: The Politics of Foreign Trade*, New York: 1963), *World Politics*, 16:4 (1964): 677-715.

<sup>11</sup> See the discussion in David Vogel, *Fluctuating Fortunes: The Political Power of Business in America* (NY: Basic Books, 1989), esp. 5-6.

<sup>12</sup> Charles E. Lindblom, *Politics and Markets: The World's Political-Economic Systems* (NY: Basic, 1977).

<sup>13</sup> Fred Block, especially "The Ruling Class Does Not Rule," *Socialist Revolution*, May-June 1977 and "Beyond Relative Autonomy: State Managers as Historical Subjects," *Socialist Register*, 1980.

<sup>14</sup> See, for example, John Woolley, *Monetary Politics: The Federal Reserve and the Politics of Monetary Policy* (NY: Cambridge University Press, 1984), 185-186. For more recent contributions, see Jacob Hacker and Paul Pierson, "Business Power and Social Policy: Employers and the Formation of the American Welfare State," *Politics and Society*, 2002; Peter Swenson, "Varieties of Capitalist Interests: Power, Institutions, and the Regulatory Welfare State in the United States and Sweden," *Studies in American Political Development*, 2004; Tasha Fairfield, *Private Wealth and Public Revenue in Latin America: Business Power and Tax Politics* (Cambridge University Press,

how business's ability to exercise power also depends on degrees of public attentiveness. Pepper Culpepper has argued that business groups tend to dominate less through the traditional tools of lobbying and campaign contributions than through informal networks that elevate business priorities especially on low-visibility issues. In the esoteric field of takeover law, therefore, top business managers consistently get what they want in a range of advanced countries. When debate shifts to issues of higher salience, such as executive compensation, business groups experience serious setbacks in some if not all countries.<sup>15</sup> Degrees of salience are particularly important for the post-enactment politics of financial regulation. The low visibility of regulatory rule-writing makes it easy for industry actors to sustain the status quo by moderating and delaying reform measures. In examining the Dodd Frank reforms, John Coffee has proposed the idea of a regulatory "sine curve" to describe the high amplitude of populist fervor that accompanies initial reform legislation, only to be followed by the downward slope of public engagement as matters turn to implementation.<sup>16</sup> Such arguments suggest that, in implementation, activist successes depend on maintaining an issue in the public eye as much as on exerting direct pressure on regulatory decision makers.

We build on these insights, but also argue that the dichotomy between instrumental and structural power gives too little attention to a range of nonmaterial political resources. While the literatures on capture and business power certainly make reference to nonmaterial factors, they do not fully incorporate the different types of intellectual capabilities and tools that have been analyzed in other areas of policymaking. The ideas that guide policy decisions range from broad

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2014); Pepper Culpepper and Raphael Reinke, "Structural Power and Bank Bailouts in the United Kingdom and the United States," *Politics and Society*, 42:4, (December 2014): 427-454.

<sup>15</sup> Pepper D. Culpepper, *Quiet Politics and Business Power: Corporate Control in Europe and Japan* (Cambridge University Press, 2011).

<sup>16</sup> John Coffee, "The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated," *Cornell L. Rev.*, 97 (2012): 1019-1082. A similar idea was earlier articulated by Anthony Downs as the issue-attention cycle in "Up and Down with Ecology," *Public Interest* (Summer 1972): 38-50.

“public philosophies,” “public sentiments,” and overarching “paradigms”<sup>17</sup> to much more discrete or policy-specific recipes described as “programmatically ideas,” “programmatically beliefs,” and “blueprints.”<sup>18</sup>

Between larger public philosophies and the detailed policy recipes that guide specific rulemaking activities, we argue that the concept of a “knowledge regime” is particularly important in illuminating the interdependencies that arise between public regulators and market participants in the realm of finance. As John Campbell and Ove Pedersen describe them, “knowledge regimes produce the ideas that inform what political and economic elites do.”<sup>19</sup> Campbell and Pedersen focus on cross-national differences in the knowledge regimes of different countries and show how country-specific knowledge regimes adapt to multiple policy domains within single countries. For example, knowledge regimes in the United States are typically produced by a set of think tanks, government research institutes and other policy-relevant organizations. In the realm of finance, however, there have been few quasi-public research organizations, think tanks, or government research facilities. Instead the relevant knowledge that connects broad principles to the practical workings of financial markets has been generated by large banks, consulting firms, and academic specialists in university departments of finance and economics. As Cornelia Woll puts it, the knowledge that governs financial markets is a “joint production” of market participants and public authorities. The result is a knowledge-based

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<sup>17</sup> For studies of ideas with particular reference to broad policy trajectories, see especially Peter Hall, “Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain,” *Comparative Politics*, 25:3 (April 1993): 275-296; Margaret Weir, “Ideas and the Politics of Bounded Innovation,” in Sven Steinmo, Kathleen Thelen, and Frank Longstreth, eds., *Structuring Politics: Historical Institutionalism in Comparative Analysis* (New York: Cambridge University Press, 1992), 188-21; and John Campbell, “Institutional Analysis and the Role of Ideas in Political Economy,” *Theory and Society*, 27 (1998): 377-409.

<sup>18</sup> See the sources above as well as Sheri Berman, *The Social Democratic Movement: Ideas and Politics in the Making of Interwar Europe* (Cambridge: Harvard University Press, 1998); Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (NY: Cambridge University Press, 2002).

<sup>19</sup> John Campbell and Ove Pedersen, *The National Origins of Policy Ideas: Knowledge Regimes in the United States, France, Germany, and Denmark* (Princeton: Princeton University Press, 2014), 6.

resource that operates much like Steven Lukes's third power of power as a force acting on what actors are doing "and sometimes even thinking."<sup>20</sup> Woll summarizes this view with the assertion that "the power of finance is best understood as productive power, which operates by shaping the actors' self-understanding and interests, both on the government side and within the financial industry."<sup>21</sup>

These different categories of ideas – public philosophies, the knowledge regime for finance, and the policy recipes that define particular rules – make up a major part of the political space in which battles over financial reform are fought. The ability of the financial services industry to mobilize across all three types of intellectual contention is an increasingly important aspect of business power that can operate in either instrumental or structural form. The ability of individual firms or trade associations to propose policy-specific recipes by commenting on particular rules is especially important to the politics of implementing financial reform. The more general battle to shape public philosophies for regulation also remains important. For financial regulation, however, the knowledge regime that informs policy is critical. As a result, contending efforts to remold the knowledge regime for finance became the essential means of coordinating loosely connected actors pursuing similar objectives.

### **III. The Institutional Context of Financial Reform**

The changing context of the Obama Administration's reform agenda has been analyzed by many authors. We therefore focus here on the primary participants, their bargaining positions, and the channels of access they have employed in their efforts to shape the politics of implementing financial reform. Specifically, we review: (1) changes in the structure and apparent political

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<sup>20</sup> Steven Lukes, *Power: A Radical View* (London: MacMillan, 1974), 48.

<sup>21</sup> Cornelia Woll, *The Power of Inaction: Bank Bailouts in Comparison* (Ithaca: Cornell University Press, 2014), 6.

power of the financial services industry; (2) the procedural and other institutional features that directly shape the process by which regulatory agencies write new rules and bring them into force; and (3) the opposing advocacy networks that coalesced around opposing views of financial reform in their efforts to influence particular rule-writing outcomes.

A. *Changes in the structure and bargaining position of the financial services industry*

The growing importance of intellectual resources in the politics of financial reform was one of many changes that appeared as inflation emerged in the 1970s and technologies evolved in subsequent decades.<sup>22</sup> Volatility in market interest rates led to new kinds of financial products, which in turn led to a steady increase in the size of the finance services, relative to the rest of the economy and in absolute terms.<sup>23</sup> Along with its dramatic growth, however, the financial services industry became far more heterogeneous and politically less coherent.

It is well-known that the relative size of the finance sector increased dramatically in the four decades before the Lehman Brothers bankruptcy of 2008. Measured by gross size, the assets of commercial banks, securities firms, and the securitizations they created increased from a level of 55 percent of GDP in 1980 to a level equal to 95 percent of GDP in 2000. Measured by annual income, the profits of the financial sector grew from an average of 13 percent of all domestic corporate profits over the period, 1978 to 1987, to an average of 30 percent for the period from 1998 to 2007.<sup>24</sup> In addition, manufacturing and nonfinancial service firms also came to rely increasingly on investment earnings and related financial activities. As Greta

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<sup>22</sup> At the start of the 1970s, the US financial industry was segmented by product and geographical markets, and there were important regulatory limits on interest rates payable by depository institutions. As market interest rates increased with inflation rates, all of these limits came under intense pressure. See John Woolley, "Persistent Leadership: Presidents and the Evolution of U.S. Financial Reform, 1970-2007," *Presidential Studies Quarterly* 42 (March 2012): 60-80.

<sup>23</sup> Krippner, chapter 2.

<sup>24</sup> Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (NY: Pantheon, 2010), pages 85, 86. For asset data, see *Federal Reserve Flow of Funds*, as cited in Johnson and Kwak, 252n8. For GDP figures and annual profits, see the Bureau of Economic Analysis, *National Income and Product Account*, as cited in Johnson and Kwak, 253n13 respectively.

Krippner has show, by 2000, financial activities accounted for 40% of the income earned by nonfinancial companies.

As the finance industry expanded, its power evolved in complex and conflicting ways. In the 1980s, as alternative sources of funding became available to large firms, the country's largest money center banks steadily lost their position as a moderating influence in the corporate community.<sup>25</sup> In the 1990s, banks shifted their revenues away from the steady lending business of prior decades to fee-based transactions for proliferating range of new services.<sup>26</sup> Banks and other suppliers of financial services competed by innovating new products and moving into the growing markets that they generated.<sup>27</sup> The largest banks soon argued that the Glass-Steagall Act, one of the Depression Era's central pieces of regulatory legislation, was blocking useful innovation by prohibiting U.S. banks from engaging simultaneously in commercial and investment banking. When Congress passed the Gramm-Leach-Bliley Act of November 1999, effectively repealing Glass-Steagall, the banking industry had shifted decisively to a faster-moving and more risk-friendly model of business

This newer and more open model of financial services led to intensified competition and a loss in the collective-action capability of the largest firms. The industry's inability to regulate itself or to design private-sector rescue plans became especially clear in the United Kingdom and

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<sup>25</sup> Mark S. Mizruchi, *The Fracturing of the American Corporate Elite* (Cambridge: Harvard University Press, 2013), 191-197.

<sup>26</sup> For retail banks, the new services included such products as credit and debit cards, retain investment advice, mutual fund marketing, and origination fees for loans that were securitized into bundles and in turn sold to other investors instead of generating the regular monthly payments that had once been at the core of the small banking business model. For institutional finance, the new services included portfolio services, the bundling of consumer loans into the new debt product that institutional investors increasingly wanted, hedging techniques based on interest-rate swaps and other second-order instruments and derivatives.

<sup>27</sup> For the changing markets on which banks depend, see Iain Hardie, David Howarth, Sylvia Maxfield and Amy Verdun, "Banks and the False Dichotomy in the Comparative Political Economy of Finance," *World Politics*, 65:4 (October 2013): 691-728; Stephen Bell and Andrew Hindmoor, *Masters of the Universe, Slaves of the Market* (Cambridge, MA: Harvard University Press, 2015).



the United States.<sup>28</sup> It was perhaps most conspicuous in the failure of the main Wall Street investment banks to produce a plan for containing the effects of the Lehman bankruptcy as they had done a decade earlier in the case of Long Term Capital Management. Although brought together by Tim Geithner as President of the Federal Reserve Bank of New York for three days of emergency meetings over the weekend of September 12, 2008, the major banks were unable to agree or even participate in a buy-out plan for Lehman.<sup>29</sup> On Monday, September 15, when Lehman filed for bankruptcy, credit markets around the world froze and plunged the advanced economies into the Great Recession.

Together these changes meant the comfortable ties that had sustained the mechanisms of regulatory capture between businesses, legislative committees, and executive-branch agencies were no longer available, or, for that matter, particularly relevant. The largest financial firms neither needed nor wanted the kinds of entry barriers that regulators had once supplied. Instead, the banks used their size and their ability to provide customized hedging products for institutional customers and other clients. After creating their own markets in derivatives and other instruments, the major banks insulated their business through the mathematical opacity of the new products and the legal complexities of using them. In addition, the largest banks became massive contributors to election campaigns and built a common knowledge base while also cultivating the cultural affinities that linked their management teams with federal policymakers. As one recent analyst puts it, the banks devoted increasing resources to the goal of “shaping the ‘intellectual environment’ of Washington.”<sup>30</sup>

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<sup>28</sup> Cornelia Woll, *The Power of Inaction*.

<sup>29</sup> James B. Stewart, “Eight Days: The Battle to Save the American Financial System,” *The New Yorker* (September 21, 2009), 59-81.

<sup>30</sup> For quoted material and detailed evidence, see Lee Drutman, “The Business of America is Lobbying: How Corporations Became Politicized and Politics became More Corporate (New York: Oxford University Press, 2015).

*B. The procedural and legal terrain of the rule-writing process.*

The nature of the rule-writing process puts a premium on intellectual capacities of a particular type. Implementing a major reform requires writing technically complex regulations while consolidating an agency's new or expanded powers. Both require formal and informal contact with many outside actors.

Much of this process is governed by the Administrative Procedures Act (60 Stat. 237) as well as the Dodd Frank Act itself. Agencies are required to publish proposed rules which clarify for the industry segments what kinds of cost burdens they face and say something about how the agency will monitor compliance. Proposed rules must be open to public comment for a reasonable time period. Agencies must respond to comments in justifying the final rules. While large firms and industry groups often comment extensively on proposed rules, smaller market participants are not as likely to communicate with agencies until the initial compliance dates are imposed. After the regulation is finalized, companies from the regulated industry may request formal exceptions or delays ("an exemptive order"), and the agency may need to provide advisory guidance to assist industry compliance.<sup>31</sup>

All of these steps occur in the shadow of possible litigation. Market participants can and do bring legal challenges when they believe agencies have made procedural errors or otherwise misinterpreted the law. A distinctive feature of the fragmented US system is the advantage it gives well-financed interests to pursue their objectives in a variety of forums – even if they are blocked in one particular venue.

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<sup>31</sup> The Commodities Futures Trading Commission has, as of this writing, finalized 50 regulations associated with DFA; they have issued 19 additional "exemptive orders" or "guidance" documents; over 150 "exemptive letters," and have published nearly 100 "no action" letters. See: <http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/index.htm>

New regulations inevitably alter the incentives and rewards for market participants. In major reforms, the cumulative effect of new regulations can change market structure deeply and create new patterns of winners and losers. Change of this kind occurred in both of the cases considered here: (1) the creation of a new oversight body, the Financial Stability Oversight Council, for macroprudential or systemic-risk regulation, and (2) the vast expansion of the CFTC's mission from regulating commodities to creating an entirely new framework for the regulation of derivatives trading. Of course, tasks of this magnitude require ongoing political support to defend the massive increases in staff capabilities and the establishment of new communication channels with regulated firms, the legal community, other executive branch agencies, Congress, and the public.

Congress does not as an institution participate directly in rule-writing, but it remains a presence in many ways. All regulatory agencies are subject to Congressional oversight. Congressional committees guard their oversight jurisdiction jealously and use hearings frequently to question agency leaders. Individual Members may submit "public comments" to regulatory agencies with the reasonable expectation that they will be carefully noted by agency staff. In addition, while the President nominates the agency directors or chairs (as well as the other commissioners for multi-member agencies), those appointments must be confirmed by Senate vote. And the budgets of some regulatory agencies, including the CFTC, are subject to the Congressional appropriations process.

Congress has used all of these instruments to shape the implementation of the Dodd Frank legislation. For example, Senate Republicans prevented the new Consumer Financial Protection Bureau from beginning any legally binding work by blocking the confirmation of a Director until July 2013. Similarly, since Republicans won the majority in the House of

Representatives in January 2011, the majority has pursued what one legal scholar calls an all-out campaign to undo the reforms through legislative revision.<sup>32</sup> The House Financial Services Committee, chaired by Jeb Hensarling (R-Texas) has consistently cut budgetary appropriations for the CFTC well below amounts requested by the White House. Given the low probability of compromise around the technical changes that were once commonplace in improving legislation, both proponents and opponents of the reform are obliged to redirect their efforts to the administrative arena of the rule-writing process.

### C. *The Policy Alliances in Post-Enactment Politics*

The politics that followed the enactment of Dodd-Frank in July 2010 were visible to a narrower set of publics but no less hard fought. As one Washington observer put it within six months of the Act's passage, contending groups had clearly launched "a pitched battle . . . over the regulations that are being written to implement Dodd Frank."<sup>33</sup>

Both sides in this battle take the form of diffuse networks that resist categorization into more familiar types of interest aggregations. These networks are instead similar to the transnational advocacy networks described by Keck and Sikkink,<sup>34</sup> but primarily domestic in focus. They include a mix of individuals and organizations that share a preference for similar policy outcomes, though they may have quite distinct commitments on other issues.<sup>35</sup> The

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<sup>32</sup> Arthur E. Wilmarth, "Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street," *University of Cincinnati Law Review*, 81:4 (2013), 1283-1446. See also Arthur E. Wilmarth, "The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau," *Review of Banking and Financial Law*, 31 (2011-2012).

<sup>33</sup> Pratt Letter, February 16, 2011.

<sup>34</sup> Margaret E. Keck and Kathryn Sikkink, *Activists Beyond Borders: Advocacy Networks in International Politics* (Ithaca: Cornell University Press, 1998).

<sup>35</sup> Advocacy networks therefore display more homogeneous preferences than the specialized policy communities that Hugh Hechlo described several decades ago as "issue networks." At the same time, advocacy networks can be more porous and transient than the "advocacy coalitions," that Paul Sabatier said would need to be studied for ten years for reliable results. See Hugh Hechlo, "Issue Networks and the Executive Establishment," Anthony King, ed., *The New American Political System* (Washington: AEI, 1979), 87-124, and Paul Sabatier, chapter 2, Sabatier and Hank Jenkins-Smith, *Policy Change and Learning: An Advocacy Coalition Approach* (Westview Press, 1993)..

network we call the stability alliance took shape in direct response to the losses caused by the financial crisis of 2008. Its members share a preference for more stringent regulation.

The stability alliance is opposed by another network of individuals and organizations arrayed around the incumbent industry leaders. Few if any members of this network argue that the industry should be allowed to regulate itself as freely as in the years leading up to the crisis. Nonetheless, the underlying logic of its positions indicates that light-handed treatment with a large component of self-regulation remains the guiding preference of its members. We therefore call this network the self-regulation alliance. Each alliance rests on a distinct set of shared propositions that link together a disparate and asymmetric set of organizations. In this sense, each alliance combines a sharply delimited degree of ideological homogeneity with an unusual degree of organizational diversity among its member groups.

Of these two alliances, the self-regulatory alliance clearly held the upper hand in the early 2000s. Its core arguments informed the deregulatory trend in U.S. policy from the late 1970s until 2007. Some of the central propositions came from the field of academic finance, while others emerged from the applied think tanks of Washington. Together, these propositions provided the key elements of the knowledge regime for financial services that, by the early 2000s, had come to be widely accepted as the basis for public policy.

These propositions included the academic theory, elaborated most clearly by Eugene Fama, that market prices accurately reflected all the information available to potential market participants. Known as the efficient market hypothesis, this view helped market fundamentalists argue that transparency could insure market performance better than regulatory oversight.<sup>36</sup> A second key proposition was the shareholder theory of the firm, elaborated by Michael Jensen.

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<sup>36</sup> Eugene F. Fama, "Agency Problems and the Theory of the Firm," *The Journal of Political Economy*, 88 (1980): 288-307. For a discussion of the application of these ideas to finance, see especially Johnson and Kwak, 68-69.

Jensen argued that investors as principals were the proper price-setters for firms and that managers as their agents would correctly act to maximize the firm's value if they were subjected to well designed incentives.<sup>37</sup>

These two views jointly buttressed the argument that investors could accurately gauge the value of a firm if financial markets were regulated by the free flow of information rather than safety-minded officials. Subsequent studies have shown that the requirements for full transparency, especially the monitoring of managerial behavior, were not systematically implemented by firms.<sup>38</sup> The new agency-driven theory of the firm nonetheless proved immensely popular, however, with institutional investors as well as free-market proponents in the policy community.

While these ideas originated in micro-economic theory, they benefited from the resilience of the deregulatory agenda in American politics of the 1980s and 1990s. As Block and Somers point out, “the seductive persistence of free market ideology is rooted in its promise to reduce the role of politics in civic and social life.” Indeed, even after the world collapse of financial markets that followed Lehman's bankruptcy September 2008, the proponents of deregulation regrouped in the diffuse network we call the self-regulatory alliance. The key assertion that unites this alliance – anticipated by Charles Lindblom and other early critics of business power – is that poorly designed regulation—that is, ultimately virtually all regulation--imposes unjustifiable costs on the economy as a whole. According to this alliance, the Dodd-Frank Act has required regulation that is unduly burdensome on small companies and imposes costs on

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<sup>37</sup> Michael C. Jensen and W C. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” *Journal of Financial Economics*, 3 (1976): 305-360. See also Eugene F. Fama and Michael C. Jensen, “Separation of Ownership and Control,” *Journal of Law and Economics*, 26 (1983): 301-326.

<sup>38</sup> Frank Dobbin and Jiwook Jung, “The Misapplication of Mr. Michael Jensen: How Agency Theory Brought Down the Economy and Why It Might Again,” in *Markets on Trial: The Economic Sociology of the U.S. Financial Crisis: Part B, Research in the Sociology of Organizations*, 30B (2010): 29-64.

major companies that far exceed any possible set of benefits. As a result, the Dodd-Frank Act not only impedes efficiency, but depresses growth and economic recovery, thereby causing unemployment and limiting income growth.

Although the force of self-regulatory arguments was blunted in the immediate aftermath of the crisis, the large investment banks and other finance firms benefited from a well developed network of allies working in their favor as well as other factors:

1. They belong to an overlapping set of trade associations that emphasize different parts of the business community and different categories of market participants within the financial services. Key associations for the financial-services sector include SIFMA (Securities Industry and Financial Markets Association), the Financial Services Roundtable, the ABA (American Banking Association), and the IIB (International Institute of Bankers). Meanwhile, ISDA (the International Swaps and Derivatives Association) and the ICI (Investment Company Institute) represented both the suppliers of financial instruments and the asset managers who appear on the buy-side of the market. These associations work closely with their law firms to submit public comment letters as well as to meet with agency staff regarding specific market dynamics and the potential effect of different rule variants on incumbent firms.
2. Beyond coordinating among themselves, the trade associations for finance have associated business allies eager to support their argument against rapid change in the status quo. The broadest cross section of the business community is represented by the U.S. Chamber of Commerce. The Chamber has been a leading opponent of Dodd-Frank initiatives. Its views are often articulated by an issue-specific entity it

established in 2007, the Center for Capital Markets Competitiveness, whose work parallels that of the Committee on Capital Markets Regulation.

3. All these organizations have well-established ties to industry-friendly members of Congress, who can delay new regulation by blocking the appointment of agency directors or commissioners.
4. Industry has aggressively exploited the opportunities in the US system to litigate when they object to new regulations. This strategy further raises costs for regulators at a time of constricted budgets.

Despite the material and organizational resources of the pro-industry alliance that emphasizes self-regulatory solutions, non-industry participants have been regularly and conspicuously engaged in the regulatory process as well. This is a major change from before the Dodd-Frank era. Not only was the overall visibility of regulatory activity much lower in the pre-Dodd-Frank era (judged by the number of total comments), but oftentimes there were few if any comments offered by any person or organization not representing or employed in the relevant industry segment.

Based on our documentary and interview research, we argue that these non-industry voices fall into an identifiable network that we call the stability alliance. In contrast to the self-regulatory alliance, members of the stability alliance share the view that more stringent external regulation of financial markets is necessary. This conclusion is organized around a set of core propositions that directly challenge the knowledge regime advanced by the self-regulatory alliance through the early 2000s. These core ideas in effect represent an alternative knowledge regime that the stability alliance proposes as an improved way to understand financial markets and as a better guide for policy.



The core propositions include the assertion that financial markets *cannot* be invariably trusted to appropriately price financial assets appropriately.<sup>39</sup> Building on this more skeptical view of market pricing, members of the stability alliance argue that the large size and interconnectedness of financial institutions present the risk of widespread market failure with tremendous social costs that reach far beyond the immediate parties to specific transactions. A group of economists working at the Bank of International Settlements under Claudio Borio argue further that large and complex financial firms therefore need external regulators capable of assessing the systemic implications of all of their activities.<sup>40</sup> A further implication of this view – increasingly known as macroprudential regulation – is that complex transactions should be located in market spaces that allow not only for competition, but also generate reliable information about pricing. Finally, this view implies that the federal government needed a new agency explicitly charged to assess system-wide risk. And, to perform these duties, the new agency needs the power to acquire information about high-risk financial transactions and the analytic capability to assess it.<sup>41</sup>

While these ideas had been percolating in academic and policy circles for over a decade, they only became a force for linking a significant network of well-informed specialists when a set of dedicated organizations emerged after 2008 to argue in favor of more robust financial regulation. This group known as Americans for Financial Reform (AFR), a coalition of labor and consumer organizations, was especially important in 2009 and 2010. Accordingly to Barney Frank, AFR was “very helpful” and especially important in providing “good information” and

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<sup>39</sup> As noted by many observers, plenty of leading economists developed models showing where and why the efficient markets hypothesis failed to hold in real-world conditions. For a discussion, see Johnson and Kwak, 69-70.

<sup>40</sup> Andrew Baker, “The New Political Economy of the Macroprudential Ideational Shift,” *New Political Economy* 18:1 (2013): 112-139.

<sup>41</sup> These views appeared in numerous reports of the Government Accountability Office through the early 2000s and were clearly articulated in the regulatory review commissioned by Treasury Secretary Paulson and published as U.S. Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (March 2008).

keeping “grass-roots pressure on the committee.”<sup>42</sup> After the bill was passed, AFR was joined by an applied think-tank known as Better Markets. They worked closely with the established consumer organizations, such as Consumer Federation of America, U.S. PIRG, and the younger public interest group, Demos. Also engaged were a number of legal scholars and other unusually well-informed individuals. Together these groups and individuals, often coordinating with each other, demonstrated an ability to enter the rule-writing process through regular comment letters and meetings with agency officials. These activities show a level of expertise and credibility unseen among non-industry groups in earlier financial regulation. These groups were further bolstered by new forces that reinforce, broaden, and elaborate the arguments for strengthening financial stability through robust regulatory action. These include:

1. The Systemic Risk Council, an organization headed by former Chair of the FDIC, Sheila Bair, now operating from a charitable foundation, the Pew Memorial Trust, and including figures such as Paul Volcker, Bill Bradley, John Reed, and Simon Johnson.
3. An attentive and often outspoken set of pro-reform members of Congress, such as Senators Jeff Merkley (D-Oregon), Carl Levin (D-Michigan), Elizabeth Warren (D-Massachusetts), Sherrod Brown (D-Ohio) and Maria Cantwell (D-Washington).
4. The Bipartisan Policy Center, a think tank founded in 2007 by a group of former Senators, has issued several reports urging a balanced approach to new regulatory capabilities in the services of strengthening financial stability.

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<sup>42</sup> Interview with Barney Frank, August 29, 2013.

5. A notable shift in academic research to address causes and solution to financial instability, including public, and international regulatory cooperation.<sup>43</sup>

On the last point, we observe that scholars have been drawn powerfully to topics relating to financial stability since the crisis. Citation sources such as Google Scholar show conspicuous increases from 2008 through 2014 in the proportion of relevant scholarly publications addressing topics including: financial stability, systemic risk, shadow banking, and “too big to fail.” In addition, the framework of thinking around macroprudential regulation has increasingly informed the work of international agencies, particularly the Financial Stability Board, which the G-20 has since 2009 charged with developing rules of international financial governance.<sup>44</sup>

These disparate organizations are key parts of the new stability alliance supporting the implementation of robust reforms within the statutory language of the Dodd-Frank Act. They consistently promote financial stability as the highest priority for regulatory reform. Our research indicates that the participants are well aware of one another’s activities and self-consciously differentiate their contributions. Moreover, they share a commitment to the ideas of the stability-oriented knowledge regime, and contribute to its elaboration and support.

Since the stability alliance commands far fewer material resources than the self-regulatory alliance, it necessarily relies more heavily on nonmaterial tools and arguments. Nonetheless, the public comment files of the regulatory agencies make it clear that the stability alliance plays a significant role in the contests over implementation. The Dodd-Frank legislation has led to a sharp increase in the number of public comments on proposed regulations that must

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<sup>43</sup> A possible candidate for inclusion in this list is an *ad hoc* group known as “Occupy the SEC,” descended from the Occupy Movement. While transitory in organizational terms, this group at least once took formal legal action and submitted several lengthy comment papers, sometimes informed by substantial expertise, to demand regulatory action from the SEC.

<sup>44</sup> Renate Mayntz, “Introduction,” in Mayntz, ed., *Negotiated Reform: The Multilevel Governance of Financial Regulation* (Frankfurt: Campus Verlag, forthcoming 2015).

be received, read, considered, and processed by the agencies. While the preponderance of thorough, substantive comments submitted to agencies such as the FSOC, the Federal Reserve and the CFTC come from financial-services firms and industry associations, their weight is not as dominating as the concept of regulatory capture, and past history, would suggest.

Commenters include academic specialists, agencies and regulators from non-U.S. jurisdictions, consumer groups and other grass-roots organizations. For several of the more contested rules that the CFTC has written, non-industry organizations accounted for very close to 25% of comments received. While the remaining 75% of comments came from industry groups and associations, these proportions show nowhere near the degree of industry dominance typical of earlier cases.<sup>45</sup>

Given the mismatch in money and positional resources commanded by the two alliances, the stability alliances cannot be expected to drive major reform outcomes by itself. Yet, in cases where its goals align with those of policy entrepreneurs inside the federal government or with counter-industry coalitions that benefit from regulatory change, the stability alliance contributes a combination of broad reform rationales, independent analytic approaches, and detailed policy recipes that can produce significant changes in financial regulation. The varied roles that the stability alliance can play are illustrated by the two major institutional changes we examine here: the creation of a new entity, the Financial Stability Oversight Council to regulate systemic risk through a new approach to macroprudential monitoring, and the expansion of the CFTC's jurisdiction to include the regulation of derivatives.

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<sup>45</sup> Figures based on author calculations from the comment archives for five of the CFTC's proposed rules through July 2013. The five rules (with abbreviated titles) include: Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities; Position Limits for Derivatives; Interpretive Guidance and Compliance With Certain [Cross-Border] Swap Transactions; End-User Exception to Mandatory Clearing of Swaps; and Prohibitions and Restrictions on Proprietary Trading [the "Volcker Rule"].

#### **IV. The Cases**

These two cases of regulatory change confronted the financial services industry with high stakes and, partly for that reason, touch directly upon the predictions suggested by theories of business power and regulatory capture. For the first case, we examine the Financial Stability Oversight Council (FSOC), a new council established by Dodd-Frank from existing regulators and charged explicitly with the new mission of guarding against system-wide financial risks. The goal of systemic-risk regulation relied on a still-emerging body of doctrine known as “macroprudential regulation.” A key element was identifying firms whose size or interconnectedness made them systemically significant in the event of failure. As the financial crisis had made clear, policymakers believed they had no choice but to bail out the largest banks, which had in effect become “too big to fail.”

The FSOC was the entity created to solve the problem posed by such large institutions, known as systemically important financial institutions (SIFIs). In effect, the FSOC was charged with clarifying a still emerging body of doctrine and creating regulatory tools capable of limiting the positional advantages enjoyed by the largest firms. As such, the FSOC embodied a novel public-sector exercise in directly managing the structural power of business.

As our second case, we examine the expanded mission of the Commodity Futures Trading Commission (CFTC) to cover wide swaths of previously unregulated derivatives transactions. As one of the younger regulatory agencies, the CFTC had been created in 1974 to take over the supervision of options and futures in agricultural, mineral, and similar commodities. Its initial mission therefore involved regulating a limited group of specialized

trading firms rather than the major money-center and investment banks. Under the Dodd-Frank legislation, the CFTC was charged with regulating the huge markets for over-the-counter derivatives which by the early 2000s made up the larger part of the so-called “shadow banking system.” Largely unregulated, the business of trading financial derivatives had been created virtually from the ground up by a small group of large investment banks. The derivatives business was a near perfect example of the sharply defined interests and stark information asymmetries that had enabled incumbent firms to achieve a high degree of regulatory capture.

#### **IV-A. The FSOC and the Creation of a Macroprudential Regulator**

The task of systemic or “macroprudential” regulation was recognized well before the bankruptcy of Lehman Brothers in September 2008. A group of economists in the research department at the Bank of International Settlements had been working on questions of financial stability from the early 2000s onward.<sup>46</sup> The need for a systemic regulatory capability was a central theme in a report commissioned by Henry Paulson shortly after he left the chairmanship of Goldman Sachs in 2006 to become Treasury Secretary under George Bush.<sup>47</sup> As the magnitude of the financial crisis became clear in October 2008, few industry voices could argue that the finance markets could be trusted to self-regulate. After the Dodd-Frank Act was signed in 2010, the finance industry began to critique the understanding of macroprudential risks that were being built into the legislative design of the FSOC. The debate over implementing macroprudential doctrine was a contest in which intellectual and organizational resources were as important as material

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<sup>46</sup> For an overview, see Claudio Borio, “Implementing the Macroprudential Approach to Financial Regulation and Supervision,” *Banque de France: Financial Stability Review*, 13 (September 2009): 31-41.

<sup>47</sup> See the report issued on March 30, 2008 under the title, “Blueprint for a Modernized Financial Regulatory Structure” (U.S. Treasury: 2008). In a speech at Cooper Union, also in March 2008, future President Barack Obama also called for a “market stability regulator.” See, respectively, <http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf> and “<http://www.presidency.ucsb.edu/ws/index.php?pid=77034>.”

resources. It was a clear example where private-sector firms and public officials were fighting over the contours of the shared knowledge regime that would constrain their respective institutions and strategies.

At the outset, reformers in the US did not agree precisely about the implications of macroprudential regulation. Existing regulatory agencies were reluctant to cede responsibilities to a new regulatory body. Once the Obama Administration took office, primary initiative for reform fell to Treasury Secretary Timothy Geithner, who proposed that systemic stability be assigned to a new interagency council chaired by the Treasury Department with operational responsibility for macro-prudential monitoring given to the Federal Reserve.<sup>48</sup> Other agencies protested the primacy of the Fed, which they viewed as too concessive to the industry.<sup>49</sup> After much politicking, the Dodd-Frank Act established the new FSOC as a council whose members included the heads of eight financial regulatory agencies and one independent member with expertise in insurance, along with five non-voting members.<sup>50</sup> The Federal Reserve is assigned a large degree of responsibility for macroprudential monitoring, but it is layered into a larger council of agencies.<sup>51</sup> To the disappointment of many reformers, the FSOC incorporated rather than resolved the country's patchwork system of financial regulation.

One of the FSOC's main tasks was to designate particular companies as systemically important financial institutions (SIFIs). The legislation explicitly designated banks with assets above a \$50 billion threshold. For nonbank holding companies, however, the criteria for

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<sup>48</sup> U.S. Treasury, "Financial Regulatory Reform: A New Foundation" (June 2009).

<sup>49</sup> Interview with Sheila Bair, December 2013.

<sup>50</sup> Chair of the Board of Governors of the Federal Reserve System, Director of the Comptroller of the Currency, the Chair of the Securities and Exchange Commission (SEC), the Chair of the Federal Deposit Insurance Corporation (FDIC), the Chair of the Commodities Futures Trading Commission (CFTC), the Director of the Federal Housing Finance Agency (FHFA), the Chair of the National Credit Union Administration (NCUA) Board, and the Director of the (new) Consumer Financial Protection Bureau (DFPB), along with one independent member with insurance expertise.

<sup>51</sup> On institutional layering, see Eric Schickler, *Disjointed Pluralism: Institutional Innovation and the Development of the U.S. Congress* (Princeton: Princeton University Press, 2001).

designating SIFIs was left to the new council. In this work, the FSOC is supported by an independent research bureau, called the Office of Financial Research (OFR), housed in the Treasury Department but headed by an independently appointed Director. The OFR is an important resource for the stability-oriented knowledge regime because of its ability to commission high-quality research from highly regarded university or think-tank scholars. The OFR has subpoena powers to demand relevant data from financial firms, and authority to elaborate a new disclosure regime for firms designated as systemically important.

More broadly, the FSOC was empowered to resolve disputes among financial regulatory agencies regarding contested jurisdiction over particular companies or rules. Even more remarkable, the Council may issue specific recommendations “to the primary financial regulatory agencies to apply new or heightened standards and safeguards” to insure against the spread of significant financial turmoil.<sup>52</sup> With these resources, challenges, and ambiguities, the new Council moved to establish itself as macroprudential regulator.

### **Designating SIFIs**

One of the new council’s key tasks was the identification of major non-bank financial institutions whose interconnectedness meant their failure could cause instability across the entire financial system. The process of designating SIFIs was protracted, owing to the legal requirements for notice and comment described above. The FSOC’s rule specifying the standards for identifying nonbank SIFIs was not finalized until April 2012. The identification process involves three steps: first, a set of thresholds of size and complexity are defined; second, companies believed to be within that scope are identified; third, companies are notified that they fall in this pool and are requested to provide additional information (including materials

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<sup>52</sup> Section 120 of the Dodd-Frank Act. The full text is available at <<http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf>>.



they think will be relevant). At the end of stage three, the FSOC informs relevant firms of their pending designation, and the firm has an opportunity to request a formal, confidential hearing.

In July 2012 and without much public notice or controversy, the FSOC designated eight U.S.-based “financial market utilities” as systemically important. These were generally clearing houses and exchanges, firms that “manage or operate multilateral systems for the purpose of transferring, clearing, or settling financial transactions.”<sup>53</sup>

In June 2013, the FSOC designated three other firms as systemically important: American International Group (AIG), GE Capital, and Prudential Financial Inc.<sup>54</sup> Of these, only Prudential requested a confidential hearing, as permitted by law.<sup>55</sup> In late September, the FSOC voted to uphold the initial designation, thereby identifying Prudential by name.<sup>56</sup>

MetLife, another large insurance company, announced in January 2013 it would be selling its bank subsidiary to GE Capital in a bid to reduce its SIFI profile.<sup>57</sup> In late 2014, FSOC designated MetLife as a SIFI despite the firm's protests. MetLife challenged the designation in court in January 2015.<sup>58</sup> The Department of Justice filed a vigorous response in May 2015, to which Metlife provided its own aggressive rebuttal.<sup>59</sup> As of August 2015, the case remained unresolved, but it had already attracted a revealing range of outside attention. Three groups of distinguished academics filed amicus briefs in support of FSOC. Together, the 33 signatories, ranging from a Nobel Laureate in Economics to authorities in finance and insurance) represented

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<sup>53</sup> FSOC Annual Report, 2013.

<sup>54</sup> <http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx>

<sup>55</sup> <http://www.lifehealthpro.com/2013/07/23/prudential-sifi-challenge-hearing-held>

<sup>56</sup> “FSOC Sticks with Prudential’s ‘Systemically Important’ Designation,” *Compliance Week*, September 20, 2013.

<sup>57</sup> <https://www.metlife.com/about/press-room/index.html?compID=91729>

<sup>58</sup> <<https://www.metlife.com/about/press-room/index.html?compID=155136>>. [MetLife's litigation team included Eugene Scalia, son of the Supreme Court Justice.](#)

<sup>59</sup> Available at : <http://www.wsj.com/public/resources/documents/metvfsoc.pdf>; MetLife motion for summary judgment, June 16, 2015 [www.metlife.com/assets/cao/sifiupdate/Motion\\_for\\_Summary\\_Judgment\\_As\\_Filed.pdf](http://www.metlife.com/assets/cao/sifiupdate/Motion_for_Summary_Judgment_As_Filed.pdf)

a nontrivial fraction of the country's firepower in matters of business risk.<sup>60</sup> Along with a fourth brief, submitted by Better Markets, these groups vigorously elaborated and defended the use of macroprudential instruments in a visibly contested case.

### **A Legal Challenge**

Another step in the FSOC's consolidation of its role came from an unexpected legal challenge. In June 2012, a small Texas bank together with other plaintiffs (including the Competitive Enterprise Institute and eleven state attorneys general) filed suit alleging that the FSOC designation of certain banks and other financial institutions as systemically important would raise the borrowing costs for smaller banks. The suit also alleged that the CFPB violated the Constitution's separation of powers doctrine.<sup>61</sup> This challenge was dismissed for lack of standing and failure to demonstrate an actual injury.<sup>62</sup> While it had not been seen as a major threat, this action nonetheless meant the FSOC had rebuffed an initial legal challenge to its very existence was uncompromised in its ability to define its mission.

### **Asserting Controversial Authority**

The FSOC's overall coordinating role, including the power to recommend actions to other agencies on macro-prudential grounds, is especially relevant in its capacity to challenge traditional business power relationships. A key test case involves the regulation of money market funds, in which FSOC action effectively altered prior SEC policy that bore the hallmarks of agency capture.

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<sup>60</sup> The briefs can be found at <<http://law.stanford.edu/wp-content/uploads/sites/default/files/publication/953598/doc/slspublic/22May2015-MetLife-v-FSOC-AMICUS-Brief-of-15-LawProfs.pdf>>; <[pubcit.typepad.com/files/economics-profs.pdf](http://pubcit.typepad.com/files/economics-profs.pdf)>; and <[guptawessler.com/wp-content/uploads/2012/05/FSOC-Amicus.pdf](http://guptawessler.com/wp-content/uploads/2012/05/FSOC-Amicus.pdf)>.

<sup>61</sup> *State National Bank of Big Spring et al., v. Jacob J. Lew et al.*, Case No. 12-1032 (ESH), United States District Court for the District of Columbia. The CFTC portion of the case was successfully appealed but the FSOC dismissal was not affected.

<sup>62</sup> <http://www.reuters.com/article/2013/08/02/us-usa-court-doddfrank-idUSBRE97105C20130802>

The safety of money market funds became an urgent issue at the height of the financial crisis in September 2008, when one of the oldest and best respected mutual funds announced that it was going to “break the buck” or deviate from its fundamental commitment to maintain a net asset value (NAV) of \$1. Combined with the Lehman bankruptcy, this event froze the commercial paper markets – the primary markets for short-term lending among business and financial institutions. It threatened to precipitate the industry-level equivalent of an old-fashioned bank run.

The U.S. Treasury and Federal Reserve responded quickly by creating special funding facilities to guarantee MMF deposits and to support the commercial paper market. Both actions were large and legally controversial. It was not surprising, then, that the risks posed by MMFs figured prominently in the Treasury Department’s reform proposals of June 2009.

The mutual fund industry quickly commissioned its own study of the crisis through its trade association, the Investment Company Institute (ICI). The ICI report, issued in March 2009, pointed to a set of possible solutions that it supported and others that it argued would do more harm than good.<sup>63</sup> This and related ICI reports were a major source of information for regulators – highlighting the important reality of information asymmetries. In June 2009, the SEC proposed rules consistent with ICI views,<sup>64</sup> and these rules were adopted in January 2010.

Meanwhile, Obama Administration appointees were developing a more aggressive set of recommendations which took form in October 2010.<sup>65</sup> The SEC shortly thereafter requested

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<sup>63</sup> Report of the Money Market Working Group, [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf); also see the ICI Money Market Working Group web page with many related documents: [http://www.ici.org/mmfs/ici\\_mmwg](http://www.ici.org/mmfs/ici_mmwg)

<sup>64</sup> <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>; published in the *Federal Register* as of July 8. <http://www.sec.gov/rules/proposed/2009/ic-28807fr.pdf>

<sup>65</sup> <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>

public comment on the new recommendations.<sup>66</sup> Despite support from Mary Schapiro, Obama's SEC chair, the commissioners as a group resisted further SEC action.<sup>67</sup> The outcome looked like a standard "capture" story. At this point, however, the FSOC indicated that MMF reform was of systemic importance and a potential topic for an FSOC official recommendation to the SEC for further prudential action. Using its new Dodd-Frank authority for the first time, the FSOC issued "Proposed Recommendations" concerning MMF reform.<sup>68</sup>

The U.S. Chamber of Commerce issued a detailed statement attacking the FSOC for improperly trying to circumvent long-established decision-making procedures at the SEC.<sup>69</sup> The ICI also attacked the FSOC's proposals with an angry submission, 115 pages long, arguing that the FSOC lacked legal authority for its action.<sup>70</sup> The ICI advanced an argument, subsequently repeated by many in the self-regulatory alliance, that the FSOC was essentially controlled by bank regulators interested in imposing bank-type regulations on non-bank competitors.

With a formal recommendation from the FSOC looming, the SEC took renewed action on its own.<sup>71</sup> SEC staff provided new studies supportive of reform and a new round of public

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<sup>66</sup> <http://www.sec.gov/rules/other/2010/ic-29497.pdf>

<sup>67</sup> United States Securities and Exchange Commission (SEC), Press release of August 22, 2012. Online at [http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484078#.UgzqnH\\_3NyE](http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484078#.UgzqnH_3NyE) (Accessed 10:37pm PST, August 12, 2013) The majority members responded with their own statements: [http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171491064#.Uhf0-H\\_3NyE](http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171491064#.Uhf0-H_3NyE); [http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171491044#.UhfqOH\\_3NyE](http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171491044#.UhfqOH_3NyE)

<sup>68</sup> Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (November 13, 2012), [http://www.treasury.gov/initiatives/fsoc/Documents/Proposed Recommendations Regarding Money Market Mutual Fund Reform - November 13, 2012.pdf](http://www.treasury.gov/initiatives/fsoc/Documents/Proposed_Recommendations_Regarding_Money_Market_Mutual_Fund_Reform_-_November_13,_2012.pdf).

<sup>69</sup> "U.S. Chamber Warns Against Flawed FSOC Process, Recommendations on Money Market Regulation," November 12, 2012, online at <https://www.uschamber.com/press-release/us-chamber-warns-against-flawed-fsoc-process-recommendations-money-market-regulation> (Accessed April 14, 2014).

<sup>70</sup> Most comment letters were hostile to the FSOC proposals. The ICI submission found it "particularly troubling" that the FSOC, "composed as it is of the heads of U.S. federal financial regulators," proposes reform for funds whose portfolios consist almost entirely of short-term Treasury and government securities."

<sup>71</sup> The questions involved the causes of investor redemptions during the 2008 crisis and whether a systemic effect could flow from "breaking the buck" outside of a period of financial distress; the efficacy of the SEC's 2010 MMF reforms; and, in particular how funds would have fared if those reforms had been in place in 2008; how future reforms might affect the demand for investments in MMF substitutes and the implications for investors.

comments began.<sup>72</sup> Highly visible support for robust MMF regulation came from outside experts and former regulators. The non-profit Systemic Risk Council, chaired by Sheila Bair, exerted steady pressure for tighter money market regulation as its first substantive priority.<sup>73</sup> MMF reform was publicly supported as well by the Presidents of the twelve Federal Reserve District Banks. With so many influential voices pushing for stronger regulation, the SEC proposed new rules in June 2013<sup>74</sup> and then a year later the Commission voted to adopt the stronger MMF regulations.

The money market fund case reveals how new FSOC gathered external support in challenging a policy that looked a great deal like capture. The "captive" policy was unlikely to be challenged within the SEC itself, but the SEC backed away from direct confrontation with the new superordinate council. The effect was to add to the credibility and stature of the FSOC.

### **Summary for the FSOC Case**

The FSOC provides an institutionalized expression for the core organizing concerns of the stability alliance and its underlying knowledge regime. It has a sweeping mandate to worry about and in critical respects to act to promote financial stability. It is assisted by a new research arm that is well-funded and has legal authority to demand information. The FSOC received important support from former regulators and a range of well-known academics who contributed to the stability alliance. The most engaged of these individuals were the particularly august individuals assembled in Sheila Bair's volunteer Systemic Risk Council. Of all the organizations in the stability alliance, the Systemic Risk Council had the closest ties to key decisions makers in

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<sup>72</sup> United States Securities and Exchange Commission (SEC). Report on November 30, 2012, entitled Responses to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher. Available at <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf> (Accessed 4:25am PST, August 11, 2013)

<sup>73</sup> Systemic Risk Council letter of January 18, 2013, to the FSOC, accessed from <http://www.systemicriskcouncil.org/issues/money-market-funds/>.

<sup>74</sup> <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575248>

the executive branch, especially Treasury and the FDIC. In this sense, the consolidation of the FSOC's mission was first and foremost an insiders' game. The regulation of money market funds was an exemplary issue where the Systemic Risk Council conspicuously took the lead in submitting comment letters and agitating for action to amend the SEC's initial decisions. And the desire of sitting regulators to receive this group's approval was signaled by Treasury Secretary, Jack Lew, when he chose to hold his first major address on financial reform at the Systemic Risk Council's auditorium in December 2013.<sup>75</sup>

#### **IV-B. The CFTC and the Construction of a New Regime for Regulating Derivatives**

Like the FSOC's development of a framework for systemic risk regulation, the task of bringing derivatives within the jurisdiction of the CFTC confronted regulators with a novel set of challenges. Rather than applying a new body of regulatory doctrine, however, the CFTC's task was to master a body of extremely detailed, market-specific knowledge that no regulatory agency had previously possessed. As is now well-known, financial derivatives had consistently been left outside the CFTC's jurisdiction during the 1990s and their exempt status became a matter of law through the Commodity Futures Modernization Act (CMFA).<sup>76</sup> The Dodd-Frank legislation effectively repealed the CMFA and assigned responsibility for derivatives regulation to the CFTC. Title VII of the Dodd Frank Act outlined major tasks for the agency. Derivatives had become a massive business conducted almost entirely through bilateral contracts rather than through open pricing. In effect, the Dodd-Frank Act charged the CFTC with a huge

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<sup>75</sup> Remarks of Secretary Lew at Pew Charitable Trusts, December 5, 2013. Online at <http://www.treasury.gov/press-center/press-releases/Pages/j12232.aspx> (accessed, March 14, 2014).

<sup>76</sup> These developments, including the decision by Robert Rubin and Larry Summers to reject Brooksley Born's bid for jurisdiction over derivatives, have been recounted in many sources, for example, Robert G. Kaiser, *Act of Congress: How America's Essential Institution Works, and How It Doesn't* (Knopf, 2013), 168-169.

responsibility: to create a new regulatory regime for transactions that made up a large part of the shadow banking system.

In contrast to other parts of the Dodd-Frank Act – where the financial-services industry hesitated so soon after a major crisis to argue against reform – the main market actors mobilized from the outset against derivatives regulation. SIFMA, the main trade association for Wall Street, adopted several joint positions against the legislation with the trade association for hedge funds and derivatives dealers, the International Swaps and Derivatives Association (ISDA). Simultaneously, the U.S. Chamber of Commerce worked with the Business Roundtable and National Association of Manufacturers to organize a group called the Coalition for Derivatives End-Users, which grouped over 170 firms and associations that sought to minimize the scope of regulation.<sup>77</sup>

At the outset of debate over Title VII of the Dodd-Frank Act, the derivatives question sparked a surprising upsurge of popular sentiment that the financial crisis had unfairly imposed costs on honest households while letting the major banks. This sentiment was only slightly less pronounced than the campaign to create a Consumer Financial Protection Bureau on the model advocated by Elizabeth Warren.<sup>78</sup> But the underlying logic – that the industry’s inability to safeguard its own stability imposed deeply unfair consequences on ordinary taxpayers – was similar in both cases.<sup>79</sup> Grass-roots groups, led by the Americans for Financial Reform, consistently brought the need for stringent oversight of derivatives into the overall narrative for robust regulation.

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<sup>77</sup> See Brady Denis, “Trade Groups Seek More Limited Plan to Regulate Derivatives Market,” The Washington Post, October 7, 2009.

<sup>78</sup> See Lisa Kastner, “Much Ado about Nothing? Transnational Civil Society, Consumer Protection and Financial Regulatory Reform,” *Review of International Political Economy* (2014), 1313-1345.

<sup>79</sup> See Agnes Orban, “The Moral Battle over Derivatives: How Non-financial Actors Shape Financial Reform,” Paper presented at the Eleventh Conference of the European Sociological Association, Turin, Italy, August 280-39, 2013.

In the case of regulating derivatives, the knowledge resources deployed by organizations in the stability alliance shifted quite noticeably as politics moved from the legislative to the administrative arena. While political actors continued to use arguments that invoked fair treatment as one reason to bolster regulatory oversight of derivatives, the most intense political contestation moved to the specifics of particular rule-making authorities. It was at this point, in October 2010, that the applied think tank, Better Markets, began to concentrate on proposing particular policy recipes in the form of comments on specific rules. Partly because it was led by an attorney with former experience as a litigator, Better Markets was particularly well positioned to engage in the legal maneuvering that began as soon as an agency published a proposed rule.

The knowledge resources at play in the debate over regulating derivatives also reflected the pronounced concentration of the main suppliers. The derivatives business initially grew out of the need for futures contracts in agricultural commodities. As the need for such instruments increased, bank extended the business by writing contracts for interest-rate swaps, foreign-currency swaps, and other customized trades that their large clients needed. As financialization proceeded, the business of designing and selling derivatives remained heavily concentrated among the most active banks on Wall Street. In the first quarter of 2002, seven banks accounted for 95.8% or \$44.4 trillion of the total \$46.331 trillion (notional values) in derivatives traded. With various shifts in the list of top banks, this degree of concentration persisted and, if anything, increased over the next decade. By the first quarter of 2012, the top four banks accounted for 93.2% or \$211.556 trillion of the total \$227.982 trillion in derivatives traded.<sup>80</sup>

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<sup>80</sup> Office of the Comptroller of the Currency, *OCC's Quarterly Report on Bank Trading and Derivatives Activities*, for the quarters cited, at Graphs 4 and 5A. The top banks for 2002 included: JP Morgan Chase, Bank of America, Citibank, First Union, BancOne, Wells Fargo, and Bank of New York. For 2012: JP Morgan, Bank of America, Citibank, and Goldman Sachs.



The highly oligopolistic structure of supply meant the knowledge regime was created almost entirely by the main market participants. The private nature of the relevant knowledge made it extremely difficult for public officials who lacked industry experience to exercise oversight. Paradoxically, President Obama's nominee to chair the CFTC, Gary Gensler, had been a successful partner at Goldman Sachs before earlier joining the Treasury Department in 1997. Positioned between the rapidly mobilizing industry groups and the grass-roots advocacy organizations, the CFTC's chairman, Gary Gensler, exercised a central role. As he and his fellow Commissioners began to construct the new regulatory regime, the initial cohesion of financial service firms and major business end-users of derivatives showed certain cleavages. Each step toward a more open, regulated regime reduced the margins available to the major Wall Street banks that had obtained outsized profits from the opaque pricing in the system of bilateral contracting through which derivatives had been traded.

After preliminary steps, such as registration and licensing of hedge funds and other market participants, the CFTC introduced its first major change in market infrastructure with rules requiring that derivatives be transacted through clearinghouses. The clearinghouses would register each transaction, make the price information widely available, and guarantee that the counterparties had adequate capital or collateral to fulfill the terms of the transaction.

The response from the Wall Street banks and their primary clients came in early 2012, when two major trade associations for financial services challenged the process by which the CFTC set position limits on several types of derivatives instruments that had previously been unregulated. The broader purpose of questioning the expansion of the CFTC's jurisdiction was made clear when a senior official for one of the plaintiffs said:

"A lot of what we're talking about here isn't specific to position limits, but more related to the process and analysis that the Commission has gone through."<sup>81</sup>

The suit effectively delayed the imposition of position limits when a District Court held for the plaintiffs and sent the rules back to the CFTC to develop a better explanation of why the new limits were necessary.<sup>82</sup> Only in 2015 were revised rules finalized with the expectation that they would stay in place.

While the requirements for clearing a large number of transactions were expected to reduce the margins captured by major banks to a calculable degree, they also began to open the door to new market participants. Top regulators at the CFTC began to see that they could find industry support from firms that stood to benefit from the new market rules. One senior official said the need to build coalitions made regulation quite similar to legislation.<sup>83</sup> These firms included a certain number of clearinghouses, some of the larger hedge funds that wanted to bypass the banks in creating their own derivative deals, asset managers, and some mutual fund advisors.<sup>84</sup> Once these actors became known to regulators through the comment process, the CFTC began to cite their views in assessing public comments and justifying its final rules on the required procedures for clearing.<sup>85</sup>

As these new participants in market-making for swaps appeared, the incumbent firms in the asset-management business mobilized against the CFTC's new rules on clearing. In early

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<sup>81</sup> Robert Pickel, Executive Vice President of ISDA in *Futures Magazine*, January 1, 2012, accessible at <http://www.futuresmag.com/2012/01/01/cftc-sued-on-position-limits> >.

<sup>82</sup> The District Court decision of September 28, 2012, is reported in numerous law firm newsletter such as <http://www.bingham.com/Alerts/2012/10/CFTC-Position-Limits-Rules-Vacated-by-District-Court-and-Remanded-to-the-Commission> >.

<sup>83</sup> Interview with senior appointed official, CFTC, December 2013.

<sup>84</sup> See FT Reporters, "Dust starts to settle on derivatives revolution," *Financial Times*, September 11, 2013.

<sup>85</sup> Final Rule on Clearing Requirement 2012-29211, *Federal Register*, 77: 240, pages 74284-74339, December 13, 2012. See footnote 246 on page 74332 for a list of such firms, including Alliance-Bernstein, R.J. O'Brien, Citadel, Eris Exchange, CME FIA, DE Shaw, Arbor Research LCH Knight Capital, Jeffries, Coherence Capital, CRT Capital, and Javelin Capital, among others.

2013, the Investment Company Institute and the U.S. Chamber of Commerce brought suit against the CFTC to challenge rules that required Registered Investment Companies to register along with other commodity traders if their swap transactions exceeded certain thresholds. The opposing alliances that took shape in the rule-writing process were sharpened by the law firms and attorneys who represented different sides in such court cases. The ICI and the Chamber of Commerce retained the same law firm, Gibson Dunn, that represented SIFMA and ISDA on position limits and MetLife in its challenge to the FSOC. According to one former regulatory counsel, this choice was predictable inasmuch as the plaintiffs in all these cases seemed to think the DC courts would hesitate to rule against a firm whose lead litigator, Eugene Scalia, was the son of a Supreme Court Justice.<sup>86</sup> The CFTC was represented by its own in-house attorneys. Interestingly, the new industry entrants who participated in the public-comment process showed little desire to oppose the incumbent firms in the legal arena. Instead of the counter-industry coalition, the stability alliance lent outside support to the CFTC through Better Markets, Inc., the applied think-tank that filed amicus briefs against Gibson Dunn in both cases.

In this case, the rules that established the CFTC's jurisdiction over investment companies as well as banks and dealers were upheld by the DC Circuit Court in its decision of June 25, 2013.<sup>87</sup> The deciding judge rejected many of the plaintiffs' argument as "nothing more than ... policy disagreement"<sup>88</sup> that did not merit any alteration of the CFTC's rules. With regard to the plaintiffs' claim that the CFTC had failed to weigh the costs and benefits of its rule in conformity

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<sup>86</sup> Interview with former counsel to one of the federal regulatory agencies, December 10, 2013.

<sup>87</sup> [http://www.cadc.uscourts.gov/internet/opinions.nsf/1CEC149BDA2443D285257B95004EB0B8/\\$file/12-5413-1443082.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/1CEC149BDA2443D285257B95004EB0B8/$file/12-5413-1443082.pdf).

<sup>88</sup> quoted in an excellent summary of the case provided by the client alert from Baker Hostetler, June 28, 2013, accessed at <http://www.bakerlaw.com/alerts/DC-Circuit-Court-Upholds-Dodd-Frank-Inspired-CFTC-Regulations-Subjecting-Mutual-Funds-That-Invest-in-Commodities-to-CFTC-Regulation-6-28-2013>.

with prior cases, the court said nothing in previous rulings “prohibits agencies from moving in an incremental manner.”<sup>89</sup>

An even higher-visibility court battle erupted over cross-border rules governing derivative contracts. The CFTC tried to prevent banks from using overseas deals to circumvent the new rules. In guidance published in July 2012, the CFTC asserted jurisdiction over all transactions involving personnel employed by U.S. based firms, regardless of their physical location. After twice postponing the effective date, Gary Gensler reasserted his expansive view of the CFTC’s jurisdiction before stepping down as Chairman in December 2013. His approach threatened to narrow the major dealers’ revenue so much that their key trade association, SIFMA, quickly joined with ISDA and the IIE in a suit against the CFTC in U.S. District Court.<sup>90</sup> Once again, the industry groups retained their preferred law firm, Gibson Dunn, in challenging the cross-border policies identified with Gensler. Amicus briefs in support of the CFTC were filed by BetterMarkets and, revealingly, a group of House Democrats who directly challenged the industry’s arguments. When in September 2014 the court upheld the agency’s ability to limit cross-border transactions through interpretive guidance, the decision confirmed the CFTC’s expanded mission and signaled that the court would not be willingly used to unwind regulatory changes initiated by the Dodd-Frank legislation.<sup>91</sup> By the end of 2014, the underlying legitimacy of the CFTC’s jurisdiction in a range of swap markets had been challenged, reaffirmed, and formally upheld.

### **Summary for the CFTC Case**

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<sup>89</sup> quoted in Courthouse News Service, June 28, 2013, at <http://www.courthousenews.com/2013/06/28/58943.htm>.

<sup>90</sup> Peter J. Ryan and J. Nicholas Ziegler, “Patchwork Pacesetter: The United States in the Multilevel Process of Financial Market Regulation,” in Renate Mayntz, ed., *Negotiated Reform: The Multilevel Governance of Financial Regulation* (Frankfurt: Campus Verlag, forthcoming November 2015).

<sup>91</sup> Ben Protess, “Federal Judge Upholds U.S. Effort to Regulate Overseas Trading,” *New York Times*, September 16, 2014.

The CFTC is illuminating because the agency faced such concerted opposition from core firms in the financial services industry as it extended its jurisdiction into the realm of financial derivatives. Interview evidence and the CFTC's written explanation for its final rules indicate that industry newcomers made up elements of a counter-industry coalition that supported the creation of more open markets for derivatives transactions. This evidence parallels the findings of Eric Patashnik, who argues that such an industry counter-coalition is one of the key factors for making general interest reforms endure.<sup>92</sup> In the CFTC case, however, the industry newcomers may have favored action on particular rules, but they showed no interest in organizing as a group to challenge the incumbent players across the entire field of finance. And in the key cases of adjudication, where the incumbent banks made substantial investments in blocking new rules, the small think tank, Better Markets rather than insurgent industry actors supported the CFTC's legal arguments.

In these cases, it was the loosely affiliated experts in the stability alliance who supplied much of the key independent information and support that helped the CFTC make the case for its rules. The comment letters and briefs filed by Better Markets were the best example of this pattern. There have, of course, been many such self-appointed public-interest organizations in Washington over the last four or five decades. What reason is there to be confident that the stability alliance, in the form of Better Markets, Inc., had an effect? The best evidence comes from the industry groups that Better Markets decided to challenge. The law firm most regularly retained by the industry associations, Gibson Dunn, clearly took the amicus briefs from Better Markets seriously. In the case on position limits, the attorneys at Gibson Dunn issued a direct reply within twenty four hours to the amicus brief filed by Better Markets in support of the CFTC. Another prominent law firm, Cadwalader, included commentary on Better Markets, Inc.,

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<sup>92</sup> Patashnik, esp. 168-169.

in its regular blog updates for its financial-services clients. Writing retrospectively about the CFTC's work before Gary Gensler stepped down in December 2013, one of Cadwalader's senior partners wrote of a "tango between the CFTC (under former Chairman Gensler) and Better Markets." Through this tango, he contended,

Regardless of the burden of regulation the CFTC would propose, Better Markets would write a comment letter asserting that the CFTC should impose a greater burden. Then, ... the CFTC would quote from Better Markets' letters extensively.... In effect, under former Chairman Gensler, Better Markets served as a device to provide the CFTC with cover for virtually any position.<sup>93</sup>

These assertions indicate clearly that the industry's allies saw Better Markets as an effective opponent with close links to the CFTC. They also reinforce the view that industry newcomers did not alone provide sufficient external support for the agency's efforts to establish its expanded mission. That task also depended upon the provision of independent expertise from the applied think-tank, Better Markets, and other small but important organizations among the loosely affiliated groups of independent experts we call the stability alliance .

## **V. Conclusion**

The two cases compared in this paper both provide compelling reasons to move toward a new framework for analyzing the politics of financial regulation. The image of regulatory capture, portrayed by public choice theorists, in which concentrated business groups successfully manipulate the rulemaking process to protect their markets no longer describes the dynamics of of regulation. Business groups continue to play an outsized role in providing the information and knowledge on which regulators depend. Indeed, business exerts an important degree of

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<sup>93</sup> See comment by Steve Lofchie in [The Cadwalader Cabinet](http://www.cadwalader.com/thecabinet/regulatory_updates.php?&ID=7457&date_filter..), (a blog from Cadwalader, Wickersham), March 20, 2014. Online at [http://www.cadwalader.com/thecabinet/regulatory\\_updates.php?&ID=7457&date\\_filter..](http://www.cadwalader.com/thecabinet/regulatory_updates.php?&ID=7457&date_filter..)

intellectual capture that varies across policy domains and even particular rules. Accordingly, these cases suggest that the concept of business power needs to be broadened to include the full range of intellectual resources that business groups can use in the political arena. Since these resources range across broad public philosophies, analytic frameworks, and rule-specific guidelines, they become politically relevant both as implicitly shared principles and as step-by-step recipes for action. .

While critical to the political advantages enjoyed by the financial services industry, the intellectual dimension of business power does not invariably dominate the arena of post-enactment politics. Neither the industry incumbents on Wall Street, nor the new industry players in other parts of the finance industry dictated the outcomes in these two cases. Instead, industry groups had to contend with a diffuse network of independent experts, advocacy organizations, former regulators, and other actors who also supplied a range of intellectual resources to pro-reform regulators.

After tracing the interplay of the ideas, coalitions, and network formations that shaped implementation by in two major cases where the Dodd-Frank Act called for new or expanded missions, this paper leads to a number of conclusions. First, it shows that post-enactment politics remain crucial in the process by which agencies define their new or revised missions in practice. Second, this analysis shows that regulatory increasingly depend upon ongoing support from external actors who can wield effective influence through a diffuse network of organizations without necessarily forging the commonality of goals typical of traditional interest-group coalitions. Third, and perhaps most important, both the stability alliance and the self-regulatory alliance that crystallized around the implementation of the Dodd-Frank Act used a combination of intellectual tools and resources varied according to the challenges raised by specific regulatory

tasks. Broad appeals to contrasting public philosophies of fairness or efficiency were a constant. At some points, the advocacy networks battled quite explicitly over the nature of the knowledge regime that underpinned general practices in financial markets. At other points, the advocacy networks provided highly specific expertise or even legal definitions about the way particular markets should work..

In the case of the FSOC, the legislation assigned the new mission of of systemic or macroprudential regulation to a newly created council of preexisting regulatory agencies. Industry groups were in no position after the crisis to argue against the new council in principle; everyone professed a support for monitoring systemic risk and preventing a future crisis. Contestation instead focused on the emerging doctrine of macroprudential regulation. Did it mean that large bank size would be capped, or that periodic stress tests would alone suffice to insure resilience? As the FSOC began to elaborate the specific procedures by which it would designate firms as systemically, industry groups argued that transparency and renewed market discipline were more reliable foundations for financial stability than than ongoing external oversight. .

Except for the new Office of Financial Research, which was only beginning to build its capability, the existing regulatory agencies had little experience elaborating or defending the principles behind the new doctrine of macroprudential regulation. Some of the necessary ideas had percolated into the regulatory community from the research department of the BIS from the mid-1990s onward. Yet the FSOC clearly benefited from the “near insiders” within the stability alliance exemplified by the former regulators arrayed in Shelia Bair’s Systemic Risk Council. The new mission depended on a clear redefinition of the knowledge regime for finance, which



had previously left the models and procedures of risk management almost entirely in the hands of the largest incumbent firms.

In the case of the CFTC, a single, relatively small agency was charged with dramatically expanding its jurisdiction from well understood markets in commodities to the vast and opaque markets in financial derivatives. In this kind of change, a different type of external support was important. The shared knowledge that allowed derivatives business to function was thoroughly circumscribed within the private sector's professional workforce. Unable to shift the overall knowledge regime for derivatives trading, the CFTC was left with few tools beyond using new rules to shift the boundaries of competition among market participants. Traces of a counter industry coalition appeared as asset managers and insurgent hedge funds began to benefit from new rules that opened markets previously dominated by the large Wall Street banks. Yet, with one or two isolated exceptions, these emerging industry actors showed little interest in mounting a cohesive challenge to the Wall Street dealers. As a result, the CFTC built its own internal capacity and relied on outside groups for rule-specific expertise. The key rules applied to the allowable size of trading positions, the number of price quotes required for a given transaction, the allowable concentration of ownership shares in the new clearinghouses, the amount of margin and the type of permissible cross-border transactions. For rules at this level, the CFTC relied on organizations including the AFR, Demos, and Better Markets. The critical type of expertise was a combination of financial sophistication and, in some of the critical battles, litigation capability.

In broader terms, these two cases mean that politics continues to matter. The growing significance of intellectual resources that this paper illuminates does not imply that reformers can always win if they are smart enough. Business influence in the implementation of Dodd Frank is

pervasive but far from determinative. And while ordinary citizens have little if any opportunity to shape implementation directly, their interests may be served, albeit indirectly and highly imperfectly, when alliances that link independent experts with policy entrepreneurs inside and outside the executive branch can be forged.

Major reforms can require as long as a decade or more to take full effect. In the most significant case of financial reform since the 1930s, much remains up for grabs. The ability of business groups and independent organizations respectively to build broad alliances remains critical to the outcomes now taking shape. The two outcomes compared here mean that we may be witnessing the beginning of a sea-change in the relationship between federal government and the finance industry. Whether future regulatory leaders can build upon these changes to construct a well-integrated framework for regulating financial services will depend on the ongoing battles among contending networks to secure the policies they want. Business's positional advantages and lobbying resources will surely matter. What this analysis shows is that intellectual resources of the different types reviewed here will play as important a role as material resources in building the alliances that determine the ultimate outcomes.