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### Authors

Wooley, John T.  
Ziegler, J. Nicholas

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## The Two-Tiered Politics of Financial Reform in the United States

John T. Woolley  
Political Science Dept.  
University of California, Santa Barbara  
[woolley@polsci.ucsb.edu](mailto:woolley@polsci.ucsb.edu)

J. Nicholas Ziegler  
Political Science Dept.  
University of California, Berkeley  
[nziegler@berkeley.edu](mailto:nziegler@berkeley.edu)

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The literature on regulation has typically emphasized the ability of concentrated interest groups to secure the rules they prefer. One view argues that concentrated interests are consistently able to impose diffuse costs across large and unorganized interests. A second, largely compatible, view emphasizes the ability of powerful interest groups to mobilize expertise and to provide informational goods to politicians who adjust their legislative proposals accordingly. This paper shows that the Dodd-Frank legislation for financial reregulation in 2010 departs from both versions of this now conventional wisdom. Instead, this paper shows that both political parties adopted what we call a two-tier political strategy of (1) maintaining good relations with the established financial elite and (2) simultaneously responding to the demands of grass-roots advocacy groups for more stringent regulation. As a result, Dodd-Frank Act falls far short of a thorough-going redesign of the regulatory landscape, but also amounted to considerably more than business as usual. While the Dodd-Frank Act creates new regulatory instruments and powers that hold the potential for far-reaching changes, most of the existing agencies and market participants remain intact. This pattern of two-tier politics is evident through the four primary policy domains treated in the legislation: macroprudential regulation, consumer protection, reestablishment of the partition between deposit banking versus proprietary trading (the Volcker Rule), and the regulation of derivatives trading.

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## Introduction

The financial crisis of 2007-2008 originated in its key essentials within the United States. Despite the cross-national interdependencies that typify twenty-first century capital markets, American financial institutions were undermined by deep imperfections that originated in U.S. asset markets and then spread to other countries.

The crisis involved tremendous costs and significant disruption to institutions throughout U.S. society. The Lehman Brothers bankruptcy of September 2008 triggered a profound discontinuity in America's financial markets. Three venerable Wall Street institutions – Bear-Stearns, Merrill Lynch, and Lehman Brothers – were absorbed by their competitors or allowed to fail outright.

According to estimates by Deutsche Bank, U.S. financial institutions experienced losses (including asset write-downs) totaling at least \$1.1 trillion; funds equal to 30 percent of GDP were committed to supporting the financial sector in the United States (Deutsche Bank, 2010). U.S. stock markets fell on average in two consecutive years by more than 14 percent, the first time that had happened since the 1930s. Nationally, housing prices dropped nearly 18 percent from mid 2007 to the end of 2010 but in several important regions, the price decline was upwards of 30 percent (US, Federal Housing Finance Agency, 2011). The U.S. unemployment rate increased from 4.5 percent in April 2007 to 10.1 percent in October 2009; the number of unemployed increased from 6.8 million to 15.6 million (U.S. Department of Labor, 2011). The U.S. Federal budget deficit expanded from about 1.2 percent of GDP in 2007 to nearly 11 percent of GDP in 2011. In 2007, U.S. gross public debt was about 64 percent of GDP. By 2011, that had increased to 103 percent.

The onset of these massive impacts in 2008 was followed closely by a national election in which the financial crisis was a significant issue. The Republicans were swept from office and the victorious

Democrats clearly believed they had a mandate for change. In February 2009, Obama told the Business Council that he supported “comprehensive financial reform” to ensure that such a crisis could “never happen again” (Obama 2009a). Previously, U.S. financial experts had a substantial consensus on several reforms to the structure and process of regulation. These ideas were readily available to policy-makers in 2009. There was also no shortage of analyses of the causes of the financial crisis.

Given this combination of factors, it is hard to think of periods in post-World-War II America equally ripe for institutional change. One of the central findings in the historical-institutionalist approach is that periods of continuity are punctuated by exogenous shocks that disrupt settled institutions and produce very significant change (Krasner, 1984; Steinmo/Thelen/Longstreth, 1992; Baumgartner/Jones 2009). Building on this approach, analysts like Streeck and Thelen have pointed out that cumulatively very significant change can also occur gradually, even without major punctuation points. Thus, when we encounter periods of significant shock, like the financial crisis, it is important to ask how much the response deflects the system from the trajectory that might have been present previously.

The crisis response in the United States seemed to foretell a profound change very unlike anything that might have been otherwise anticipated. A number of large banks were effectively nationalized. The largest insurance company was explicitly nationalized. The two largest government sponsored enterprises, heavily engaged in mortgage finance, were placed under government conservatorship. Two automobile manufacturers were nationalized. In an effort to keep the financial system afloat, the Federal Reserve abandoned a decade-long practice of avoiding selective credit allocation and instead worked assiduously to support specific market sectors including the commercial paper market, the secondary mortgage market, investment banks, commercial banks, and money market funds.

But did these events signal a larger shift in the U.S. political economy? Did the shock translate into more enduring institutional change? The Dodd-Frank Act, (formally the Dodd-Frank Wall Street Reform and Consumer Protection Act (PL 111-203), was signed into law on July 21, 2010. It represents the most ambitious overhaul of the country's financial regulations since the 1930s. It establishes a powerful council of regulators to monitor financial markets for signs of systemic risk. This council has extensive new powers to close large firms in financial distress before they collapse. The bill mandates new rules to force most derivatives contracts onto public markets. It redraws a number of bureaucratic boundaries and creates some new funding mechanisms for several of the existing regulatory agencies. It merges one functional regulator, the Office of Thrift Supervision, into an older agency, the Comptroller of the Currency. It includes a number of additional changes in the rules that govern executive compensation, the licensing of credit rating agencies, and the registration of investment vehicles such as hedge funds and private-equity groups. Equally important, it creates an entirely new regulatory bureau for consumer financial protection. These changes are very real. They are widely expected by close observers to have far-reaching consequences.

Despite these broad changes, the Dodd Frank Act falls well short of a new institutional design for financial regulation, and it certainly does not shift the basic contours of the U.S. political economy away from a transaction-based market economy. Rather than a unified or logically consistent plan for reform, the bill comprises an unwieldy set of compromises in several linked domains of regulatory policy. In some domains, industry interests were promoted by a cohesive elite that had dominated financial policymaking for several decades. In other domains, specific policy entrepreneurs, working with the backing of newly mobilized of grass-roots coalitions, succeeded in opening the policymaking process to a broader range of actors (Kingdon 2011, Zahariadis 2007). The reforms also failed to pit contending

theoretical paradigm against one another as had occurred in some other major instances of economic turmoil and policy change (Hall, 1989).

Such an outcome – of significant but less-than-transformational change – requires closer examination. The apparent opening for fundamental redesign of policy and institutions did not lead to any deep-seated change in organizational structures. Only one new agency was created and new regulatory powers were very cautiously drawn. In many more cases, existing powers were reallocated among existing agencies while prior procedures and tools were enhanced. How can we explain the limited scope of reform in comparison to the profound anxiety provoked by the triggering crisis?

Several strands of literature provide plausible hypotheses. One hypothesis from the interest-group literature would hold that concentrated industry interests were able to beat back proposals for unfavorable regulation (Wilson 1980) and to trump more diffuse coalitions (Olson 1965, 1984). Alternatively, it could be that existing regulatory agencies had sufficient autonomy and wielded enough clout to protect their pre-existing jurisdictions (Carpenter 2011). A third possibility, drawn from the institutionalist literature, suggests that incremental adjustments can, over time, allow existing institutions to persist in gradually changing form through exceptionally turbulent environmental changes (Thelen 2004).

Rather than choosing among these alternative explanations, we draw on elements of all in order to emphasize the coalitional politics that shaped the Dodd Frank legislation. More specifically, we argue that this reform required a creative brokering of elites and grass-roots interests by Congress and the White House. This complex coalition building prevented Congress from enacting a consistent overarching design for regulatory reform, but it also allowed for a range of new regulatory powers that may, over time, yield consequences more substantial than apparent from strictly formal changes in the regulatory landscape. The legislation clearly reflected the financial sector's familiar interest-group veto

politics, but that politics was altered substantially by a new dynamic of political mobilization. In part, the new mobilization resulted from the Obama administration's initial legislative proposal, which affected interests far beyond the traditional core financial sector. And, in part, it resulted from the configuration of interests that influenced Congressional action. In particular, this new dynamic hinged on several factors:

1. a clear effort by the executive branch to maintain continuity among existing organizations and elites in the finance sector;
2. political entrepreneurship by sophisticated, independent policy experts;
3. grass-roots advocacy organizations new in financial regulation;
4. openness to historical contingencies arising from electoral politics and the procedural rules of Congress.

These factors coalesced in a pattern we call two-tiered politics. The pattern of two-tiered politics was anticipated in the executive branch proposals and was further shaped in the Congressional debates that followed. The Obama White House, continuing the approach of the Bush White House, went to great lengths to stabilize financial markets. The Obama administration continued the same emergency response measures that the Bush administration put in place in October 2008, and crafted a set of reform proposals that maintained most of the existing regulatory landscape. This "preservationist" approach initially helped the White House maintain strong ties with the financial elite who were seen as necessary for managing the crisis. It was amplified and reinforced by business-friendly blocks in both Congressional parties.

A consequence of the White House preservationist tactic was that the most powerful financial firms and associations remained potent. They were able to block many measures they most intensely

opposed. They were not, however, able to squelch the proposals of several policy entrepreneurs, most notably Paul Volcker and Elizabeth Warren, who interestingly, were propelled to the forefront largely by the White House. In addition to these policy entrepreneurs, a new coalition of policy advocates injected fresh voices into the policymaking process and limited the sway of the country's financial policy elite. As a result, the second tier emerged, with White House encouragement, and created scope for the most interesting reform efforts.

Accordingly, for both White House and Congressional leaders there were two different logics operating. On the one hand, they worked assiduously to maintain friendly relations with the Wall Street elite whenever possible. Some analysts began to speak of the "gilded network" between Wall Street and Washington (Carpenter 2011) while others claimed the Wall Street elite had become a veritable oligarchy (Johnson/Kwak 2010) more reminiscent of developing countries than advanced democracies. Through its high-powered compensation incentives, the financial elite helped define the upper frontier of an increasingly skewed distribution of wealth and simultaneously consolidated ever stronger ties to the Washington policy community (Bebchuk/Fried, 2006; Bartels, 2010; Hacker/Pierson, 2010). This elite shared a commitment to deep capital markets within the United States, and insisted that any regulatory changes in the domestic market should be carefully geared to corresponding international agreements within the G-20 countries.

At the same time that they cultivated this Wall Street elite, Washington leaders wanted to accommodate the popular backlash against precisely the closed elite politics that had previously dominated financial regulation. For this reason, the White House and the Congressional Democrats needed to cultivate coalitions that would confer broader legitimacy on their actions. According to Gunnar Trumbull, such "legitimacy coalitions" had often taken the form of industry alliances with regulators (Trumbull, forthcoming 2012b). In the Dodd-Frank discussions, activist-regulator coalitions



appeared in the form of grass-roots advocacy organizations that mobilized Washington expertise to challenges longstanding industry ties to regulators and key Congressional committees.

The unavoidable tension in this strategy created unusual openness that perturbed a legislative process already vulnerable to quirky developments driven by institutional rules and procedures. Congressional outcomes frequently turned on unpredictable electoral contingencies and rapid shifts in public opinion. The legislative outcome was a mix of significant, if limited, structural changes with many provisions for enhanced tools and procedures that would enable existing regulators to supervise a finance industry chastened, but by no means reconstructed, by the crisis. The potential for regulators to adopt important changes was accompanied by the potential for hostile interests to weaken future regulations and the regulatory agencies themselves.

In the following pages, we elaborate this argument in several steps. First, we very briefly review the regulatory landscape before the financial crisis. Second, we provide a compressed chronology of the reform debate, showing how the primary sites of discussion shifted over time. And third, we illustrate the distinctive factors that shaped the Dodd-Frank outcome by reviewing debates in the major domains covered by the legislation.

### **I. The Existing Regulatory Landscape on the Eve of the Crisis**

The crisis of 2007-2008 was deeply rooted in the historical development of America's regulatory landscape. For over 175 years, two trends dominated U.S. financial regulation. The first was decentralization. Private banks were initially chartered only by the states. Under the U.S. Constitution, Congress alone has power to "coin money," but States have the power to charter banks. Insurance has always been a state-regulated industry. The Office of the Comptroller of the Currency (OCC) was established in 1863 to provide a unified currency during the Civil War and to anchor more stable

conditions for the larger banks that needed a national charter. Not until 1913 was the Federal Reserve System created with 12 regional branches and a central Board of Governors in Washington DC.

The second trend affecting U.S. regulatory structure is competition with industry segmentation. Since 1933, the regulatory structure was organized around industry segments which proved, starting in the late 1970s, to be porous. Competition arose between segments, and differentiation between products and firms declined. Nonetheless, groups of firms had well-established links to, and provided important political support for, regulators. This regulatory equilibrium was fundamentally unstable with both industry and regulators typically eager to poach on adjacent turf.

Three further developments in the second half of the twentieth century were especially important. The first of these shifts was the growing preference among finance firms for a holding-company structure that projected their activities into a number of previously prohibited markets. Congress explicitly extended the Glass-Steagall provisions in the 1950s by disallowing deposit banking and securities activities within the same multi-bank holding conglomerate, but many other combinations were permitted. The new holding companies resisted the traditional functional classification and were mostly overseen by the Federal Reserve. Only later did the Securities and Exchange Commission (SEC) and the Home Loan banking agency also gain supervisory authority over those holding companies that chose to designate them as preferred or “lead” regulators. Through this extended shift, the Federal Reserve staff acquired growing knowledge of emerging business models and steadily gained in reputation for sophisticated regulatory policy.

The second significant shift included a compound set of changes in the sophistication of financial instruments, the velocity of transactions, and the geographic scope of financial markets. These changes rapidly gained momentum in the 1990s and early 2000s. They represented a major transformation at the industry level rather than the firm. These changes, often called financialization (e.g., Davis, 2009;

Krippner, 2011), meant that vast new markets began to link financial institutions globally, largely outside the purview of existing regulatory agencies.

A final trend involved deregulation, which not only reduced the constraints on firms, but explicitly eliminated the differentiation between different kinds of financial firms. Thus thrift institutions became largely indistinguishable from commercial banks, and investment banking and commercial banking functions were performed within a single corporate entity. Several turning points are noteworthy:

- Interest rate caps for thrift institutions were removed in 1982.
- A new independent regulator, the Office of Thrift Regulation (OTS), was created in 1989.
- The 1999 Gramm-Leach-Bliley Act (GLBA) effectively repealed restrictions against universal banking activities.
- The Commodities Futures Modernization Act (2000) explicitly barred federal agencies from regulating new markets in derivatives.

In short, consistent with the thesis developed by Streeck/Thelen (2005) and Mahoney/Thelen (2010), the U.S. financial regulatory system gradually and dramatically evolved over a period of 65 years in response to competitive pressures and periodic shocks. These institutional changes, together with a powerful faith in the stabilizing force of market systems, prepared the way for the financial crisis. The deregulatory efforts since 1982 diminished the capacity of existing regulatory agencies. The result was a kind of institutional “displacement” where regulatory institutions were replaced piecemeal by the rules of open market competition. But this result was not a form of dynamic institutional stability. Instead markets and regulatory institutions became increasingly fragile. The bundling of residential housing loans into so-called mortgage backed securities (MBS) prompted a wild proliferation of newly securitized loans and related financial innovations that created the rapidly growing markets known as the shadow

banking system. As early as 2004, government reports noted that the GLBA had made it excessively easy for financial conglomerates to position major activities outside the jurisdictions of the regulatory agencies. With increasing urgency by 2007, official reports were pointing out the jurisdictional gaps between key regulatory agencies such as the SEC and the Federal Deposit Insurance Corporation (FDIC), as well as the OCC and the OTS (GAO, 2007). This growing fragility culminated in a dangerous crisis in the economy's key banking and regulatory institutions, which were sustained only through the extraordinary decision-making of the Treasury and the Federal Reserve in 2008.

## **II. The Chronology and Political Context of Reform**

Legislative efforts to revamp U.S. regulatory structures followed and had to deal with the consequences of emergency measures adopted to ameliorate the crisis triggered by Lehman's bankruptcy in September 2008. Within weeks, the Bush Administration persuaded a reluctant Congress to enact the Troubled Asset Relief Program (TARP), which authorized the Treasury to spend up to \$700 billion in assets tainted by the collapse of mortgage securities (a majority of House Republicans voted against). After Barack Obama won the presidential election in November 2009, his transition team worked closely with Bush Administration officials to refine the TARP program, while planning the new Administration's own legislative agenda. Even before the election, Obama's commitment to preservation was signaled by his reliance on well-connected mainstream economic advisors.

Upon taking office in late January, 2009, the new White House placed top priority on economic stimulus and a plan for health reform; financial reform was a lesser priority in the Administration's very large agenda. In June of 2009 the Administration released a White Paper outlining measures for regulatory reform accompanied by a statement by the President (U.S. Treasury, 2009; Obama 2009c).

Congressional movement to consider new regulatory laws was quickly apparent in a number of different House and Senate committees. The Treasury proposals of June became the starting point for the broad bills drafted in the House of Representatives by the Committee on Financial Services and in the Senate by the Committee on Banking. Hearings were held by the House Committee, chaired by Representative Barney Frank, through the fall of 2009, followed by passage of the House bill in December.

In October, 2009, Goldman Sachs led investment banks in announcing their plan to distribute large bonuses to its executives. In following weeks, White House polling showed that the public thought Obama was too close to Wall Street (Heilemann 2010). On December 13, Obama appeared on the television news show *60 Minutes* to say pointedly “I did not run for office to be helping out a bunch of, you know, fat-cat bankers on Wall Street.” He expressed frustration at the fact that banks that were bailed out “are fighting tooth and nail . . . against financial regulatory reform” (Obama 2009d).

In this context, in January 2010, President Obama again raised the salience of financial reform. He advocated imposing a “Financial Crisis Responsibility Fee,” to assure that government would be reimbursed for the cost of the bailouts. Shortly thereafter, he appeared with economic advisor and former Federal Reserve Chairman Paul Volcker in support of tough regulations to segregate deposit banking from proprietary trading—the “Volcker Rule.” Days before, on January 19, Republican Scott Brown had won an upset victory in a special election in Massachusetts to fill the seat of the late Senator Edward Kennedy, a very liberal Democrat. This critically reduced the Democrat’s seat share to 59, one less than the 60th pivotal vote required to stop filibusters in the Senate. While Brown was a very moderate Republican on most issues, his election exacerbated an already tense and highly partisan split in Congress.

In March, the Senate Committee on Banking, chaired by Senator Chris Dodd, took up the bill and debated it through April. In April, reforms received a major boost when the SEC filed fraud charges against Goldman-Sachs in connection with the design and marketing of instruments known as credit default swaps. In subsequent days, Obama gave a forceful speech to the Business Council supporting financial reform. After a number of amendments, the Senate approved its version of the bill on May 20 and requested a conference committee with the House to mesh differences between the two versions. A tough set of Conference deliberations occurred from June 10 through June 29, 2010, after which the reconciled bill was passed, easily by the House (June 30) and only by the minimum filibuster-proof majority in the Senate (July 15). The bill became law as the Dodd-Frank Act when President Obama signed it on July 21, 2010.

One of the key factors driving the dynamic of two-tiered coalition building was the breadth of the interests affected. These involved many groups beyond the traditional core financial interest groups. The Center for Responsive Politics, which tracks lobby registrations and expenditures, identified 697 financial sector lobbying organizations in 2010. Their data also showed that 788 organizations were registered to lobby concerning HR 4173, the Dodd Frank Bill. Of those Dodd-Frank lobbies, *only 36 percent* were identified as mainstream financial sector groups. Remarkably, nearly two-thirds of the groups mobilized to influence the Dodd-Frank legislation were “nonfinancial.” These proportions reflect the broad reach of the legislation, and helped create opportunities to shake up traditional coalitions.

Even in this heated atmosphere, financial reform engaged the general public far less than health care reform, which passed in March 2010. The agenda-setting media were focused far more intensively on health care reform. In a graphic reviewing major events in 2010, *Time Magazine* prominently mentioned health care reform, but did not mention Dodd-Frank (27 December 2010, 32-33). The graph in figure [1] from Google Trends shows in indexes for the news reference volume as well as Google

searches that the public's attention to financial reform ranked consistently lower. This pattern suggests strongly that even a dramatic crisis did not overcome the political barrier to popular involvement posed by the perception that financial issues are primarily technical in nature.

### **III. Systemic Risk Regulation**

The Dodd Frank Act created (Title I) a new Financial Stability Oversight Council as its central solution to the problem of systemic risk. This new Council groups the main functional regulators together, oversees the financial system as a whole, and exercises the power to establish enhanced levels of regulation for the largest financial services firms.

The idea for such a council appeared as soon as the immediate rescue operations of late 2008 began to take hold, allowing policymakers to focus on longer-term reforms that would prevent similar crises in the future. The Obama Administration followed the prevailing regulatory wisdom by seeking better tools for monitoring so-called "systemic risk" and new powers, in extreme cases, to restructure firms deemed significant enough to endanger the entire financial system. In both respects, the Administration revealed a strong preference for continuity in the regulatory structure and in the major firms that dominated the industry.

While unfamiliar to many members of Congress, the problem of monitoring systemic risk was by no means new to the financial policy elite. Indeed, key members of this elite shared a broad understanding of how the crisis had unfolded and why the recipes of the past failed to work in 2008. In critical respects, the template for responding to systemic risk emerged from the rescue of the famous hedge fund, Long-Term Capital Management (LTCM), in 1998. Since LTCM had been financed by Wall Street's key investment banks, the New York branch of the Federal Reserve convened the heads of a

dozen major firms in September 1998 to finance a private-sector bailout. In the space of a weekend, these firms stopped any contagion by taking a 90 percent ownership stake in LTCM (Lowenstein 2001; McKenzie 2008). The senior officials who were to grapple with the impending collapse of Lehman Brothers ten years later were all fully familiar with the LCTM bailout as participants or close observers (see Stewart, 2009).

This familiar solution – a solution negotiated with a consortium of market participants convened by the New York Fed – failed in resolving the problems at Lehman Brothers in September 2008. By backstopping J.P. Morgan’s acquisition of Bear-Stearns in March 2008, the Fed had signaled its willingness to reverse market outcomes that threatened wider contagion. In mid-September, top policymakers – including Treasury Secretary Hank Paulson, Chairman of the Federal Reserve Ben Bernanke, and Chairman of the New York Fed Tim Geithner – gathered again in lower Manhattan to spearhead a private-sector bailout for Lehman Brothers. When a private-sector solution failed to materialize and policymakers told Lehman to file for bankruptcy, financial centers around the world were gripped by fear. The consequence was a profound crisis of confidence that spread instantaneously, freezing an over-leveraged system of credit markets while dramatically deepening the downturn that soon became known as the Great Recession.

Although Lehman’s bankruptcy was not predicted, the gaps in the country’s regulatory structure were well understood beforehand. Hank Paulson’s earlier experience with LTCM left him acutely aware of the risks posed by highly leveraged and interconnected firms. As Treasury Secretary, he commissioned a major study for redesigning the U.S. regulatory system, entitled *Blueprint for a Modernized Financial Regulatory Structure*, issued in March 2008, six months before the Lehman bankruptcy (U.S. Treasury, 2008). The *Blueprint* said the U.S. system of functional regulation by business area made less and less sense as financial firms moved increasingly into multiple parts of the industry –



commercial banking, securities brokerage, investment banking, mortgage lending, and their own proprietary trading. The existing framework meant no single regulatory agency was responsible for monitoring risk across the system as a whole. The Paulson *Blueprint* therefore recommended that a single agency be made responsible for what it called “macro-prudential regulation,” while two new agencies should be established, one with consolidated responsibility for day-to-day monitoring and inspection across all financial markets, the other for enforcing overall conduct-of-business regulation.

**The Main Actors.** As the Obama Administration took office, the new Treasury Secretary, Timothy Geithner, commanded extensive knowledge of the regulatory problems and prescriptions of the preceding decade. The Administration White Paper of 2009 outlined a new “systemic risk” council. Called the Financial Stability Oversight Council (FSOC), the new council would shift macroprudential responsibility away from the Federal Reserve (where Paulson’s *Blueprint* had proposed putting it). The FSOC would be chaired by the Treasury Secretary. After the Treasury, the Federal Reserve was preeminent, with operational authority for supervising all systemically important companies, but its responsibilities were submerged within a broader set of voting members. These voting members consisted mainly of existing functional agencies. In addition to the Treasury Secretary and the chairman of the Federal Reserve Board, they were to include the Comptroller of the Currency, the Chair of the SEC, the Chair of FDIC, the Chair of the Commodities Futures Trading Commission (CFTC), the Director of the Federal Housing Finance Agency, the Chair of the National Credit Union Administration (NCUA) Board, the Director of the (new) Consumer Financial Protection Bureau, and one independent member with insurance expertise to be appointed by the President with approval by the Senate.

Given the severity of the crisis, the underlying goal of systemic risk regulation was beyond controversy. Neither the firms nor their champions in either party could plausibly claim after 2008 that market discipline alone was sufficient. While the idea of a systemic-risk council quickly gained

acceptance, the role of the Federal Reserve remained open to question. The House version of the legislation specified the Fed's role as that of agent of the FSOC (Dodd-Frank, 2010: subtitle A., section 1100 of the bill as passed in the House; See also Davis Polk, 2010: 2, 10). The initial Senate Committee drafts in November 2009 proposed, by contrast, to strip all regulatory competencies from the Federal Reserve as part of a thorough regulatory redesign. But by March 2010 the Senate had converged toward the House proposals to group existing agencies into a new macroprudential council which would include the Chairman of the Federal Reserve (Washington Post, 12 December 2009: Brady Dennis. See also DLA Piper, 2010). Within the expert community, some observers felt the duties of day-to-day prudential regulation would burden the Fed with unnecessary tasks that could undermine its independence in monetary policy. Other specialists said the Fed possessed such preponderant expertise that, as former Fed governor Alan Blinder put it, "we would have to tie ourselves in knots" to move the tasks of systemic-risk away from the Fed (quoted in Bloomberg News, 9 May 2009: Robert Schmidt). Existing regulators, such as Sheila Bair, chairperson of the FDIC, accepted the role of the Fed, but preferred that the super-council of regulators be entrusted with the setting of overall guidelines for macro-prudential regulation (Bloomberg News, 9 May 2009). Such proposals echoed earlier efforts to deepen coordination in financial regulation since the late 1970s (FFIEC, 2011).

Beyond the precise role of the Fed, Congressional discussion focused on the criteria by which firms would be designated as "systemically important" and therefore subject to heightened regulatory standards. Banks of over \$50 billion in assets were automatically designated as "systemically significant." The Senate bill diverged from the House by separating Bank Holding Companies (BHCs) from systemically important Non-Bank Holding Companies (NBHCs). For NBHCs, the Senate proposal called upon the FSOC to develop criteria and decide by a two-thirds majority of voting members that a particular firm would come under the rules of enhanced supervision. The designation of NBHCs seemed

like an esoteric issue, but the stakes were high. The details determined whether conglomerates like General Electric or IBM as well as hedge funds or private-equity groups would be included under the new requirements for enhanced regulation. At the peak of the crisis, the remaining investment banks became bank holding companies, subjecting themselves to Fed regulation, in order to qualify for help from the Federal Reserve (*New York Times* 9/21/2008). But nothing prevented them from dropping their bank charters, in which case under the House draft they would escape the new rules for systemic risk monitoring (New York Times, 2010).

Outside Congress, the debate over systemically significant firms included more radical remedies. A number of observers saw the Dodd-Frank reforms as too modest. Unless the banks were broken up and capped in size, they would remain “too big to fail.” A number of bankruptcy lawyers and respected economists such as Simon Johnson recommended this approach, arguing that anything else would either elevate the Treasury Secretary to the position of a restructuring “czar” or simply leave the bank executives in place as virtual “oligarchs” (Skeel, 2010; Johnson/Kwak, 2010).

Such proposals were never central in Congressional deliberations although related amendments were soundly rejected. Once the structure of the FSOC was clarified, the main legislative debates revolved around technical matters of definitions, procedures, and degrees of discretion in setting regulatory rules. To bolster the process of macroprudential oversight, the FSOC was to be supported by a new Office of Financial Research (OFR) with independent subpoena powers and a Director appointed directly by the President. Virtually all versions of the bill directed regulators to align domestic regulations with international agreements, and the Treasury took an active role in preparing to implement the Basel III rules for capital adequacy (Bernanke, 2011; see also Kerwer and Goldbach, this volume). The other aspects of macro-prudential regulation were a realm where the specialists’ specialists held sway. Congressional Republicans tended to criticize the bill for imposing burdensome

compliance costs, while Congressional Democrats had to wrestle with how to define new and more effective instruments of macro-prudential oversight.

**Interest-Group Influence.** Given the broad agreement on improving macroprudential regulation, industry groups were initially restrained in their criticism of the Dodd-Frank proposals. From their viewpoint, a superordinate council that left day-to-day oversight with familiar regulatory agencies had advantages (Ryan, 2009). Such a Council would ameliorate the regulatory “gaps” that appeared between the functional regulators as new firms entered the industry. As long as the new information-gathering powers were not used too aggressively, most industry groups affirmed their support for the new FSOC. As the legislation moved from enactment into the implementation phase, however, some divergences among industry groups began to appear.

The Securities Industry and Financial Markets Association (SIFMA) supported a strong macroprudential regulator. . Since its member firms were already highly regulated by the SEC, SIFMA favored a broad ambit for the new risk regulator. The new systemic risk council could then fill important gaps in the regulatory landscape and dampen competition from new and less regulated entrants. The main limit on the council’s activities should concern information-gathering, where SIFMA recommended close coordination with existing regulators to avoid duplicative information requirements. The securities traders emphasized repeatedly that U.S. regulators should coordinate closely with the G-20 to obtain comparable regulatory standards at the international level (Ryan, 2009).

Other industry associations ranged in their comments from supportive to restrained. But few of them saw any mileage in opposing the goal of systemic risk monitoring while the legislation was being formulated. Several months after passage, the American Bankers Association (ABA), highly critical of other elements, clearly favored macro-prudential regulation. The ABA saw systemic-risk regulation as a promising way to subject newer firms to the same kind of rules that its own members – mostly

traditional banks – had long lived with. The U.S. Chamber of Commerce expressed far more qualified support. The Chamber’s Center for Capital Markets Competitiveness emphasized the negative consequences of defining the concept of “systemically important” too broadly. In contrast to the ABA, the Chamber explicitly opposed “bank-like regulation for large nonbank financial institutions,” arguing that the process of defining new rules would create unwarranted uncertainties for firms like General Electric or the auto companies’ financing subsidiaries (McTighe, 2010; Hirschman, 2010).

Labor and consumer groups sought a macroprudential regulator with enough power to bring the entire shadow banking system within its purview. The precise organizational location and structure of a new regulator mattered less than giving it adequate tools to gather comprehensive information that the alternative investment vehicles, hedge funds and private equity groups, had previously been able to keep confidential (Silvers, 2009).

By establishing the FSOC as the central executive body for regulatory policy, the Dodd-Frank Act achieves several purposes and sidesteps several irresolvable controversies. By including the Chairman of the Federal Reserve, the FSOC can draw on the Fed’s deep expertise without putting macro-prudential monitoring entirely in the Fed’s hands. As enacted, the legislation gives the FSOC ten voting members including the Treasury Secretary as chair. By including the existing functional regulators (except the OTS, now eliminated), the legislation satisfies industry representatives who wanted to avoid the costs of switching from agencies with which most of the country’s banks and financial-services firms were already familiar. Yet, owing to the real power it was given to intervene in cases of systemically important financial distress, the FSOC also responds to those who said a new and powerful regulatory body was essential.

#### IV. Consumer Protection

A widely-hailed change of the Dodd-Frank bill was the creation, in Title X, of a new, independent Consumer Financial Protection Bureau (CFPB). This bureau has some elements familiar for independent agencies: the Director is appointed by the President for a relatively long term and cannot be dismissed except for cause. However, it differs from many such agencies in that decisions do not need the support from a bipartisan board of voting commissioners. Above all, the CFPB is uniquely located within another independent agency, The Federal Reserve. Funding for the CFPB is defined by law as a percentage of the Federal Reserve's budget and is thus, like the Fed itself, not dependent upon the Congressional appropriations process. Moreover, the Fed explicitly has no role in overseeing the CFPB.

Few observers argue that general consumer lending practices were the central cause of the financial crisis (by contrast to derivatives markets) although they did contribute. The CFPB provides a classic example of the way a well-developed reform proposal, widely discussed prior to the crisis, became politically viable in the subsequent highly-charged atmosphere (Kingdon 2011). The adoption of the CFPB was hardly a certainty, and major groups in the financial industry resisted it strongly—winning on some key points. The agency drew powers from many other agencies including the Fed and the Federal Trade Commission.

Since the biggest and most powerful financial institutions do not earn their profits from lending to ordinary consumers, they were little inclined to fight on these issues. As a result, this issue had the potential to split the industry. Community banks and thrifts, already closely regulated, might be expected to welcome closer regulatory scrutiny for non-bank competitors including payday lenders, mortgage companies and consumer credit agencies. Precisely because of its broad reach, however, the proposal could potentially galvanize in opposition the thousands of organizations making consumer loans

**Elizabeth Warren, Policy Entrepreneur.** Virtually every account traces the CFPB back to two academic articles by Elizabeth Warren, a professor at Harvard law school (Warren 2007 and Bar-Gill/Warren 2008). The articles powerfully make the case that consumers face a much more risky market for credit products than for physical products because of the relatively lax regulation in the case of credit products. In these articles, Warren called for the creation of a Financial Product Safety Commission. Bar-Gill and Warren 2008 (p. 98) recommended a single new regulatory agency with a broad mandate or, “a new consumer credit division within an existing agency (the FRB or FTC).” They did not specify that it be an independent agency.

As important as those papers, however, was Elizabeth Warren herself. By 2008, she was a seasoned and skilled reformer known as a creative, unflappable and intelligent advocate. Her connections to Obama dated to 2004. She was also close to Hillary Clinton and many other members of Congress. She had achieved prominence in 2005 as an opponent of bankruptcy reform (Sullivan/Warren/Westbook 2001, 2004). Her research was cited repeatedly in 2008 in Congressional hearings and news reports and had been reflected in legislation that long predated Dodd-Frank.

In October 2008, when Congress authorized TARP, it created the Congressional Oversight Panel (COP) to “review the current state of financial markets and the regulatory system.” (U.S. Senate, COP) In November, in an important development, Senate Majority Leader Harry Reid named Warren as a COP member and she was subsequently selected as panel chair. The COP was primarily focused on the question of how TARP funds were being used and how banks were accounting for them. Warren became a very visible critic of TARP, frequently interviewed on television.

In late January 2009, the COP issued a "Special Report on Regulatory Reform." This report, prepared by academic consultants, comprehensively surveyed prior investigations and studies concerning financial reform. It was fully up-to-date with the international context, citing the Financial

Stability Forum as well as Basel I and II. The Report included a list of recommendations for policy action including a call to “Create a New System for Federal and State Regulation of Mortgages and other Consumer Credit Products” (p. 30). This portion of the report closely paralleled Bar-Gill and Warren 2008, and suggested creation of either a new independent agency *or* placing the new regulator within the Federal Reserve Board (p. 35). The report included a lengthy minority analysis which accurately anticipated the arguments leveled at the CFPB in subsequent debates.

In February 2009, Warren blasted the Treasury for failing to spend TARP money as Congress had been promised. The Obama Administration, however, “did not echo the congressional concerns” (Washington Post, 6 February 2009: A03). In short Warren was known to the Obama administration early on, but was clearly, at that stage, not on the same wavelength as Treasury Secretary Geithner.

On March 25, 2009, the Financial Product Safety Commission Act of 2009, influenced by Warren’s ideas, was introduced simultaneously in the House and Senate. It was promoted by House Financial Services Committee Chair, Barney Frank (*Newsweek*, 20 April 2009: 34). A group of Senators who had cosponsored the bill wrote Geithner urging that the consumer finance agency be included in the Administration’s plan (*Washington Post* 20 May 2009: A01). In testimony in late March concerning financial reform plans, Geithner was criticized by consumer advocates for making no mention of consumer issues (*Washington Post*, 27 March 2010: D01). Reports surfaced in late May 2009 that Secretary Geithner and National Economic Council Chair Larry Summers were discussing including the consumer protection agency in the administration’s reform proposal, but that the administration was still undecided on the concept (*ibid*).

The June 2009 Administration “White Paper” called for creation of a “single regulatory agency,” to be called the Consumer Financial Protection Agency, essentially Warren’s proposal (U.S. Treasury 2009). Powers over consumer protection in finance would be transferred to the new agency from the



several agencies to which they had become dispersed over the years: the Fed, OCC, OTS, FDIC, FTC (Federal Trade Commission), NCUA, and the Department of Housing and Urban Development (HUD). Strikingly, aside from the FTC, there was little bureaucratic resistance to these reforms.

**A New Coalition.** At virtually the same time the Administration unveiled its proposal, a new pro-reform coalition was announced, known as the Americans for Financial Reform (AFR). This coalition, which eventually numbered more than 250 consumer groups and labor organizations, provided for the first time in the history of U.S. financial politics a cohesive non-industry voice. AFR was financially marginal in contrast to the traditional major lobby groups—its annual budget was reported to be around \$1.5M; the Chamber of Commerce reportedly spent over \$700M in lobbying on all issues in 2010.

Comments from representatives of the financial industry earlier in the year suggested that they believed the consumer financial protection proposals were unlikely to be seriously considered. Once they showed up in the Administration’s White Paper, the industry began “lobbying furiously” in opposition (Heilemann, 2010). The American Financial Services Association stated that they could not accept a solution that involved a new separate agency. A lobbyist for the Financial Services Roundtable said flatly, “our goal is to kill it” (*American Banker*, 13 July 2009: 1). Opposition also came from the American Banker’s Association, the American Land Title Association, the Independent Community Bankers of America, the Chamber of Commerce, and many others.

The opponents succeeded in making a number of changes as the legislation progressed. Early on, they eliminated a requirement that lenders be required to offer basic, standardized (“plain vanilla”) products to facilitate consumer comparison shopping. They won on strong language requiring coordination and communication between CFPB and other bank regulators. They won requirements for dispute resolution processes when regulators disagreed among themselves. Later in the process they restricted the new agency to *enforcing* (as opposed to writing) regulations only for the largest firms

(larger than \$10B assets), whereas other functional regulators would enforce regulations for smaller firms. Eventually there was an agreement to completely exempt auto dealers (who make consumer loans), from agency oversight.

As 2010 progressed, President Obama repeatedly endorsed the idea of a new independent agency. In April, the SEC brought fraud charges against Goldman Sachs, and in May, opinion polls showed that the public strongly supported stricter bank regulation. In this environment, reform advocates were emboldened. The Senate Bill, passed in late May, placed the CFPB inside the Federal Reserve. Not only had the agency not been killed, it had been granted more robust autonomy. The FSOC may “stay” CFPB regulations (Title X, Section 1023). However, such an action requires a two-thirds vote in the FSOC, and each member voting in favor must represent an agency which has independently determined in a public meeting that the CFPB proposal would put banking system safety and soundness at risk. Contrary to the urging of the financial industry, the CFPB may not preempt state law when state law provides more consumer protection than does Federal law. This was a major change to the status quo.

**Implementation.** the CFPB received a relatively high number of new rulemaking authorities granted under Dodd-Frank (though far fewer than granted to the SEC, FRS, and CFTC). The initial implementation problem confronting CFPB was the creation of an entirely new agency from groups of staff drawn from several existing agencies. Most CFPB authority officially began on July 21, 2011, but as early as March 2011 the agency had a functioning website dispensing advice to consumers, inviting comments, and offering assistance with complaints.

Obama appointed Elizabeth Warren to launch the agency -- a decision strongly opposed by Republicans in Congress and most of the financial industry. She went on a “charm offensive” with financial industry executives in order to try to get the agency off to a good start (*Wall Street Journal* 15

March 2011). She advised bankers that her main targets are nonbank firms making payday and student loans, doing debt collection, and lending for mortgages. She emphasized a “principled approach” to supervision rather than strict enforcement of precise rules.

Of course, the impact of the CFPB remains to be seen. Opponents succeeded in blocking the appointment of Elizabeth Warren as the agency’s first director. The fact that the agency exists at all, and has drawn resources from many other existing agencies is a remarkable event. The fact that it is well-financed, headed by a single director, and lodged in, but not controlled by, Fed, is even more remarkable. At the same time, the agency’s enforcement scope is restricted to the very largest financial firms, and it has no mandate to require the creation of the standardized, easily understood instruments initially recommended by Warren. While it is a tremendous accomplishment in some respects, the agency is ultimately of more concern to consumer advocates than to the financial policy elite that cared most about the shadow banking world and its unregulated derivatives products.

#### **V. The Volcker Rule.**

The portion of the Act known as “the Volcker Rule” (Title VI sections 619-621) attempts to require banks to separate risky, speculative activity conducted on behalf of the bank, from the basic banking functions serving bank clients. The latter enjoy a variety of explicit public guarantees and supports. The Volcker rule was also seen as addressing conflicts of interest that might emerge between banks operating for their own interests and those of their clients.

The Congressional debate over the Volcker rule was highly visible but by some accounts not really very contentious. Contrary to several press accounts, the Volcker Rule did not recreate the bright-line separation of commercial and investment banking of the Glass-Steagall Act of 1933. However, the echo of Glass-Steagall has been widely noted.

The Obama Administration's June 2009 White Paper called for regulatory action to strengthen firewalls between banking affiliates that dealt in OTC derivatives versus the deposit-taking parts of a bank that enjoyed federal guarantees. That proposal was relatively timid compared to what emerged later in the process. Consistent with the initial Administration plan, the version of the legislation passed by the House of Representatives in December 2009 made only a nod toward the kind of separation required by the Volcker Rule—at that time the phrase had not yet been coined.

In response to increasingly negative public opinion about the bank bailouts, the Obama Administration decided in December 2009, as a matter of political strategy, to back stronger legislation and to identify it rhetorically as “the Volcker Rule” in order to draw on the deference accorded the former Fed Chairman. Obama's decision was announced in January 2010, to general surprise because of the widespread belief that this direction was opposed by Larry Summers, Director of the National Economic Council, and Tim Geithner, Treasury Secretary. Obama's announcement followed hard on a White House proposal to place a “Financial Crisis Responsibility Fee,” on the liabilities of the largest financial firms in order to repay the loans and subsidies provided by the Government. Both proposals marked a hardening of Obama's approach to financial reform.

In subsequent months, the draft legislation concerning the Volcker Rule became stronger as criticism of Goldman-Sachs became sharper; many observers saw these developments as linked. Shortly after the SEC charged Goldman with civil fraud, a stronger version of the Volcker Rule, known as the Merkley-Levin Amendment (MLA) was introduced in May 2010. Among other differences, Merkley-Levin prohibited proprietary trading as a matter of law, not just prospective regulation, and applied to all “banking entities” rather than to only insured depository institutions.

Congressional consideration of MLA became linked with another controversial provision, the Brownback Amendment to exempt auto dealers from coverage by the Consumer Financial Protection

Agency. Both passed the Senate in late May in an apparent compromise. The MLA was weakened in Conference Committee in order to win the support of newly-elected Massachusetts Republican Senator Scott Brown on a vote necessary to halt debate (Cassidy 2010). In this case, language was inserted that permits banks to invest up to 3 percent of their tier 1 capital (not, as in a prior draft, the more inclusive “common equity”) in hedge funds and private equity funds, provided that they may not own more than 3 percent of a fund’s capital.

**Volcker’s Entrepreneurship.** The idea of restricting banks’ involvement with proprietary trading was not among the ideas proposed in prior U.S. regulatory reform documents. Nor had this been an issue for the G-20. By 2006, securities regulators, most prominently in Australia, were expressing concerns about proprietary trading as a source of conflicts of interest (Australia, Securities and Investment Commission 2006). However, in late 2008, following the crash, industry observers noted that proprietary trading was “under scrutiny” because of the extensive leverage involved (*Wall Street Journal Market Watch*, 31 October 1998).

The main agenda-setting event was a report issued on January 12, 2009 by the Group of 30 (G-30), a private policy-advisory group which was headed by former Fed Chairman Paul Volcker, who had been named by Obama in November 2008 to be Chairman of the President’s Economic Recovery Board (Group of 30, 2009). The report called for limiting the proprietary activities of “systemically important banking institutions” that “present particularly high risks and serious conflicts of interest.” The G-30 also called for prohibiting bank sponsorship or management of hedge funds and urged that in packaging and sale of “collective debt instruments” banks should be required to retain a “meaningful part of the credit risk.”

The idea gained no immediate traction. When Volcker outlined the proposal to Congress on February 26 (Volcker 2009), close observers doubted that it would play a significant role in the U.S.

reform. There was a widespread impression was that, despite his official advisory position, Volcker lacked strong influence with Obama. Consistent with that view, the idea of limiting bank proprietary trading figured modestly in the Administration's June 2009 "White Paper," (p. 31) and it was not mentioned at all in Obama's accompanying public statement (Obama 2009c). The media rarely mentioned the topic. When Obama made a major speech on financial reform in New York City in September 2009, he again omitted any mention of the Volcker rule or proprietary trading (Obama 2009e). When Volcker continued to advocate for prohibition of proprietary trading a few days later, the *Wall Street Journal* (17 September 2009) speculated that he was likely at odds with the Obama Administration. The *New York Times* (20 October 2009) observed that Volcker "may not be alone in his proposal, but he is nearly so."

The House bill, passed December 11, 2009 on a strict party-line vote, did not include a *prohibition* on proprietary trading, but it did specify that the Federal Reserve Board could restrict the ability of a financial firm to trade on its own account (Section 1117).

**Key Events.** The progress toward adopting the Volcker Rule was primarily a response to public anger about bailouts and bonuses—anger that came from both the right and the left. Obama decided in late December 2009 to reverse course explicitly and prominently support the proposal. In doing this, he had to overcome the objections of Geithner and Summers (Alter 2010, Heilemann 2010). One prominent observer was quoted at the time as saying the change was a "fundamental shift" (*Washington Post* 22 January 2010).

The reaction from Wall Street was anger and a sense of betrayal. Congressional reception to the idea was, initially, luke-warm. Within days of Obama's announcement, Volcker testified before the Senate Banking Committee. Chairman Dodd spoke passionately of his commitment to addressing the problem of too-big-to-fail and his desire to make the idea of future bailouts "absolutely off the charts."

He pointed out that the committee had held 52 hearings in the past year that had thoroughly considered the problems of reform. The Volcker Rule issue, he said, came up late and was generally viewed as a political response to the Republican victory in the Massachusetts special election. Dodd warned against trying to do too much, and added, presciently, that “I don’t want to go to the floor of the United States Senate begging for a 60<sup>th</sup> vote.” Volcker pointed out that the President’s decision long preceded the Massachusetts special election, a point Dodd conceded (US, Senate, Committee on Banking, Housing and Urban Affairs, 2010).

Within a month, there were leaked accounts that the Administration was backing away from the Volcker Rule because they were having trouble selling it to the Treasury and Congress (*New York Post*, 23 February 2010). However, momentum swung back strongly toward the Rule—and all of financial reform—in April, when the SEC filed its civil fraud charges against Goldman. In this environment, many elements of the stronger version of the Volcker Rule, taken from the Merkley-Levin Amendment, prevailed.

**Implementation.** Ultimately, as passed, the Volcker Rule includes a number of contingencies, exceptions, and limits. Nonetheless, real adaptations have been made already, and the principles articulated in the Volcker Rule permit modes of supervision and monitoring that were previously unknown. The new law directed the FSOC to complete a study within six months including detailed guidance to regulatory agencies required to complete drafts of regulations within another nine months. The law required clarification about the nature of activity related to “market-making” that would be permitted. Other terms will be clarified in part through a study to be conducted by the GAO. The FSOC reported receiving over 8000 public comments about its report, of which 6,550 were substantially the same letter arguing for strong implementation of the Volcker Rule (US, FSOC 2011). This seems to have

reflected mobilization by Americans for Financial Reform coalition partner Public Citizen (Krawiec 2011). The remaining comments addressed in detail the ambiguities and problems in implementing the law.

The FSOC report was a statement of intent to strongly enforce the new law. The report innovated in proposing quantitative metrics that can be used to monitor bank investment activities and that may signal an engagement in prohibited proprietary trading. The report notes that its direction will impose additional burdens on regulatory agencies and on banking entities as well.

By the end of January 2011 several major banks had already decided to close down their proprietary trading (*Wall Street Journal*, 1 September 2010; *Business Insider*, 3 September 2010; *Dealbook*, 29 September 2010; *Financial Times*, 1 October 2010). Despite the opportunity for a considerable period to implement changes required by regulations yet to be promulgated, the leading investment banks moved quite promptly to reveal plans to eliminate proprietary trading. Skeptics suspected them of essentially reassigning people to permitted areas related to making markets.

The next step is rulemaking by the SEC; CFTC, FRB, FDIC, and OCC. The proposed regulations were expected in October 2011. Additional joint rulemakings “shall” address activities that may threaten U.S. financial stability, additional capital requirements, internal controls and recordkeeping.

## **VI. New Regime for Derivatives Trading**

Derivatives regulation represented one of the most urgent but difficult reform tasks. This problem was taken up in Dodd Frank in Title VII, which set new rules for transparent pricing and public documentation in most derivatives markets. Derivatives, as contractual agreements based on underlying assets or commodities or revenue streams, were central to the financial crisis. As a broad class of instruments, they had become a core element in the business strategies of thousands of firms. Since they were private, over-the-counter (OTC) contracts, they could inject inestimable levels of



uncertainty into a variety of financial markets. This combination of centrality and uncertainty meant the prospect of regulating derivatives unleashed a remarkable high-energy politics. Affected constituencies included interest groups from all parts of the business community, labor, professional groups, consumer advocacy groups, and public officials from many federal, state, and municipal jurisdictions.

Reform proponents had two main goals in the derivatives debate: first, to segregate derivatives trading from other banking activities; and, second, to take derivatives out of the unregulated shadow banking system by forcing them into more open venues as fully documented transactions. Both goals provoked bitter resistance from particular segments of the finance industry, but both appeared in the final bill. As enacted, both measures provisions give regulators the tools to limit dramatically excessive risk-taking in derivatives, but only if regulators are provided with adequate staffing and expertise.

Despite earlier debates on the subject, derivatives had remained largely unregulated into the early 2000s. They came into existence as hedging instruments, similar to commodities futures, to help market participants insure predictable revenues for agricultural products or anticipated revenues in foreign currencies. As the complexity of the assets underlying derivatives expanded, their notional value began to dwarf all other markets. By the late 1990s, the volume of mortgage-backed securities was growing geometrically and the popularity of the credit-default-swaps that insured the revenue streams from them appeared to be growing even more quickly. In May 1998, the CFTC, led by Chair, Brooksley Born, issued a concept paper proposing that derivatives be regulated by the CFTC (CFTC 1998). In an episode famous for its short-sightedness, Treasury Secretary Robert Rubin sided with Fed Chairman Alan Greenspan and other regulators in opposing Born's view. The Commodities Futures Modernization Act, passed in late 2000, legally barred the CFTC (or any federal regulator) from asserting jurisdiction over off-exchange derivatives (Hirsch: 2010; McLean/Nocera: 2010, 104-106).

Through the early 2000s, the idea of regulating derivatives continued to percolate. Iconic investor Warren Buffett described derivatives as “financial weapons of mass destruction” in 2003 and his remarks were widely quoted (e.g., Congressional Record, 4 March 2003: 5309). Between 2005 and early 2008, the Financial Stability Board led discussions of the G-20 to ensure that the “operational infrastructure” for OTC derivatives markets was sound. Over the same period, the Federal Reserve Bank of New York held several industry meetings pursuing the same goals (Federal Reserve Bank of New York, 2008). By November 2008, the U.S. Treasury had shifted toward an activist position within the G-20 by circulating an Action Plan in preparation for the G-20 Pittsburgh summit the following September, including efforts to “reduce the systemic risks of CDS” while also bolstering “infrastructure for OTC derivatives” (U.S. Delegation to the G-20, 2008). By 2008, all relevant actors acknowledged that financial derivatives had played a key role in the failure of Bear-Stearns in March in freezing credit markets after Lehman went bankrupt in September.

**Key Actors.** Given the urgency of improving oversight for derivatives, many actors staked our early positions. In early 2009, bills were appearing in various Congressional committees to address the danger of speculation in derivatives for energy and agriculture. Seeking to maintain the initiative on financial regulation, Secretary Geithner wrote to House Speaker Nancy Pelosi on May 13, 2009, a month before publication of the Administration White Paper, to outline Administration proposals on derivatives.

The Treasury’s plan showed that the financial policy elite was reassessing its earlier views with regard to the derivatives business. The earlier consensus held that sophisticated banks and hedge funds could use derivatives to promote a better allocation of risk and resources. But after the crash, regulators had to acknowledge that derivatives could also concentrate risk in “opaque and complex ways.” According to the Treasury Department’s report, “the build-up of risk in the

over-the counter (OTC) derivatives markets, which were thought to disperse risk to those most able to bear it, became a major source of contagion through the financial sector during the crisis” (U.S. Treasury, 2009: 43). Accordingly, Treasury proposed that derivatives be traded through verifiable transactions and guaranteed by registered clearing-house institutions. Instead of the “lax regulatory regime” that had taken shape by 2008, the Treasury report said adequate regulation required that clearing through central counterparties. (U.S. Treasury, 2009: 47).

This proposal would have effectively reversed the Commodities Futures Modernization Act of 2000. To implement this, the Treasury plan asked the SEC and the CFTC to mesh their rules. The CFTC’s duties were to be dramatically expanded to cover most derivatives, while the SEC would cooperate by continuing its oversight of “security-based” derivatives.

Given the stakes involved, a broad range of interests sought to shape the Treasury’s proposals as they made their way through Congress. Owing to the unprecedented profits that derivatives had generated, financial-services firms mobilized quickly to press for more moderate changes. They wanted to stabilize the market without subjecting the main players to major surgery and, above all, without adding onerous requirements for margin or capital reserves.

Perhaps more surprising, within a few months, the broader grass-roots advocacy organizations also met the challenge. They secured the necessary expertise and began to push their own positions on issues of derivatives regulation. By summer 2009, the Americans for Financial Reform had begun to articulate alternatives to industry proposals.

The main Congressional bodies involved in derivatives were, again, the House Committee on Financial Services and the Senate Committee on Banking. But the origins of derivatives in agricultural trade meant that these committees shared jurisdiction with the House and Senate agriculture committees. This shared jurisdiction became pivotal at a later point because the two agriculture

committees retained oversight for the CFTC, which was now proposed to be the lead agency to oversee the largest financial markets in existence.

The pattern of interest-group activism on derivatives highlighted the two-tiered politics that increasingly confronted elected officials. Initially the interest group terrain was characterized by three features. First, while industry groups shied away from opposing the Administration's plans for monitoring systemic risk, they were fully prepared to oppose any measures on derivatives from the outset. Major non-banking firms immediately scrutinized the plans for regulating derivatives. Even before Congressional committees took up the Treasury's proposal, companies including Caterpillar, IBM, and Boeing Aerospace were pushing back against the regulations they anticipated (Wall Street Journal, 10 July 2009: Kara Scannel).

Second, derivatives had become so deeply enmeshed in the economy that firms in almost all sectors reacted to the proposals for new regulation. Several industry associations said their members needed customized derivatives to offset specific risks in their everyday business activities – something quite distinct from purely financial speculation that might require special regulatory provisions. One prominent example, the Coalition for Derivatives End-Users, was formed in August 2009 and commented regularly on draft legislation through the fall (Coalition for Derivatives End-Users, 2009a). This consortium included many firms that counted as significant players in financial markets, but its component organizations were sufficiently broad in membership that they could plausibly distinguish themselves from the Wall Street banks at the center of the crisis (Coalition for Derivatives End-Users, 2009b).

A third feature of lobbying on derivatives was shared across the industry spectrum and the consumer advocacy groups. All of them displayed a tendency to form dedicated, issue-specific coalitions. The Consortium of Derivatives End-Users was one clear example, and the financial-services

firms adopted a parallel approach. Two associations that represented the main market-makers and dealers in derivatives were the ISDA (International Swaps and Derivatives Association) and SIFMA (the Securities Industry and Financial Markets Association). They approached the relevant Congressional committees jointly in November and December of 2009. And after the bill was signed into law in July 2010, these two groups began to work also with the Securities Association of the American Bankers Association (ABA) and a number of other industry associations in financial services.

Grass-roots advocacy groups from the progressive Left also mobilized surprisingly quickly around the issue of derivatives. Although consumer protection and executive compensation ranked higher among the initial priorities of the Americans for Financial Reform, this group advanced informed arguments for serious regulation of derivatives (Tekiela, 2011). In August 2009, AFR urged Congress to require that all derivatives be traded on regulated and fully transparent exchanges. The AFR specifically argued against the kind of exemptions proposed by industry groups such as the End-Users Coalition.

The tensions of two-tier politics appeared sharply from the autumn of 2009 onward. The finance industry had reliable entrée to the House of Representatives via the business-friendly members in the New Democrat Coalition. Within days after the Lehman bankruptcy, this group set up a task force on financial reform co-chaired by Melissa Bean (D, NY) and Representative Jim Himes (D, Ct), a former banker at Goldman Sachs. The New Democrats prevailed upon the House Financial Services Committee to exempt derivatives end-users from the “discussion draft” of October 2009 (Propublica, 25 October 2011: Sebastian Jones/Marcus Stern). When hearings were held on the initial proposals, the CFTC Chairman, Gary Gensler, immediately warned that such “end-users” exemptions would enable banks to shield a major portion of their derivatives business from any new regulatory oversight. The American for Financial Reform supported tough language, testifying that fully public exchanges would provide a safer arena for derivatives trade than would centralized clearinghouses favored by the business-friendly

House members (Washington Post, 7 October 2009“ Brady Dennis; see also Gensler, 2009; Johnson, 2009).

**Key Events.** As legislative action moved from the House to the Senate, reformers gained resources through unpredicted political events. The Financial Crisis Commission held widely televised hearings in January 2010, and the unrepentant remarks of several Wall Street chieftains shifted the atmospherics in favor of more sweeping measures. Also in January 2010, a popular critic of Wall Street’s culture, Michael Lewis, published a bestselling book on the pathologies of the derivatives trade, which became virtually required reading for Congressional staffers. Then, as noted above, came the special election of Scott Brown, altering Senate politics.

As the Senate approached a vote on the financial overhaul in April and May of 2010, the dynamic of two-tier politics building became unmistakable. On April 16, President Obama made a point of signaling his intent to veto any bill “that does not bring the derivatives market under control” (Obama, 2010). A more surprising source of help for the network of progressive groups came from Senator Blanche Lincoln of Arkansas, the chair of the Agriculture Committee. Lincoln had alienated the left wing of the Democratic party by helping block “the public option” in health care. Then, even more controversially, she opposed President Obama’s efforts to strengthen the position of labor unions in plant-level organizing contests. In response, the Arkansas branch of the AFL-CIO labor federation decided to support a far more liberal candidate in the Arkansas primary elections in May 2010. Lincoln reacted by championing tougher language on derivatives regulation than either the House or the Senate committees. Senator Lincoln’s amendment strengthened the bill’s provisions by requiring all banks to put their derivatives-trading desks into separate subsidiaries that would have to be capitalized independently from all parts of the firm that enjoyed federal guarantees (Associated Press, 1 March 2010; Huffington Post, 10 June 2010: Sam Stein).

Proponents of stronger derivatives regulation began to coalesce in April and May. As head of the CFTC, Gary Gensler published an essay in the Wall Street Journal, arguing that it was time to treat complex derivatives like commodity futures and bring them under the control of clearinghouses with known prices and public record-keeping (Gensler, 2010). Those arguments were supported by another business coalition, the Commodity Markets Oversight Coalition. Its members included household oil delivery firms, trucking associations, some airlines, farmers and other retailers. Arguing that they were in fact the genuine users of derivatives in markets that had been flooded by speculators since 2000, this group kept in close touch with the Congressional agriculture panels. They reinforced the views of CFTC Chairman Gensler by arguing against exemptions from the clearing requirements that might allow “hedge funds and other financial players” to shield large portions of their portfolios from scrutiny. For good measure, they explicitly attacked the authenticity of the much larger “Coalition for Derivatives End-Users” by writing that “they are not traditional end-users,” and that “it is questionable whether in fact they have the issues of the commercial end-users at heart” (CMOC, 2010). Although the AFR did not, as a rule, coordinate with this consortium, its views were so similar on the clearinghouse issue that AFR re-posted the letter on its website within a day.

When the Senate and House conferees met in June to reconcile the bills passed by each chamber, the dynamic of two-tier politics produced unexpected and important consequences. Blanche Lincoln emerged as the exception to a process of legislative dilution that seemed particularly conspicuous in the area of derivatives. While the Volcker rule spoke generally to preventing speculation by institutions with federal banking guarantees, the Lincoln Amendment required an additional “push-out” of all derivatives transactions, whether client-linked or part of the bank’s own proprietary trading portfolio. Now, progressive groups including the AFR, visibly supported Lincoln’s efforts in the conference committee. The finance industry still thought its backers in the New Democrat Coalition

would be able to weaken the Volcker rule and strip the Lincoln Amendment out of the final legislation. The business-friendly group wrote to the conferees on June 16, urging them to restore the House language on limits to the derivatives rules and to remove the Lincoln Amendment (Huffington Post, 14 June 2010: Shahien Nasiripour/Ryan Grim; Propublica, 25 October 2011: Sebastian Jones/Marcus Stern; Washington Post, 24 June 2010: David Cho).

As discussions approached a conclusion, Congressional leaders started to limit their face-to-face contacts with representatives of industry. There was little doubt that the major banks could reach the key contacts by telephone, but many lobbyists began to complain that they were losing face-to-face access (Wall Street Journal, 14 June 2010: Aaron Luccetti/Damian Paletta). Since the overhaul was to count as one of the Obama Administration's major legislative achievements, the pressure on key committee members to reach agreement mounted steadily.

At the same time, the role of CFTC chairman Gary Gensler became especially noteworthy. Given the complexity of the derivatives issue, it was not surprising that the heads of the agriculture committees, Senator Lincoln and Representative Collin Peterson, welcomed his availability. Other legislators said it was "a little unusual" to see him conferring with legislators so regularly. According to one account, during a particularly long 20-hour session, Gensler "hovered just behind lawmakers, and could be seen whispering to staff and negotiators as the House and Senate sought to iron out the 2,300-plus page bill" (Wall Street Journal, 15 July 2010: Michael Crittenden/Victoria McGrane).

Toward the end of the conference negotiations, Senator Lincoln, resolutely independent, claimed that her language would "make banks get back to being banks and those of us who grew up in small towns in America understand what that means" (Politico, 24 June 2010: Carrie Budoff Brown/Meredith Shiner). Ultimately, she compromised but only in part by allowing banks to continue their customary trade in interest-rate swaps and foreign currency swaps, while other derivatives had to



go through separate subsidiaries. Whether for electoral reasons or underlying conviction, Blanche Lincoln provided the legislative voice for the same views that the Progressive Left had less successfully urged upon Congress in earlier efforts to secure tougher regulation of the derivatives markets

### **Conclusion**

The financial turmoil of 2008 gave the new Obama Administration no choice but to initiate major financial reforms as it came into office in 2009. At that time, a vague commitment to financial regulatory reform was balanced against economic stimulus, energy policy, education reform, and health care reform as Presidential priorities (Obama, 2009). But the reality of financial distress – acute in many cases – gave financial reform even greater urgency among the financial policy elite that dominated the industry.

By passing the Dodd-Frank Act, the Congress produced a broad-gauged piece of legislation. In terms of structural changes affecting key market participants and their corresponding regulators, the changes enacted by the law were significant but cautious. These structural changes included:

- Establishing the Financial Stability Oversight Council as a new body composed of existing regulatory agencies;
- Eliminating one existing bank regulator, the Office of Thrift Supervision, by merging it into the Office of the Comptroller of the Currency;
- Creating a new agency, the Consumer Financial Protection Bureau, with the purpose of setting rules and monitoring compliance of financial products for retail financial products.

As important as these structural changes may turn out to be, the new law mandates important new procedures for governing the key competitors and regulatory agencies in financial markets. Among the central regulatory changes were:

- Enhanced prudential regulation for systemically important firms, including the imposition of higher capital and margin requirements at levels to be set by the regulators;
- The spinning off of (most) proprietary-trading activities by banks or other deposit-taking institutions (Volcker Rule);
- The spinning off of (most) derivatives activity, whether as proprietary trader or market-making dealer, by banks or institutions that benefit from federal government guarantees (Lincoln Amendment);
- The shifting of (most) standardized derivatives contracts from private contracts to centralized counterparty transactions.

These changes, both structural and procedural, were important. Their ultimate significance will depend upon implementation decisions and the judicial interpretations that follow. In this period, regulatory agencies will develop the capabilities necessary for their revised missions, propose the new rules that implement the law, receive public comments, and prepare for the legal challenges that make regulatory law a matter of ongoing practice in the United States. While the processes of administrative rule-making will remain procedurally normal, they will be contested with heightened vigor in the case of the Dodd-Frank Act. There is no doubt that the parties and interest groups have chosen to fight over financial reform in the legal thickets of post-enactment implementation as much as in the brighter light of public debate. As one Washington newsletter put in early 2011, a “pitched battle ... has been joined over the regulations that are being written to implement Dodd-Frank” (Pratt Letter, 2011)

The Dodd-Frank legislation represents an ambitious effort to adapt the underlying structure of core financial and regulatory institutions, but without rebuilding them. In this sense, the Dodd-Frank legislation confounds the simplest predictions from institutionalist theory: that major external shocks are the primary source of institutional transformations. In this case, the external shock was severe but

profound institutional transformation did not follow. The Dodd-Frank overhaul therefore provides some support to a more incremental view of institutional change. Despite the magnitude of the external shock, it was not enough to completely delegitimize leading institutions or to shatter old coalitions. Republicans and Democrats alike displayed a consistent preference for maintaining the key institutions in the financial landscape. The deregulatory changes in the decades preceding the crisis can only be characterized as a process of intentional institutional evolution: institutional disassembly via the repeal of key laws and the hollowing out of the regulatory agencies that had previously preserved market stability.

Interestingly, the Dodd Frank reform included changes that clearly diverged from the other prevalent theories of regulatory policymaking. The creation of the CFPB ran diametrically counter to the goals of some of the most entrenched interest groups in the finance sector, particularly the American Banking Association. And, for similar reasons, the changes in agency jurisdictions do not conform in any simple manner to predictions that bureaucratic agencies can defend their turf successfully.

For these reasons, the Dodd-Frank legislation must be understood as the result of other distinctive factors:

The preservationist approach of the Obama White House put great emphasis on the need to avoid further disruption to the incumbent market participants or the key regulatory bodies. This emphasis on maintaining continuity in the financial policy elite clearly supported the existing interest groups in the financial arena. But the politics of finance were shaken up by a number of unusually knowledgeable and skillful policy entrepreneurs. The efforts of Elizabeth Warren and Paul Volcker (and, perhaps behind the scenes, Gary Gensler) gave a very different cast to debates that would otherwise have been dominated by familiar dynamics of concentrated interest-group pressure.

At the same time, a form of grass-roots mobilization represented by the Americans for Financial Reform reflected popular anger and the efforts of the advocacy groups. The AFR brought together a range of labor unions and consumer groups and, perhaps most important, a reservoir of expertise that pushed the Democratic party to subordinate the preferences of established industry groups on several occasions. It was partly the organizational skill of the AFR that enabled this result, but also partly the depth of the populist backlash against the financial establishment that forced Congressional leaders to seek broader levels of support than available from the industry groups alone.

The result was a pattern we call two-tier politics, in which both political parties sought to appeal to the established actors and the popular activists at the same time. At the level of elite or top-tier politics, both parties had strong ties to Wall Street as symbolized by the seamless transition from Hank Paulson to Tim Geithner. Beyond Wall Street, the parties had somewhat different constituencies in the business community, the Republicans with many of the multinational manufacturing and extractive segments, the Democrats with more support from transportation, infrastructure, and domestically-oriented manufacturing segments. At the lower tier of grass roots coalition building, the party constituencies differed especially clearly. For Democrats, the two-tier strategy meant appealing to labor, consumer advocates, and the broad networks of activists known as the net roots. For Republicans, the two-tier imperative meant maintaining loyalty from their core business constituencies while also placating the Tea Party and other populist groups that rejected the very elite consensus that had dominated financial policy for several decades.

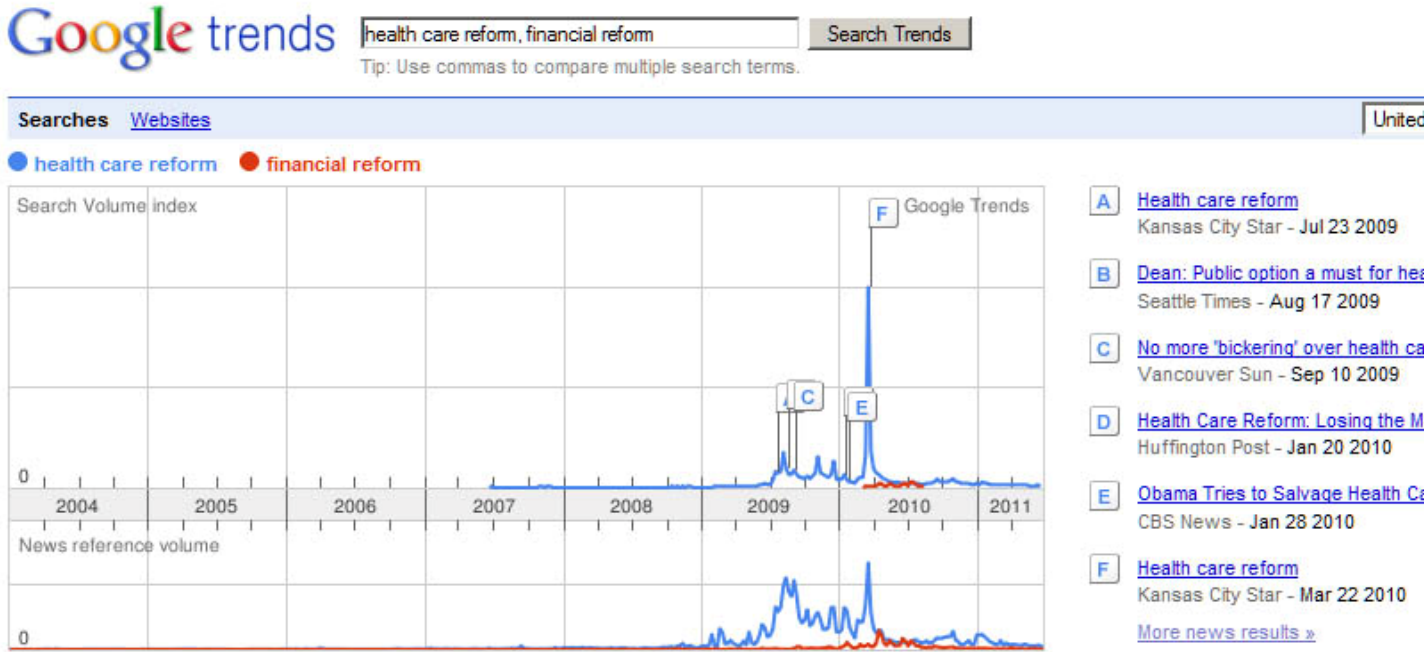
This two-tier dynamic is likely to appear in other policy areas in the coming years. For financial regulation, the two-tier dynamic distinctly helped policy entrepreneurs like Elizabeth Warren and Paul Volcker. Without the ongoing scrutiny provided by the Americans for Financial Security, it is unclear

whether the Consumer Financial Protection Bureau or the Volcker Rule would have survived the legislative process.

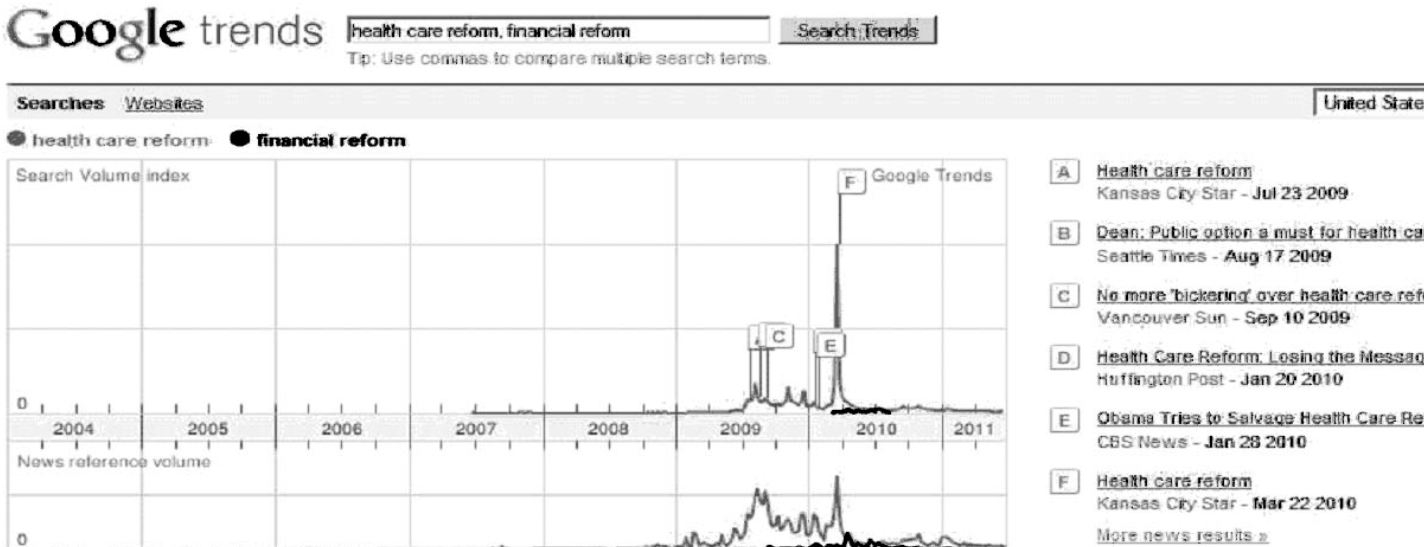
But another, equally important effect of two-tier politics was the pronounced susceptibility to unpredicted political events. The special election of Republican Scott Brown as Massachusetts Senator in January 2010 led to a significant dilution of the language outlining the Volcker rule in the Conference negotiations of June 2010. And the electoral challenge that faced Senator Blanche Lincoln within the Arkansas Democratic primary elections in 2010 led her to insist upon much tougher provisions for the regulation of derivatives than would otherwise have found its way into the final legislation.

These final twists in the legislative process directly shaped two of the most important procedural changes to affect U.S. financial markets through the crisis and the regulatory response. The first change, by diluting the Volcker rule, meant that after Dodd-Frank, the separation of deposit banking from proprietary trading was significantly less clear-cut than it might have been. The second change, by bringing Senator Lincoln's language into the final bill, created a far stronger set of tools than regulators would otherwise have received in their efforts to squeeze excessive levels of risk out of the derivatives markets. Given the centrality of both issues to the workings of contemporary capital markets, it is hard to underestimate the importance of political contingency in the Dodd-Frank outcome. Much of the institutional context can be well accounted for by our familiar theoretical perspectives. Key features in the outcome as well as the political process that produced it can, however, can only be explained by a new form of two-tier politics in which elected officials have to balance grass-roots advocacy organizations with the most powerful elites and interest groups in the political arena.

Figure 1. Google Trends Graphs of Volume of News and of Internet Searches Concerning “Health Care Reform” and “Financial Reform” in the United States



BLACK AND WHITE VERSION THAT EMPHASIZES THE CONTRAST:





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