Is Financial Regulation Structurally Biased to Favor Deregulation?
(Forthcoming in SO. CAL. L. REV. (2012))

Carolyn Sissoko

USC Center in Law, Economics and Organization Research Paper No. C12-4

CENTER IN LAW, ECONOMICS AND ORGANIZATION RESEARCH PAPER SERIES

University of Southern California Law School
Los Angeles, CA 90089-0071

Is Financial Regulation Structurally Biased to Favor Deregulation?

Carolyn Sissoko*

April 13, 2012

Abstract: This article finds that the financial regulatory agencies operate in an environment where regulatory actions often face legal challenge, but deregulatory actions are rarely challenged, and argues that the growing use of interpretive rules combined with administrative law doctrines that restrict access to legal review create an environment that is structurally biased to favor deregulation.

Two examples of deregulatory agency action are explored in detail. The implementation of the 2004 Final Rule governing the provision of eligible liquidity facilities to asset-backed commercial paper conduits is evaluated and found to almost certainly fail a "clearly erroneous" standard of judicial review. The second example reviews Omarova's study of the process by which the "business of banking" was reinterpreted to include trade in derivatives; the method of legal analysis that supported this reinterpretation was rejected by the D.C. Circuit. Both of these actions were implemented using interpretive rules, and in both cases these deregulatory actions have not faced legal challenge.

This article argues that the combination of the growing use of interpretive rules and the application of doctrines determining who has standing to challenge the actions of the financial regulatory agencies in court forces agencies to favor deregulatory action over regulatory action. The article proposes (i) that every financial regulatory statute be amended to include a "citizen suit" clause and that courts uphold the right of citizens to sue under such clauses, and (ii) that a division of the Consumer Financial Protection Bureau be created that is dedicated to opposing the policy proposals made by regulated parties to financial regulatory agencies.

---

* Many thanks go to Daniel Klerman, who prompted me to pursue this topic further, read many drafts of the paper and always provided insightful comments. Scott Bice, Jennifer Phillips and Emerson Tiller also gave me very useful comments. All errors are, of course, my own.

TABLE OF CONTENTS

I. Introduction ... 1

II. Examples of Deregulatory Agency Bias ... 5

A. Regulation of Eligible Liquidity Facilities in the Asset-Backed Commercial Paper Market 5

1. Background on Asset-Backed Commercial Paper ... 5

2. Regulating ABCP Programs: The 2004 Final Rule ... 11

3. Implementation of the Final Rule in 2005 ... 16

4. A systemic crisis: the collapse of the ABCP market in 2007 ... 22

B. How Derivatives Became Part of the "Business of Banking" ... 26

1. From Glass-Steagall to Bank Purchases of Commodities and Stocks ... 27

2. Implications for Administrative Process ... 36

III. Administrative Law Background ... 37

A. Growing Reliance on Interpretive Rulemaking ... 38

B. Doctrines of Judicial Review that Adversely Affect Beneficiary Suits ... 41

1. Deference ... 41

2. Access to Judicial Review: Standing ... 43

3. Access to Judicial Review: Finality and Ripeness ... 48

C. Judicial Review and Financial Regulation ... 50

IV. Model of Financial Regulation ... 52

V. Application: The Deregulatory Examples in Light of the Law and the Model ... 58

A. The August 2005 ABCP Guidance Almost Certainly Fails *Auer* Review ... 58

B. The OCC Analytic Process that Authorized Derivatives Trading Exceeds Reasonable Bounds ... 59

VI. Recommendations ... 61

A. Expansion of Standing ... 62

B. CFPB Division Dedicated to Opposing Regulatee Proposals ... 65

VII. Conclusion ... 67

Appendix: Mathematical model ... 67

A. Policy Space ... 67

B. Utility ... 68

C. Actions ... 69

D. Analysis ... 69

E. Proofs ... 70

I. INTRODUCTION

In the early months of the financial crisis that started in August 2007, Citigroup suddenly had to take onto its balance sheet $25 billion of assets—which, due to subprime mortgage exposure, were worth on the market only a third the amount that Citigroup was required to pay for them.[2] The reason for the appearance of these troubled assets on the bank's balance sheet was a liquidity guarantee provided by Citibank from the time it originally sold the assets to protect short-term lenders from the possibility that their debt could not be refinanced at maturity. The Financial Crisis Inquiry Commission would conclude that such guarantees helped "bring the financial conglomerate to the brink of failure."[3]

The assets in question were collateralized debt obligations ("CDOs"), which package together a large number of loans and other debt products and use the income from those loans to pay returns to the investors in the CDOs. It is clear, however, that not all of the "loans" underlying Citibank's CDOs were actual loans. Some of them were financial contracts called derivatives that promised payments based on the performance of a specific set of actual loans.[4] That is, some of the underlying assets were not loans, but simply represented the promise of one financial institution to make payments to another.

---

[2] FINANCIAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT, 137-39, (2011) available at http://www.gpoaccess.gov/fcic/fcic.pdf [hereinafter FCIC REPORT]; Bradley Keoun, Jesse Westbrook & Ian Katz, *Citigroup 'Liquidity Puts' Draw Scrutiny From Crisis Inquiry*, BLOOMBERG, Apr. 13, 2010, http://www.bloomberg.com/apps/news?pid=20601103&sid=aZELabu4NReI.

[3] FCIC REPORT, *supra* note 2, at 139.

[4] Most of the information on Citibank's CDOs has not been made public. The FCIC tells us, however that the series of Klio transactions made up 40% of the $25 billion, *id.* at 138, and the Klio III Funding Corp. prospectus is available on the Irish Stock Exchange website. The prospectus tells us that 16% of Klio III's assets were synthetic (i.e. derivatives instead of actual loans). OFFERING CIRCULAR, KLIO III FUNDING, LTD. 76, (2005) available at http://www.ise.ie/debt_documents/KlioIII_1084.pdf.

Long before the financial crisis broke out, regulators recognized the need to structure liquidity guarantees to reduce or eliminate the possibility that they would result in the purchase of bad assets, and they recognized the need for banks to manage carefully their exposure to the risks created by derivatives. Despite the fact that regulators were aware of the risks of these products, their regulatory policies failed. To understand what went wrong, this paper looks in detail at two examples: the implementation via two guidance documents of the joint bank regulators'[5] 2004 Final Rule governing liquidity facilities provided to asset-backed commercial paper conduits, and the redefinition of "the business of banking" to include derivatives, a policy that was put in place using interpretive letters issued by the largest banks' regulator, the Office of the Comptroller of the Currency ("OCC").

In both of these examples, the decisions being analyzed were not taken via the notice-and-comment process that both announces the policy to the public and gives the public the opportunity to provide feedback to the agency, but via interpretive rules, a form of agency decision-making that is subject to few, if any, statutory guidelines, and often takes place outside the public view. The increasing use by agencies of interpretive rules has been the subject of some concern, because in the absence of public comment such rules may lack the careful consideration and quality of notice-and-comment regulations, and because these rules can be used to insulate agencies from judicial review.

---

[5] The bank regulatory agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision. They frequently act jointly in developing and issuing bank regulatory policy, even though they are implementing different regulatory statutes. For this reason, a single bank regulation will typically be entered into four different parts of the Code of Federal Regulations. These four regulators will be called the "joint bank regulators" or the "bank supervisory agencies."

In fact, one motivation for the growing use of interpretive rules is that regulators often face aggressive and costly challenges to their notice-and-comment regulations, as evidenced by the response of our largest banks to the regulations that have been issued subsequent to the financial crisis. For example, recognizing that the crisis increased shareholders' concerns about the responsiveness of companies and their boards to the interests of the shareowners, the Securities and Exchange Commission ("SEC") promulgated a final rule that would have made it easier for shareholders to nominate directors.[6] The regulation was challenged—and vacated a year later—on the basis, in part, that the SEC's 60-page cost-benefit analysis was inadequate.[7] Other lawsuits are still in progress: industry groups have challenged the Commodities Futures Trading Commission regulation setting position limits for commodities traders,[8] a regulation that implements § 737 of the Dodd-Frank Act,[9] which was passed by Congress in an effort to address the dangers still lurking in our financial system. Illustrating the current atmosphere, within weeks of the appointment of a director to the Consumer Financial Protection Bureau ("CFPB"), the new financial regulator created in response to the crisis,

---

[6] Facilitating Shareholder Director Nominations, 75 Fed. Reg. 56,668, 56,668 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240 & 249).

[7] Bus. Roundtable v. S.E.C., 647 F.3d 1144, 1152 (D.C. Cir. 2011). The 60-page analysis is the one presented double-spaced at the SEC website, http://www.sec.gov/rules/final/2010/33-9136.pdf; in the Federal Register the analysis only takes 19 pages.

[8] Ben Protess, *Wall St. Groups Sue Regulator to Challenge New Trading Rule*, N.Y. TIMES DEALBOOK, Dec. 2, 2011 available at http://dealbook.nytimes.com/2011/12/02/wall-street-groups-sue-regulator-over-dodd-frank/.

[9] Dodd-Frank Wall Street Reform & Consumer Protection Act § 737, 7 U.S.C.A. § 6a(a)(2) (West 2012); Position Limits for Futures and Swaps, 76 Fed. Reg. 71,626 (Nov 18, 2011) (to be codified at 17 C.F.R. §§ 1, 150 & 151). Note that 7 U.S.C. § 6a(a)(2) is also known as Commodity Exchange Act § 4a(a)(2).

the American Bankers' Association news magazine was asking: "*Who Will Be the First to Sue the CFPB?*"[10]

By contrast, when deregulatory policy taken by the financial regulators is at issue, lawsuits are relatively uncommon. There are many reasons for this: First, the parties who have both standing and the incentive to bring suit are, for the most part, limited to competitors of the regulated institutions. Second, in many areas where deregulation has taken place, such as commercial paper conduits and many derivatives markets, the banks face no non-bank competitors. Finally, when the agency action at issue is an interpretive rule, regulated parties have an easier time bringing suit because they can usually demonstrate a harm, and can sometimes convince a court that this harm causes immediate and significant hardship, which helps shift the balance in favor of judicial review.[11] By contrast, even if the beneficiaries of a statute had standing, the types of cases they can bring are less likely to involve an immediate and significant financial harm, which therefore is less likely to outweigh the factors favoring an agency which seeks to avoid judicial review of its interpretive rule. In this environment, regulation is held to a reasonableness standard by judicial review, but financial deregulation, for the most part, is not. This creates a structural bias in favor of financial deregulation that is seen clearly in the two examples below.

Much of the literature on the relationship between agencies and the courts focuses on the problem of "ossification" created when courts impose ever-increasing procedural burdens on the agency rulemaking process, thus, discouraging agencies from

---

[10] Kate Davidson, *Who Will Be the First to Sue the CFPB?*, AMERICAN BANKER, Jan. 23, 2012, available at http://www.americanbanker.com/issues/177_15/cfpb-cordray-recess-appointment-lawsuit-plaintiffs-regulations-enforcement-1045956-1.html

[11] *See infra* note 169 and accompanying text.

implementing new rules at all. In the area of financial regulation, however, this "ossification" is usually one-sided: additional regulations are subject to the burdens imposed by judicial review, but there is little evidence that deregulation faces similar burdens. In fact, it appears that the financial regulatory agencies' deregulatory decisions can and do violate both statutes and their own regulations.

Part II presents two detailed examples of deregulatory agency bias. Part III discusses the administrative law that applies to these agency decisions. Part IV develops a formal model of the interaction of agencies, regulated parties, courts and the public. Part V reviews the examples in light of the law and the model. Part VI gives recommendations for dealing with the problem of deregulatory agency bias, and Part VII concludes.

II. EXAMPLES OF DEREGULATORY AGENCY BIAS

Here, two clear examples of deregulatory bias are explained in detail. While these examples were chosen because they have the most immediate bearing on the recent financial crisis, they are not the only examples available. Subpart A presents the regulators' failed efforts to exclude bad assets from the liquidity facilities provided by banks to asset-backed commercial paper conduits and subpart B, the reinterpretation of the "business of banking" to include trade in derivatives.

A. Regulation of Eligible Liquidity Facilities in the Asset-Backed Commercial Paper Market

1. Background on Asset-Backed Commercial Paper

Asset-backed commercial paper is a relatively new invention, but commercial paper is not. Traditional commercial paper is just a short-term, unsecured, business loan. It allows a company to borrow money over a period of days or months without providing

any collateral. Because there is no collateral to secure the loan, typically only large well-known firms—that have a very, very small likelihood of default over the near term horizon—can issue commercial paper.

Defaults on traditional commercial paper are extremely rare, but when they occur can be highly disruptive to the financial system. The Penn Central default of 1970 led to a sudden reduction in willingness to lend to the country's largest firms, and required temporary, but aggressive, Federal Reserve action to stabilize the financial system.[12] More recently, the collapse of Enron would have led to a default on commercial paper, if not for the firm's decision to pay off debt that was not due before declaring bankruptcy.[13] (The Enron creditors committee's attempt to reclaim these payments as fraudulent conveyances failed.[14]) And, of course, Lehman Brothers' default on its commercial paper in 2008 led to the failure of a money market fund and the sudden flight of investor funds from money market funds that invest in commercial paper issued by financial firms.[15]

The Lehman failure illustrates the close relationship between money market funds and the commercial paper market. While large companies, pension funds, and governments with excess funds often have divisions that invest directly in commercial paper, almost 40% of the market is funded by the lending of relatively small investors through money market funds as intermediaries.[16] In fact, it is likely that the vast majority

---

[12] Marcin Kacperczyk & Philipp Schnabl, W*hen Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007–2009*, 24 J. ECON. PERSPECTIVES 29, 37 (2010). *See also* Charles Calomiris, *Is the Discount Window Necessary? A Penn Central Perspective*, 76 FED. RESERVE BANK OF ST. LOUIS REV. 31–55 (1994).

[13] Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329, 331 (2d Cir. 2011). (SC review history? None to date.)

[14] *Id*. at 339.

[15] Kacperczyk & Schnabl, *supra* note 12, at 30.

[16] Richard G. Anderson & Charles S. Gascon, *The Commercial Paper Market, the Fed, and the 2007–2009 Financial Crisis*, 91 FED. RESERVE BANK OF ST. LOUIS REV. 589, 596 (2009).

of lenders on the commercial paper market aren't even aware of the role they play in this market, because they have never looked closely at the holdings of their money market funds.

The asset-backed commercial paper market is a segment of the commercial paper market that developed as banks sought to comply with the stringent capital requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 by removing assets from their balance sheets and placing them in "conduits" controlled by the banks.[17] Conduits are special purpose vehicles that issue asset-backed commercial paper (or other liabilities) and secure the paper with the portfolio of assets owned by the conduit. Conduits are created as entities that are legally separate from the bank that creates and manages them and, in particular, have assets that are typically not available to the sponsoring bank's creditors in the event that the bank fails.[18]

Almost any asset can be "securitized"—that is, turned into a marketable security like commercial paper—by placing it into a conduit. Thus conduits are sometimes distinguished by the type of assets that they hold: there are credit card receivable conduits, auto loan conduits, trade receivable conduits, etc. Other conduits hold a mixture of assets of different types.

Buyers of the commercial paper issued by conduits risk losing their money for two reasons: first, they face credit risk as the assets owned by the conduit may go into default if the loans are not repaid; second, they face liquidity risk. Liquidity risk is

---

[17] *See* Federal Deposit Insurance Corporation Improvement Act § 131, 12 U.S.C. 1831*o*; Prompt Corrective Action, 57 Fed. Reg. 44866, 44866 (Sept. 29, 1992); 12 C.F.R. §§ 6, 208, 325, 565. Mitchell A. Post, *The Evolution of the U.S. Commercial Paper Market Since 1980,* 78 FED. RESERVE BULL. 880, 885 (1992); Richard Cantor & Anthony P. Rodriques, *Nonbank Lenders and Credit Slowdown, in* STUDIES ON CAUSES AND CONSEQUENCES OF THE 1989-92 CREDIT SLOWDOWN 171, 199 (1994); Kacperczyk & Schnabl, *supra* note 12, at 33.

[18] Post, *supra* note 17, at 886.

created, because the commercial paper issued by the conduit typically matures in three months or less, but the assets held by the conduit are not due for payment in full for a year or more. Thus, the structure of the conduit requires it to reissue new commercial paper every three months and creates the risk that there will be no buyers of the reissued paper: this is liquidity risk.

For the most part, money market funds may only purchase commercial paper that has the highest rating from two of the rating agencies;[19] and data leading up to the 2008 financial crisis indicates that second tier commercial paper comprised less than 5% of the commercial paper market.[20] The rating agencies, in turn, require that asset-backed commercial paper ("ABCP") issuing conduits protect investors against credit risk and liquidity risk in order to earn their highest rating. Thus, the structure of the asset-backed commercial paper market requires virtually all ABCP issues to have access to credit enhancement facilities and liquidity facilities.

Credit enhancement facilities may take the form of overcollateralization, where the assets backing the conduit are worth more than the commercial paper issued by the conduit, or third-party obligations to purchase assets that are delinquent or in default.[21] They cover only a fraction of the assets in the ABCP program.[22] By contrast, the liquidity facility guarantees either a credit line to the program or the purchase of the underlying assets in the event that a conduit cannot roll over its commercial paper, and typically it

---

[19] *See* SEC Rule 2a-7, 17 C.F.R. § 270.2a-7(c)(4)(iv). Money market funds may not invest more than 5% of their portfolio in second tier commercial paper under this rule.

[20] Data available from the Federal Reserve at http://www.federalreserve.gov/datadownload/Download.aspx?rel=CP&series=7e2bc09a5046298b6eb6ee0bc7e06fc1&lastObs=100&from=&to=&filetype=spreadsheetml&label=include&layout=seriescolumn

[21] *See* MOODY'S INVESTOR SERVICE, THE FUNDAMENTALS OF ASSET-BACKED COMMERCIAL PAPER 39-41 (2003); FITCH RATINGS, ASSET-BACKED COMMERCIAL PAPER EXPLAINED 8 (2001).

[22] *Id.*

must cover the full face value of all ABCP issued by the conduit that remains outstanding.[23]

The provision of credit enhancement and liquidity facilities by banks is regulated, and an important tool employed by bank regulators is the imposition of capital requirements. All banks are required to maintain a minimum ratio of capital to total assets.[24] The risk-based capital requirement, which imposes a minimum ratio of 8% capital to risk-weighted assets, is, however, more likely to have a binding effect than the capital-asset ratio. Risk-based capital assigns a "credit conversion factor" to the different assets on a bank balance sheet: consumer and commercial loans typically have a 100% conversion factor and, thus, an 8% capital requirement; cash and United States' government bonds have a conversion factor of zero and, thus, no capital requirement.[25]

The provision of a credit or liquidity facility is subject to risk-weighted capital requirements.[26] Credit enhancement facilities carry a 100% credit conversion factor, and liquidity facilities of more than one year, 50%. (The latter are, therefore, subject to 50% of the full capital requirement or a 4% capital requirement.) In the early years of the current millennium, however, liquidity facilities of less than one year had a 0% credit conversion factor.

To summarize: (i) ABCP conduits need to have first tier ratings in order for investors to be willing to purchase their commercial paper, (ii) those first tier ratings

---

[23] FITCH, *supra* note 21, at 8; MOODY'S, *supra* note 21,at 6. The exceptions generally involve special cases where the underlying assets are short-term in nature. *See* MOODY'S, *supra* note 21, at 42.

[24] *See, e.g.,* 12 C.F.R. Part 225, App. D, *available at* http://www.fdic.gov/regulations/laws/rules/6000-2200.html.

[25] 12 C.F.R. § 567.6(a)(1)(i), (iv).

[26] While credit and liquidity facilities are clearly contingent liabilities in economic terms, for accounting purposes they are generally neither assets nor liabilities – that is, they are "off-balance sheet." Thus, regulators have chosen to impose risk-weighted capital requirements on these facilities despite their off-balance sheet accounting treatment. *See* 12 C.F.R. §567.6(a)(2).

require credit and liquidity enhancement, and (iii) prior to 2005, banks faced a 100% capital charge for credit enhancement and a 0% capital charge for short-term liquidity enhancement.

Because short-term liquidity facilities were much less costly to banks than credit facilities, over time these liquidity facilities were used to mitigate credit risk as well liquidity risk. As Moody's, the credit rating agency, explained in 1997: "The use of structured liquidity by an ABCP program is, in effect, merely an extreme case of shifting risk from the program's credit enhancement facility (if there is one) to its liquidity facility."[27] Moody's goes on to detail how a short-term liquidity facility can be structured to "always provide 100% of the funds needed to retire maturing ABCP [and ensure that the] program's credit enhancement facility will never be needed to absorb losses on Company X receivables."[28]

Observe that when such a structured liquidity facility was used to provide credit enhancement to a conduit, the bank guarantor was exposed to the full credit risk of the assets, but faced no capital requirement under the bank regulations at the time. As a principal purpose of securitization is to reduce the need for bank capital by removing assets from bank balance sheets and "transferring credit risk away from the banking system to a more diversified set of holders,"[29] the development of structured liquidity facilities was an example of regulatory arbitrage that seriously undermined the benefits of securitization—and by eliminating capital requirements made such securitizations more

---

[27] MOODY'S INVESTOR SERVICES, UNDERSTANDING STRUCTURED LIQUIDITY FACILITIES IN ASSET-BACKED COMMERCIAL PAPER PROGRAMS, Moody's Special Report, reprinted from the Asset-backed Commercial Paper Market Review, First Quarter 1997 at 4.

[28] *Id*. at 5.

[29] IMF, GLOBAL FINANCIAL STABILITY REPORT: NAVIGATING THE FINANCIAL CHALLENGES AHEAD 77 (October 2009).

risky for the banking system than old-fashioned on-balance-sheet lending. It did not escape the notice of regulators.

2. Regulating ABCP Programs: The 2004 Final Rule

In a notice-and-comment rulemaking process that started on October 1, 2003 the bank supervisory agencies[30] acknowledged that the 0% credit conversion factor on short-term liquidity facilities underestimated the credit risks that were being taken by the banks and sought to reform the rules.[31] The agencies allowed 48 days for comment and issued the final rule on July 28, 2004. In the preamble to this rule, they explained and addressed many of the comments received.

The new rule defined an "eligible liquidity facility," and imposed a 10% credit conversion factor on such facilities. Ineligible liquidity facilities would be subject to a 100% conversion factor.[32] The final rule allowed for a transition period, requiring compliance starting on September 30, 2005.[33]

An eligible liquidity facility must satisfy two criteria. The first criterion applies explicitly "[a]t the time of draw," imposing an asset quality test on any assets that are funded: "the . . . liquidity facility must be subject to an asset quality test that: (1) Precludes funding of assets that are 90 days or more past due or in default; and (2) If the assets that a[] . . . facility is required to fund are externally rated securities at the time

---

[30] The bank supervisory agencies frequently act jointly in implementing different regulatory statutes. For this reason, a single bank regulation will typically be entered into four different parts of the Code of Federal Regulations. *See supra* note 5.

[31] Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Asset-Backed Commercial Paper Programs and Early Amortization Provisions, 68 Fed. Reg. 56568, 56568 (October 1, 2003) (column 2).

[32] Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Consolidation of Asset-Backed Commercial Paper Programs and Other Related Issues, 69 Fed. Reg. 44908, 44911 (July 28, 2004) (column 1) [hereinafter Final Rule].

[33] 12 C.F.R. § 3 App. A § 3(b)(6)(iv).

they are transferred into the program, the . . . facility must be used to fund only securities that are externally rated investment grade at the time of funding." The second criterion regulates the contractual terms of the liquidity facility at the time that it is being evaluated for eligibility for a 10% credit conversion factor: the "liquidity facility must provide that, prior to any draws, the bank's funding obligation is reduced to cover only those assets that satisfy the funding criteria under the asset quality test" above.[34] The final

---

[34] 12 C.F.R. Pt. 3 App. A § 3(b)(6)(ii);12 CFR § 225 App. A § III.B.3.a.iv; 12 CFR § 325 App. A § II.B.5(a)(5); 12 CFR 567.1. The complete text of 12 CFR Pt. 3 App. A § 3(b)(6) is:

(6) Liquidity facility provided to asset-backed commercial paper.

(i) Noneligible asset-backed commercial paper liquidity facilities treated as recourse or direct credit substitute. Unused portion of asset-backed commercial paper liquidity facilities that do not meet the criteria for an eligible liquidity facility provided to asset-backed commercial paper in accordance with section 3(b)(6)(ii) of this appendix A must be treated as recourse or as a direct credit substitute, and assessed the appropriate risk-based capital charge in accordance with section 4 of this appendix A.

(ii) Eligible asset-backed commercial paper liquidity facility. Except as provided in section 3(b)(6)(iii) of this appendix A, in order for the unused portion of an asset-backed commercial paper liquidity facility to be eligible for either the 50 percent or 10 percent credit conversion factors under section 3(b)(2)(ii) or 3(b)(4) of this appendix A, the asset-backed commercial paper liquidity facility must satisfy the following criteria:

(A) At the time of draw, the asset-backed commercial paper liquidity facility must be subject to an asset quality test that:

(1) Precludes funding of assets that are 90 days or more past due or in default; and

(2) If the assets that an asset-backed commercial paper liquidity facility is required to fund are externally rated securities at the time they are transferred into the program, the asset-backed commercial paper liquidity facility must be used to fund only securities that are externally rated investment grade at the time of funding. If the assets are not externally rated at the time they are transferred into the program, then they are not subject to this investment grade requirement.

(B) The asset-backed commercial paper liquidity facility must provide that, prior to any draws, the bank's funding obligation is reduced to cover only those assets that satisfy the funding criteria under the asset quality test as provided in section 3(b)(6)(ii)(A) of this appendix A.

(iii) Exception to eligibility requirements for assets guaranteed by the United States Government or its agencies, or the central government of an OECD country. Notwithstanding the eligibility requirements for asset-backed commercial paper program liquidity facilities in section 3(b)(6)(ii), the unused portion of an asset-backed commercial paper liquidity facility may still qualify for either the 50 percent or 10 percent credit conversion factors under section 3(b)(2)(ii) or 3(b)(4) of this appendix A, if the assets required to be funded by the asset-back commercial paper liquidity facility are guaranteed, either conditionally or unconditionally, by the United States Government or its agencies, or the central government of an OECD country.

(iv) Transition period for asset-backed commercial paper liquidity facilities. Notwithstanding the eligibility requirements for asset-backed commercial paper program liquidity facilities in section 3(b)(6)(i) of this appendix A, the unused portion of an asset-backed commercial paper liquidity will be treated as eligible liquidity facilities pursuant to section 3(b)(6)(ii) of this appendix A regardless of their compliance with the definition of eligible liquidity facilities until September 30, 2005. On that date and thereafter, the unused portions of asset-backed commercial paper liquidity facilities that do not meet the eligibility

rule made an exception to the asset quality test for assets that are guaranteed by the central government of an OECD country or a US government agency,[35] an issue which is discussed below.[36]

On March 30, 2005 the agencies provided detailed guidance for the implementation of the final rule with respect to guarantees provided to ABCP programs. This guidance document, which unlike the final rule was not subject to the notice-and-comment process, clearly explains the reasoning underlying the new regulation: Because most legal documents for ABCP programs do not specify the priority position of liquidity and credit enhancement programs, the bank sponsoring a conduit can use its liquidity facility to purchase non-performing assets.[37] This use of liquidity facilities to provide credit support to ABCP programs can only be prevented by requiring liquidity agreements to preclude funding of bad assets: "Liquidity agreements must be subject to a valid asset quality test that prevents the purchase of defaulted or highly delinquent assets. Liquidity facilities that are not limited by such an asset quality test are to be viewed as credit enhancement, and subject to" a 100% credit conversion factor.[38]

A liquidity facility compliant with the final rule is depicted in the "Before" segment of Figure 1. This diagram shows that the default of 5% of the imaginary conduit's holdings causes the liquidity facility to shrink by 5%, so that it can now cover

---

requirements in section 3(b)(6)(i) of this appendix A will be treated as recourse obligations or direct credit substitutes.

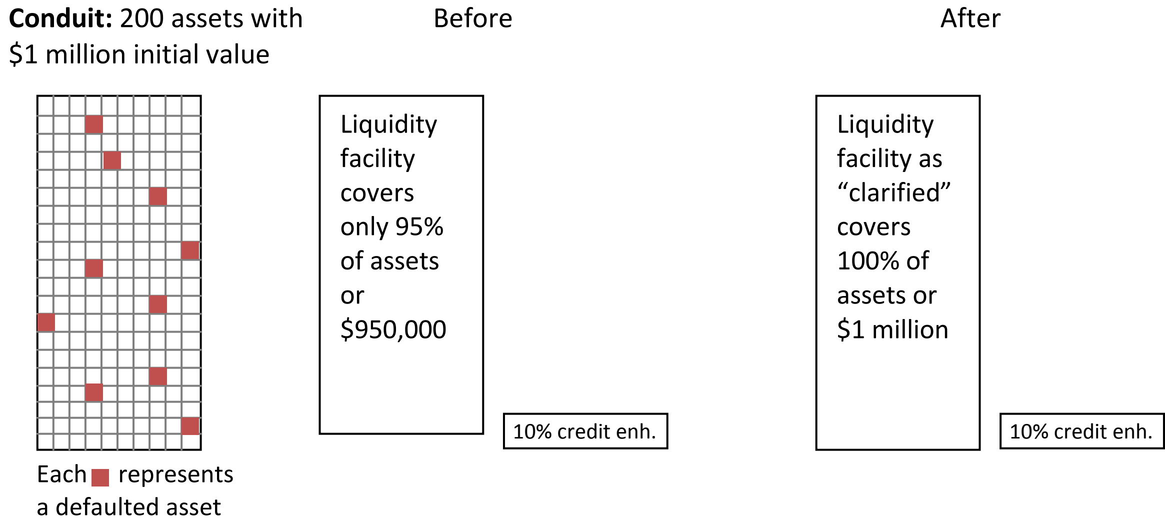
[35] *See* 12 CFR Pt. 3 App. A § 3(b)(6)(iii). Note that this is the OCC citation. The same regulation is also found in 12 CFR Pts 208 and 205 App. A § III.B.3.a (FRB); 12 CFR Pt. 3 App. A § II.B.5(a) (FDIC); 12 CFR 567.1 (OTS).

[36] *See infra* text accompanying notes 49–50.

[37] JOINT BANK REGULATORS, SUPERVISORY GUIDANCE TO ASSIST IN THE DETERMINATION OF THE APPROPRIATE RISK-BASED CAPITAL TREATMENT TO BE APPLIED TO DIRECT CREDIT SUBSTITUTES ISSUED IN CONNECTION WITH ASSET-BACKED COMMERCIAL PAPER PROGRAMS 30 (March 30, 2005), *available at* http://www.federalreserve.gov/boarddocs/srletters/2005/SR0506a1.pdf [hereinafter MARCH GUIDANCE].

[38] *Id.*

Figure 1: A comparison of "eligible liquidity facility" regulation before and after "clarification" when there are 5% defaults



only 95% of the conduit's assets. Because the liquidity facility cannot fund these assets, they must be funded (if they are funded at all) through credit enhancement.

The guidance document goes on to explain that even eligible liquidity facilities are subject to some credit risk, because they are likely to be used to fund assets that are on the path to default. "[W]hen drawn prior to the ABCP program's credit enhancements, [a liquidity facility] is subject to the credit risk of the underlying pool. . . . [T]he sponsor of the ABCP program would most likely manage the asset pools in such a way that deteriorating portfolios or assets would be put to the liquidity [facility provider] prior to any defaults that would require a draw against the program-wide credit enhancement."[39] The guidance document states clearly that the asset quality test serves to mitigate this risk.[40] This, too, indicates that the requirement that an eligible liquidity facility "provides

---

[39] MARCH GUIDANCE, *supra* note 37, at 32.
[40] *Id.*

that" funding is reduced to cover only assets that meet the asset quality test is an essential protection justifying the liquidity facility's low credit conversion factor.

In short, the policy position of the bank supervisory agencies was explicit: liquidity facilities must be designed so that they could not be used to purchase defaulted or highly delinquent assets, unless those assets carried a government guarantee. The purpose of this regulation was equally explicit: when ABCP liquidity facilities are used to provide credit enhancement, the capital requirements imposed on banks sponsoring ABCP programs fail to accurately reflect the credit risks of their obligations. The regulation was carefully designed to ensure that the bank capital requirements imposed on facilities provided to ABCP programs would accurately reflect the credit risk of those facilities.

Testimony to the expected success of this regulation is found in a report released by Fitch Ratings, one of the credit rating agencies that evaluates ABCP programs. In April 2005 Fitch indicated that the weaker liquidity support required by the new rules for ABCP programs would increase the risk to purchasers of the commercial paper and that increased credit enhancement might be needed to maintain the current ratings on the programs.[41] The "Before" segment of Figure 2 illustrates this. When 15% of the assets default, the liquidity facility can cover only 85% of the total assets; if the credit enhancement covers 10% of the assets, then the commercial paper investors are left to bear 5% of the losses. To the degree that a credit rating agency's analysis indicated that there was a significant possibility of such losses, the rating agency would be unable to

---

[41] *Fitch: New Liquidity Capital Rules May Result in More Credit Enhancement for U.S. ABCP*, BUSINESS WIRE, April 18, 2005, http://www.businesswire.com/news/home/20050418005751/en/Fitch-Liquidity-Capital-Rules-Result-Credit-Enhancement.

give a top rating to the ABCP program. In order to attain the top rating, the credit enhancement available to the program would have to increase to cover potential losses.

Under the new regulation, ABCP programs could no longer leave the credit risk of the assets with the bank providing liquidity at a 0% capital charge: either ABCP investors would have to bear the credit risk of the assets or the bank would have to provide explicit credit enhancement and incur the capital charges commensurate with taking on such credit risk. As noted above, however, the market for commercial paper without the highest credit rating is extremely small.[42] Thus, the regulation was going to require banks to bear the full capital costs of providing credit enhancement to their ABCP programs or to shut them down if accounting for the credit risks of the programs rendered them uneconomic.

3. Implementation of the Final Rule in 2005

Apparently, however, when regulation requires the banks to bear the actual costs of the guarantees they provide and when bearing these costs is likely to make an erstwhile profitable product unprofitable, the banks see a problem that needs to be fixed. Thus, "the industry . . . requested clarification of the requirement for an asset quality test to determine the eligibility of an ABCP liquidity facility."[43]

On August 4, 2005, the regulators issued additional guidance in order to facilitate the implementation of the final rule. This guidance, which was not subject to the notice-and-comment process, "clarif[ied] the requirement for an asset quality test to determine

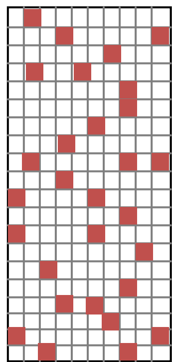
---

[42] *See supra* text accompanying note 20.

[43] BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM, SUPERVISION AND REGULATION LETTER, SR 05-13, INTERAGENCY GUIDANCE ON THE ELIGIBILITY OF ASSET-BACKED COMMERCIAL PAPER PROGRAM LIQUIDITY FACILITIES AND THE RESULTING RISK-BASED CAPITAL TREATMENT (August 4, 2005) available at http://www.federalreserve.gov/boarddocs/srletters/2005/SR0513.htm and http://www.federalreserve.gov/boarddocs/srletters/2005/SR0513a1.pdf [hereinafter AUGUST GUIDANCE].

Figure 2: A comparison of "eligible liquidity facility" regulation before and after "clarification": when there are 15%, defaults, the "clarification" results in a jump to ineligibility.

Conduit: 200 assets with $1 million initial value



Each ■ represents a defaulted asset

Before

Liquidity facility covers only 85% of assets or $850,000

10% credit enh.

The gap between the liquidity facility and the credit enhancement facility represents losses to investors.

After

Liquidity facility as "clarified" covers 100% of assets, but is now ineligible

10% credit enh.

Here, there is no gap, but the liquidity facility becomes ineligible as soon as a gap appears in the "Before" diagram.

the eligibility" of a liquidity facility: "[T]he agencies will deem an ABCP liquidity facility to be in compliance with the requirement for an asset quality test if the liquidity provider has access to certain types [and amounts] of acceptable credit enhancements . . ."[44] Observe that the "clarification" converts the second criterion of the final rule, which specifies that an eligible liquidity facility "must provide" that any asset which fails the asset quality test will not be funded, into a requirement for access to credit enhancement. The contrast with the guidance issued just four months earlier is remarkable: "Liquidity agreements must be subject to a valid asset quality test that prevents the purchase of defaulted or highly delinquent assets. Liquidity facilities that are not limited by such an asset quality test are to be viewed as credit enhancement . . ."[45]

---

[44] *Id.*
[45] MARCH GUIDANCE, *supra* note 37, at 30.

The dramatic change in policy that took place with the issuance of the August 4 guidance is not discussed by the agencies. Nor is there any explanation for why the change in policy was necessary. Instead the agencies "reiterate that the primary function of an eligible ABCP liquidity facility is to provide liquidity"; they "emphasize … that an eligible liquidity facility should not be used to . . . fund assets with [a] high degree of credit risk . . ."[46] And, then, the agencies follow these exhortations with the "clarification" that makes it unnecessary for the industry to obey them:

> Accordingly, the agencies will deem an ABCP liquidity facility to be in compliance with the requirement for an asset quality test if (i) the liquidity provider has access to certain types of acceptable credit enhancements and (ii) the notional amount of such credit enhancements available to the liquidity facility provider exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade that the liquidity provider may be obligated to fund under the facility. In this circumstance, the liquidity facility may be considered "eligible" for purposes of the agencies' risk-based capital standards because the provider of the credit enhancement generally bears the credit risk of the assets that are 90 days or more past due, in default, or below investment grade rather than the banking organization providing liquidity.[47]

Observe the contrast between this guidance document and the one that preceded it by four months. The careful analysis of the effects of asset deterioration over time and the concern over the failure of the legal documentation to specify the priority position of liquidity and credit enhancement programs has disappeared and is replaced by a bald claim that "the provider of the credit enhancement generally bears the credit risk of the

---

[46] AUGUST GUIDANCE, *supra* note 43, at 2.
[47] *Id.*

assets" that are past due or in default. The fact that four months ago the regulators reached a contrary conclusion is not mentioned and no effort is made to rebut the arguments made in the earlier guidance.

The "After" segment of Figure 1 illustrates the difference between the regulation described in the March 30 guidance document and that described by the August 4 document. As the diagram indicates, under the new interpretation, an eligible liquidity facility may now continue to cover all of the assets even though 5% of them are in default—as long as the credit enhancement exceeds the assets in default.

The substantial difference between the regulation and its "clarification" is illustrated in the "After" segment of Figure 2. When 15% of the assets are in default and the credit enhancement covers only 10% of the assets, the liquidity facility which was eligible in Figure 1 has become ineligible, because the credit enhancement is insufficient to cover the assets that are in default.

Because the rule, as it is drafted and as it was interpreted in the March 30 guidance, requires that an eligible liquidity facility have a contractual provision that excludes defaulted assets, a liquidity facility that is eligible will remain eligible—and subject to only 10% of the risk-weighted capital requirement—over time. By contrast, under the "clarified" rule of the August 4 guidance, eligibility of a liquidity facility depends on the relationship between defaulted assets and credit enhancement. Thus, it is a structural aspect of the "clarified" rule that eligible liquidity facilities may become ineligible—and subject to 100% of the risk-weighted capital requirement—as more and more assets default and eventually exceed the level of credit enhancement. Clearly, the "clarified" rule exposes an eligible liquidity facility to much more credit risk than the

original rule. In fact, liquidity facilities that comply with the "clarified" rule fail the test laid out in the March 30 guidance that "liquidity agreements must . . . prevent[] the purchase of defaulted or highly delinquent assets . . . [and if they do not] are to be viewed as credit enhancement, and subject to" a 100% credit conversion factor.[48]

Figure 2 also illustrates how the "clarification" reduces the need for credit enhancement. Under the rule as interpreted in the March 30 guidance, defaults in excess of the ABCP program's credit enhancement will be losses to the ABCP investors; thus, to the degree that a credit rating agency believes that there is a probability of 15% defaults that is not insignificant, in order to get a first tier rating the ABCP program will have to have sufficient credit enhancement to cover that possibility. After the "clarification," however, there is no risk of loss to the ABCP investors when defaults exceed the credit enhancement; instead, the bank that offers the liquidity facility is at risk for the losses, since, when the losses take place, the liquidity facility will become ineligible. Because the "clarification" allows the bank that provides the temporarily "eligible" liquidity facility—which is only subject to a 10% capital charge—to bear the losses of defaults in excess of the credit enhancement, the credit rating agencies can give the ABCP program a first-tier rating without requiring additional credit enhancement—which would be subject to a 100% capital charge. In short, by reducing the need for additional credit enhancement in ABCP programs, the "clarification" significantly alters the effects of the regulation on the capital required to be held by banks that sponsor ABCP programs.

An additional reason to question the validity of this "clarification" of the eligible liquidity facility regulation is that it implements a suggestion that was made in comments

---

[48] MARCH GUIDANCE, *supra* note 37, at 30.

on the proposed rule, considered by regulators, and rejected by them. The "clarification" states that "the agencies have determined" that credit enhancement in the form of third party guarantees, such as "surety bonds and letters of credit" are acceptable for satisfying the asset quality test as long as the third party has a credit rating of single A or higher.[49] The Final Rule describes comments on the proposed regulation and the regulators' responses. Some comments suggested that "the asset quality test should be modified to reflect guarantees providing credit protection to the bank providing the liquidity facility." The response was: "The agencies agree that in the case of a government guarantee, the past due limitation is not a relevant asset quality test. As a result, this final rule does not apply the 'days past due' limitation in the asset quality test with respect to assets that are either conditionally or unconditionally guaranteed by the United States government or its agencies, or another OECD central government subsequent to a draw on a liquidity facility."[50]

The clear implication of the agencies' position was that after due consideration the agencies concluded that only when the guarantee is provided by a government entity is the reduction in credit risk sufficient to affect the asset quality test. Thus, the "clarification" implemented a suggestion that was considered and rejected by regulators. The "clarification" neither acknowledges the change in policy from that implemented in the final rule, nor explains why the change was made. This change also increases the risk that the provider of the liquidity facility will end up bearing credit risk—without making any adjustment to the credit conversion factor to compensate for the increase in risk.

---

[49] AUGUST GUIDANCE, *supra* note 43, at 2.
[50] Final Rule, *supra* note 32, at 44912 (column 1)

As noted above, the level of analysis in this second guidance document is much less sophisticated than that in the first, and little or no effort is made to evaluate carefully the effects of the "clarification" on the credit risks faced by the provider of a liquidity facility, aside from a simple assertion that the risks are borne by the providers of credit enhancement. The "clarification" made such significant changes to the final rule that it effectively rewrote the rule to increase dramatically the credit risk of an "eligible" liquidity facility and reduce the capital requirements for banks sponsoring ABCP programs.

4. A systemic crisis: the collapse of the ABCP market in 2007

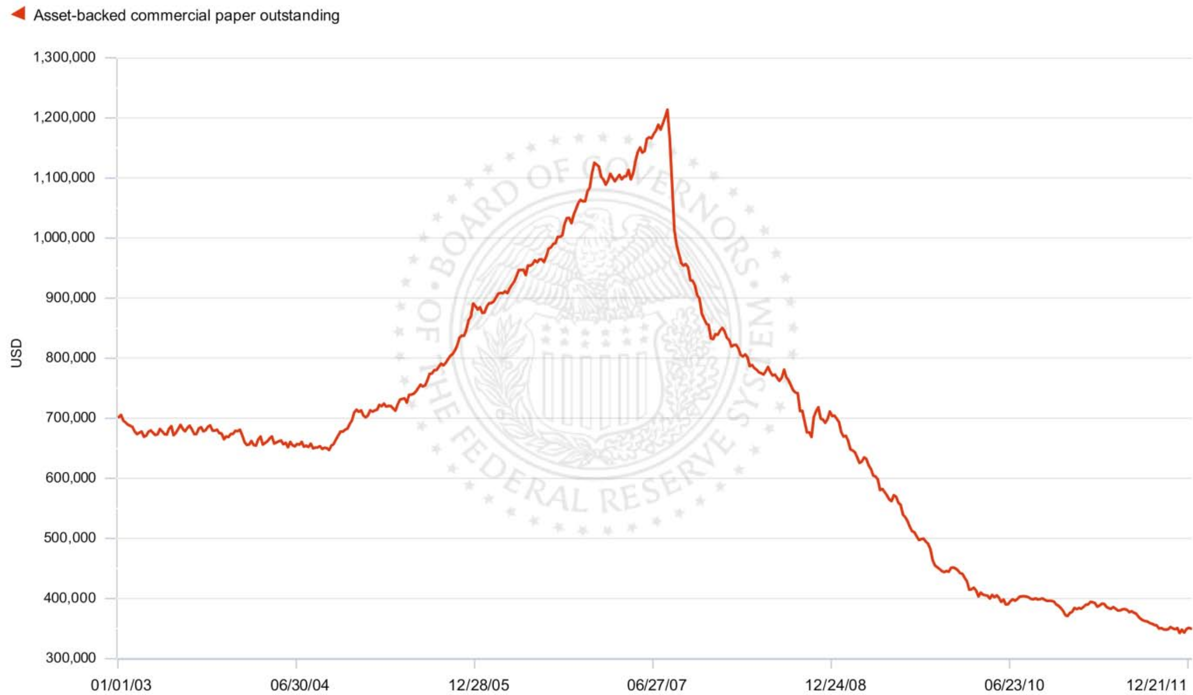
The Federal Reserve data on the amount of asset-backed commercial paper outstanding from 2003 through 2011 is depicted in Chart 1. The extraordinary growth in the ABCP market that took place starting in 2005 and that ended abruptly with the collapse of the market in August 2007 is clearly visible. As Fitch noted in April 2005, if the "eligible liquidity facility" regulation had not been "clarified," credit enhancement would have had to increase.[51] This would have raised the costs of issuing ABCP and worked to slow the growth of the ABCP market.

Asset-backed commercial paper was the first element of the modern system of financing loans via securitization—in contrast to the traditional financing of loans on bank balance sheets—to collapse in the recent crisis, requiring extraordinary action on the part of regulators. In August 2007, the Federal Reserve was forced to take the unusual step of allowing banks to pledge ABCP for which they also provided backup lines of

---

[51] *See supra* text accompanying note 41.

Chart 1: Asset-backed Commercial Paper Outstanding



Available at:
http://www.federalreserve.gov/datadownload/Chart.aspx?rel=CP&series=ff17468b394e2251e20e6c3d9d56106d&lastObs=&from=01/01/2001&to=12/31/2011&filetype=spreadsheetml&label=include&layout=seriescolumn&pp=Download

credit at the discount window.[52] In December 2007, the Federal Reserve created a new lending facility to help support troubled banks like Citibank and Bank of America that were forced over the course of the ABCP crisis to honor liquidity guarantees and take billions of dollars of assets onto their balance sheets.[53] Thus, the ABCP crisis served as a bellwether foreshadowing the financial troubles of 2008 and the need for even greater

---

[52] Greg Ip, *New York Fed Takes Step To Bolster Credit Market*, WALL ST. J., August 27, 2007, http://online.wsj.com/article/SB118798079732208114.html. Note that the article also indicates that the Fed explained that this was just a "clarification" of existing policy.

[53] The facility was called the Term Auction Facility. Federal Reserve Board of Governors Press Release, Dec 12, 2007, *available at* http://www.federalreserve.gov/monetarypolicy/20071212a.htm. On Citibank and Bank of America, see *infra* text accompanying notes 58–59.

Federal Reserve support of the financial system. More than four years after the ABCP collapse neither securitization, nor the ABCP market, has recovered.[54]

The collapse of the ABCP market was precipitated by concerns over losses on subprime mortgages. Major subprime mortgage lenders like Countrywide relied on the ABCP market to finance their mortgages after they were originated and before they were sold.[55] In addition, senior tranches of CDOs, a debt instrument that typically had about 25% mortgage backed securities exposure,[56] were sometimes funded using ABCP.[57] In November 2007 $25 billion of new sub-prime CDO exposure suddenly appeared on Citigroup's balance sheet, when it was forced to pay out $25 billion in cash to honor liquidity "puts" that had been sold to conduits.[58] Bank of America also recognized $10 billion of CDO exposure from liquidity "puts."[59]

That bank balance sheets would be affected by liquidity guarantees was not only predictable, but predicted by the bank regulators themselves who wrote in March 2005:

---

[54] *Asset-Backed Securities*, FINANCIAL TIMES, Sep. 14, 2010, http://www.ft.com/cms/s/3/673805b6-c008-11df-9628-00144feab49a.html?ftcamp=rss ("Sales of US asset-backed securities this year – excluding mortgages – languish at about one-tenth of pre-crisis levels.") Proquest's "securitized consumer non-revolving credit" series indicates that securitized consumer loans (excluding mortgages and credit card debt) remain at a level that is approximately one-third the level in 2007. Proquest Statistical Datasets, Terms of Credit Outstanding: Securitized Consumer Non-Revolving Credit, 1999-2011 [Data file], *available at* https://web.lexis-nexis.com/statuniv.

[55] FCIC REPORT, *supra* note 2, at 249.

[56] Daniel Covitz, Nellie Liang, & Gustavo A. Suarez, *The Evolution of a Financial Crisis: Panic in the Asset-Backed Commercial Paper Market* 10 (Bd. of Governors of the Fed. Reserve System Finance & Economics Discussion Series 2009-36), *available at* http://www.federalreserve.gov/pubs/feds/2009/200936/200936pap.pdf .

[57] Viral Acharya & Philipp Schnabl, *Do Global Banks Spread Global Imbalances? Asset-Backed Commercial Paper during the Financial Crisis of 2007–09*, 58 IMF ECONOMIC REVIEW 37, 46–47 (2010). FITCH RATINGS, CDO ASSET MANAGEMENT IN A TIME OF ILLIQUIDITY 3 (Sept 21, 2007).

[58] FCIC Report, *supra* note 2, at 138–39; Carol Loomis, *Robert Rubin on the job he never wanted*, FORTUNE, Nov. 28, 2007, http://money.cnn.com/2007/11/09/news/newsmakers/merrill_rubin.fortune/index.htm?postversion=2007111119; Bradley Keoun, Jesse Westbrook & Ian Katz, *Citigroup 'Liquidity Puts' Draw Scrutiny From Crisis Inquiry*, BLOOMBERG, Apr. 13, 2010, http://www.bloomberg.com/apps/news?pid=20601103&sid=aZELabu4NReI.

[59] FCIC Report, *supra* note 2, at 139; Floyd Norris, *As Bank Profits Grew, Warning Signs Went Unheeded*, NYT, Nov. 16, 2007, http://www.nytimes.com/2007/11/16/business/16norris.html.

“[T]he sponsor of the ABCP program would most likely manage the asset pools in such a way that deteriorating portfolios or assets would be put to the liquidity [facility provider] prior to any defaults that would require a draw against the program-wide credit enhancement.”[60] To mitigate this problem the Final Rule required (i) that eligible liquidity facilities bear a 10% credit conversion factor and (ii) that in order to be eligible the liquidity facility must “provide that” defaulted and severely delinquent assets would not be funded. That is, regulators knew—and explained with perfect clarity in March 2005—that a liquidity facility that did not include a contractual provision excluding bad assets should carry the same capital charge as carrying the assets on the balance sheet.

In August 2005 the regulators ignored their own advice and analysis in order to reduce the costs of providing credit guarantees—masquerading as liquidity guarantees—to ABCP conduits by 90%. Even if the assets that Citigroup and Bank of America took on their balance sheets were neither delinquent nor in default, the fact that the regulators reduced by 90% the cost to these banks of providing liquidity “puts” that were ineligible under the Final Rule as interpreted in March 2005 almost certainly had an effect on the fact that such guarantees were issued and had to be honored. In short, in lieu of enforcing the regulation and ensuring that banks which offered credit and liquidity guarantees to ABCP conduits faced capital charges commensurate with the risks they were taking on, the regulators chose to “clarify” the regulation so that the banks faced costs that underpriced the risk. It is entirely possible that this “clarification” was the determining factor leading to the spectacular growth of the ABCP market that preceded the crisis.

[60] MARCH GUIDANCE, *supra* note 37, at 32.

Since the crisis, studies of the ABCP market have proliferated.[61] Only Acharya, Schnabl and Suarez, however, focus on the role of regulatory arbitrage in the market: they conclude that the ABCP conduits were designed to allow banks to take on credit risk without incurring the capital charges of carrying assets on the balance sheet.[62] They find a profoundly negative effect on the financial positions of the commercial banks involved, and their econometric analysis indicates that the crisis had a significant effect on bank stocks.[63] The analysis here differs significantly from that in Acharya et al. because they focus on a different source of regulatory arbitrage.[64] The conclusions of this paper also contrast with those of Acharya et al., who find that ABCP conduits and the guarantees associated with them "deserve regulatory scrutiny";[65] here, the conclusion is that the process of regulation itself deserves scrutiny.

B. How Derivatives Became Part of the "Business of Banking"

The Office of the Comptroller of the Currency ("OCC") administers the National Bank Act and is tasked with interpreting the "business of banking" clause that delimits

---

[61] *See, e.g.* Acharya & Schnabl, *supra* note 57; Viral Acharya, Philipp Schnabl, & Gustavo Suarez, *Securitization without risk transfer*, (NBER w15730, 2010); Anderson & Gascon, *supra* note 16; Carlos Arteta, Mark Carey, Ricardo Correa, & Jason Kotter, *Revenge of the Steamroller: ABCP as a Window on Risk Choices* 15, (unpublished working paper, Board of Governors of the Federal Reserve System, Division of International Finance, May 15) *available at* http://webuser.bus.umich.edu/jkotter/papers/revengesteamroller.pdf ; Covitz, Liang & Suarez, *supra* note 56; Kacperczyk & Schnabl, *supra* note 12.

[62] Acharya, Schnabl, & Suarez, *supra* note 61, at 3. *But see also* Arteta, Carey, Correa, & Kotter, *supra* note 61, at 15 (arguing that expectation of stricter regulation under Basel 2 should have forestalled such regulatory arbitrage).

[63] Acharya, Schnabl, & Suarez, *supra* note 61, at 2, 4.

[64] *Id*. at 12-13. Acharya, Schnabl, and Suarez focus on the regulatory response to the Financial Accounting Standards Board's adoption of a rule that would require some ABCP conduits to be consolidated onto bank balance sheets. Note that Acharya & Schnabl, *supra* note 57, at 50 also takes this approach.

[65] Acharya, Schnabl, & Suarez, *supra* note 61, at 36.

the powers of a national bank.[66] Over the past quarter century the OCC has steadily expanded this interpretation to include trade in an ever increasing range of derivatives—and finally to include trade in commodities and stocks. Derivatives are a broad class of financial contracts that include futures contracts, which fix the price today for the purchase of a commodity or financial asset at a specified date in the future, options contracts that permit, but do not require, the holder of the option to purchase an item at a specified future date and price, and swaps contracts which are effectively packages of futures contracts.

In a seminal study Saule Omarova details the administrative process used by the OCC to expand dramatically the range of activities available to a national bank.[67] She concludes that regulators used "superficially reasoned interpretations"[68] of the bank powers clause to enable "regulated financial institutions to take increasingly greater and more complex risks."[69] These interpretations "rendered [the bank powers clause] . . . meaningless as a potentially limiting device and transformed it into a powerful enabling mechanism."[70] Here, highlights of Omarova's argument are presented, demonstrating the OCC's use of interpretive letters to alter dramatically the regulatory environment in which banks operate.

1. From Glass-Steagall to Bank Purchases of Commodities and Stocks

The bank powers clause grants national banks the right "to exercise . . . all such incidental powers as shall be necessary to carry on the business of banking," and lists five

---

[66] The largest banks in the country, including Citibank, J.P. Morgan Chase and Bank of America, are all national banks supervised by the OCC.

[67] Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking"*, 63 U. MIAMI L. REV. 1041 (2009)

[68] *Id.* at 1047.

[69] *Id.* at 1044.

[70] *Id.* at 1100.

activities including the purchase of debt instruments, taking of deposits, trading in currencies, and lending.[71] The “business of banking” is, however, not limited to the enumerated powers in the National Bank Act.[72] “[W]ithin reasonable bounds” the OCC has the discretion to authorize additional activities.[73] In addition, under the Glass-Steagall Act the purchase by a bank “of any shares of stock of any corporation” for its own account is not authorized, and dealing in “securities and stock” is limited to transactions “solely upon the order, and for the account of, customers, and in no case for its own account.”[74]

In the 1980s the OCC approved trade in derivative contracts on Treasury bonds, currencies and other debt instruments that were traditionally held on bank balance sheets.[75] These decisions were uncontroversial, because they did not substantially change the risks to which a bank was exposed, but arguably made it easier to manage those risks.[76]

Commodities derivatives transactions, however, raise complicated issues. The distinction between banking and commerce has a long history in the American tradition,[77] and trade in commodities, particularly when delivery is, or may be, taken is likely to be considered a commercial activity.[78] Omarova carefully details the evolution of the OCC’s reasoning as it expanded the range of permissible activities:

---

[71] 12 U.S.C.A. § 24 Seventh (West)

[72] NationsBank of N. Carolina, N.A. v. Variable Annuity Life Ins. Co. (“VALIC”), 513 U.S. 251, 258 (1995).

[73] *Id.*

[74] 12 U.S.C.A. § 24 Seventh (West)

[75] Omarova, *supra* note 67, at 1058.

[76] *Id.* at 1057.

[77] *Id.* at 1049.

[78] *Id.* at 1061.

- Stage 1: Perfectly matched swaps[79]

  In 1987 the OCC approved perfectly matched swaps on a commodity price index. In perfectly matched swaps the bank enters into two offsetting transactions with different counterparties. Thus, as long as both parties make good on their obligations, the bank will not be exposed to fluctuations in commodities prices. The OCC argued that "[b]ecause these transactions are matched, the only risk to the Bank would be its credit risk with respect to a particular" counterparty.[80] In short, the approval was based on the claim that the bank was not exposed to the risk that commodity prices would move, but only to credit risk—which is the risk that a borrower will default on a loan. The OCC argued that these swap contracts were comparable to a traditional bank guarantee of a commercial trader's debt.

- Stage 2: Commodity- and equity-linked deposits[81]

  In 1988, the OCC approved deposit accounts that paid a return based on commodity price or stock index movements, arguing that the banks' deposit taking authority included the authority to set the measure of returns on deposits. The same letter concluded that using derivatives to hedge the risk created by offering index-linked deposits was permissible as an activity incidental to the business of banking. Thus, while banks could not trade in stock index derivatives on their own account, such trade was permissible if it hedged the risk of a deposit

---

[79] *Id.* at 1062.
[80] OCC NO-OBJECTION LETTER NO. 87-5, 1987 WL 267920 (O.C.C.), 1 (July 20, 1987).
[81] *Id.* at 1064.

account product offered to customers. Under *Chevron* deference[82] this decision was upheld by the D.C. District Court.[83]

- Stage 3: Unmatched commodity swaps[84]

  In 1990, the OCC approved unmatched commodity swap transactions, as long as they were hedged by purchasing exchange-traded derivatives. Because "the Bank itself never retains unhedged commodity price risk, . . . by entering into unmatched commodity price swap contracts, a bank does not undertake any risks that are qualitatively different from those met in the course of two of banking's most fundamental activities: making loans and taking deposits."[85] This argument relied heavily on the authorization for commodity-linked deposits as the OCC argued: "any residual commodities price risk the bank retains as a result of the inability of any hedging strategy to perfectly offset the exposure from an unmatched swap is not qualitatively different from the risks a bank may permissibly encounter when offering a deposit account with interest payments tied to the same commodity."[86]

Here, the OCC first appears to assume that the bank can hedge price risk perfectly, and later relies on the fact that commodity-linked deposits have just been approved to argue that any unhedged risks are also incidental to standard

---

[82] *See infra* text accompanying note 125.
[83] Inv. Co. Inst. v. Ludwig, 884 F. Supp. 4,5 (D.D.C. 1995).
[84] Omarova, *supra* note 67, at 1068–69.
[85] OCC NO OBJECTION LETTER NO. 90-1, 1990 WL 362127 (O.C.C.), 4 (Feb. 16, 1990)
[86] *Id.*

banking activities like taking deposits. Omarova correctly describes this process as a "regulatory technique of bootstrapping bank-permissible activities."[87]

- Stage 4: Portfolio hedging and cross-hedging[88]

  In 1992, the OCC allowed banks to trade swaps as long as they hedged the whole swap portfolio, replacing the requirement that each individual transaction be hedged, and it also approved the use of over-the-counter derivatives to hedge the portfolio. Most remarkably, the use of closely related but not identical commodities when hedging (that is, cross-hedging) was approved—with the proviso that banks must take the risks of price mismatches into account when adjusting hedges.[89]

  All three of these changes were likely to increase the risk that the hedging would be imperfect: Aggregating swaps into a portfolio made it more likely that the hedges would be less closely matched to the specifics of the transactions. Over-the-counter derivatives lack the transparent pricing of exchange traded derivatives, so pricing may be more subject to movements, not related to the fundamentals of the underlying assets. Finally, hedging with non-identical commodities creates the obvious risk that prices of the two goods will not move according to historical norms. The OCC letter addresses none of these concerns.[90]

- Stage 5: Physical delivery of commodities

  In 1993 and 1995, the OCC approved banks to make or take physical delivery of

---

[87] Omarova, *supra* note 67, at 1072.
[88] *Id.* at 1067.
[89] OCC INTERPRETIVE LETTER, 1992 WL 125220 (O.C.C.), 5 (Mar. 2, 1992)
[90] *See id.*

commodities and found that the storage of commodities was permissible.[91] This was, afterall, a "logical outgrowth" of their existing activities and could be used as a hedge to reduce their risks.[92]

Over the course of only six to eight years, OCC interpretive letters were used to change the environment in which banks operated from one where only derivatives referencing assets which banks were allowed to trade and hold were permitted to one where trade in commodities derivatives was not only permitted, but also used to rationalize authorizing banks to trade in commodities. While the OCC repeatedly explained that banks were not permitted to speculate or take positions for their own account using these instruments, as Omarova observes, it is far from clear that the regulator had the capacity to enforce the prohibition on speculation.[93]

A similar evolution took place with respect to equity derivatives:

- Equity swaps

In 1994, the OCC argued that:

> equity derivative swap contracts involve payments that are analogous to those made and received in connection with a national bank's express powers to accept deposits and loan money. The contracts require a bank to pay money to a party depending on the rise or fall in the price of a particular equity or commodity or equity index. Like a deposit that bears interest, the customer's receipt of swap payments constitutes the receipt of income for the hypothetical use of customer monies. Like debtors on bank loans, parties to swap contracts are also required to

[91] Omarova, *supra* note 67, at 1078.
[92] *Id.* at 1078–79.
[93] *Id.* at 1097–98.

> provide money to the bank based upon agreed fluctuations in the price of the relevant equity or index.[94]

Thus, even though banks were explicitly prohibited by § 16 of the Glass-Steagall Act from trading equities,[95] the OCC found that "[s]ince national banks are exercising . . . statutory powers related to deposit taking, lending and funds intermediation when engaging in equity derivative swap activities, the prohibitions of Glass-Steagall are inapplicable."[96]

As with commodities, the OCC found that trading in unmatched equity derivatives was an activity so similar to deposit taking, now that banks were allowed to pay a stock market return on those deposits, that it was authorized under the "business of banking" clause of the National Bank Act.[97] Effectively the OCC put great faith in the banks' ability to hedge their risks on these markets and their ability to put into place "prudent practices" that would ensure that these activities were carried on "in accordance with safe and sound banking principles."[98]

- Holding of equity securities

In 2000, the OCC authorized four banks to purchase and hold equity securities as a hedge on their swaps contracts, as this was a less expensive way to hedge than the alternatives.[99] This authorization was issued in such a nonpublic manner, that

---

[94] O.C.C. INTERPRETIVE LETTER NO. 652, 1995 WL 156767 (O.C.C.), 3 (Mar. 1995)
[95] 12 U.S.C.A. § 24 Seventh (West)
[96] O.C.C. INTERPRETIVE LETTER NO. 652, *supra* note 94, at 4
[97] *Id.*
[98] *Id.*
[99] Omarova, *supra* note 67, at 1080.

the GAO, after investigating, published a report titled *Equity Hedging: OCC Needs to Establish Policy on Publishing Interpretive Decisions*.[100]

More recent regulatory decisions authorize banks to play a role in speculative activities undertaken by other subsidiaries of the financial holding company to which they belong.

- Hedging commodities with a subsidiary

  In 2005, the OCC authorized the hedging of a bank's commodity swap portfolio with a subsidiary that was in the business of trading commodities. According to the OCC this did not "alter the nature of the proposed activities."[101] Omarova observes that this was part of a process by which, J.P. Morgan Chase, the financial holding company which owned the bank seeking the interpretation, was permitted to enter the commodity trading business.[102] It is well known in the industry that bank counterparties are often preferred in derivatives markets, precisely because they have access to a federal safety net and are far less likely to fail than other market participants.[103] There is little question that this would give the J.P. Morgan Chase commodities business a significant advantage over its competitors.

In these decisions the OCC was generally applying a test synthesized by Julie Williams, the OCC's Chief Counsel, and Mark Jacobsen into three factors: "(i) whether

[100] U.S. GAO, EQUITY HEDGING: OCC NEEDS TO ESTABLISH POLICY ON PUBLISHING INTERPRETIVE DECISIONS, 5 (2001).

[101] OCC INTERPRETIVE LETTER NO. 1039, *available at* : http://www.occ.gov/static/interpretations-and-precedents/sep05/int1039.pdf, 3.

[102] Omarova, *supra* note 67, at 1093–94.

[103] Christopher Whalen, *What is to be Done? Interview with Bert Ely*, THE INSTITUTIONAL RISK ANALYST, Sept. 23, 2008, http://us1.irabankratings.com/pub/IRAstory.asp?tag=310. Or SEEKING ALPHA, Sept. 24, 2008, http://seekingalpha.com/article/97125-what-is-to-be-done-an-interview-with-bert-ely.

the activity in question is functionally equivalent to, or a logical outgrowth of, a recognized bank power; (ii) whether the activity benefits bank customers and/or is convenient or useful to banks; and (iii) whether the activity presents risks of a type similar to those already assumed by banks."[104]

The issue raised by this analytic process is whether the OCC's discretion was exercised "within reasonable bounds"[105] or whether the bootstrapping of one permissible activity onto another using the "logical outgrowth" test was a means of rationalizing an unreasonable expansion of the bank powers authorized by the National Banking Act. At least one court has rejected the OCC's approach.

The D.C. Circuit roundly criticized the OCC's analytic process in a decision holding that the bank powers clause of the National Bank Act does not authorize national banks to sell crop insurance.[106] First, the court expressed exasperation that "the facts of this case are a rerun of those in" two previous insurance sales cases,[107] and then criticized the foundations of the Williams/Jacobsen test: "While the sale of crop insurance may be a 'logical outgrowth' that national banks could apply their prior experience to, that alone cannot constitute legal authorization. If it did, national banks would be able to constantly expand their field of operations on an incremental basis without congressional action. First would be the authority to sell crop insurance, followed by whatever insurance

---

[104] Julie L. Williams & Mark P. Jacobsen, *The Business of Banking: Looking to the Future*, 50 BUS. LAW. 783, 798 (1995).

[105] *See supra* note 73 and accompanying text.

[106] Independent Ins. Agents of America v. Hawke, 211 F.3d 638 (D.C. Cir., 2000).

[107] *Id.* at 642.

against business risks of a bank customer is the next 'logical outgrowth.' There would be no logical stopping point."[108]

Effectively the D.C. Circuit held that the OCC's policy of bootstrapping from one authorized banking activity to another is a means of circumventing Congressional authority to delimit the activities that National Banks are authorized to undertake. The bank powers clause "cannot bear the weight the Comptroller proposes to place on it under its test. The Comptroller may of course authorize activities . . . 'within reasonable bounds,' but today's interpretation is not within such bounds."[109]

2. Implications for Administrative Process

As Omarova also argues, this history of OCC decisionmaking via interpretive letters raises important questions of administrative process: Rules promulgated in the form of interpretive letters bypass rulemaking procedures such as a public notice and comment period that facilitate public discussion of the rule changes.[110] Because swaps were new financial products and there was no existing industry to challenge the banks' expansion into this area, there have been no court challenges to bring this issue into the public view.[111] Not only has there been a lack of public attention to this area, but it's not clear that the OCC's exercise of discretion is effectively monitored by either the courts or the lawmakers.[112]

Omarova remarks that the "letters conspicuously lack any substantive discussion of the potential drawbacks of allowing banks to get into various derivative markets and

---

[108] *Id.* at 645.
[109] *Id.* Internal citation omitted.
[110] Omarova, *supra* note 67, at 1103, 1105.
[111] *Id.* at 1105.
[112] *Id.* at 1055

come across more as advocacy than an objective and measure analysis."[113] Each of the interpretive letters responds to a request from a regulated entity, that undoubtedly argued its case to the best of its well-funded ability. The "Matched Swaps Letter" in fact states outright: "We have reviewed your legal opinion contained in your May 1, 1987, letter and your July 9, 1987, draft supplemental memorandum, in which you conclude that the activities are permissible, and have relied on the information and opinions contained therein."[114] Thus, one reason for the one-sided impression created by reading the OCC's letters is that they are being written by regulators who have been presented with one side of the argument, and, perhaps, have had neither the time nor the resources to fully develop the counter argument. This aspect of the regulatory process will be addressed below.

III. ADMINISTRATIVE LAW BACKGROUND

In both of the cases above the regulator made a deregulatory decision using an interpretive rule. Interpretive rules are distinguished from regulations (which are also known as legislative rules), because the latter are promulgated using the notice and comment procedure described in the asset-backed commercial paper example above. When agencies interpret statutes or their own regulations without using the notice and comment process, they issue interpretive rules.[115] A wide variety of names is used by the different agencies for such interpretive rules: here the rules were called guidance or interpretive letters.

---

[113] *Id.* at 1104.

[114] OCC NO-OBJECTION LETTER NO. 87-5, *supra* note 80, at 1.

[115] Robert A. Anthony, *Interpretive Rules, Policy Statements, Guidances, Manuals and the Like – Should Federal Agencies Use them to Bind the Public?*, 41 DUKE L.J. 1311, 1325 (1992). Note that there is a third category of "formal" rulemaking which involves significantly more procedure than notice and comment; this form of rulemaking has, however, fallen into disuse.

The necessity of interpretive rulemaking by agencies is generally recognized. The responsibility to administer and enforce a statute typically requires an agency to take a stand on the meaning of the statute.[116] The agency must, then, issue interpretive rules, and these are not required by law to be promulgated by notice-and-comment rulemaking processes, "even when the agency intends, if it can, to make the interpretation bind affected private parties."[117] Robert Anthony, a prominent critic of agency use of non-legislative rules, has argued, however, that when "substantial interpretive changes" are involved, an agency "should endeavor to observe notice-and-comment procedures."[118] Courts have sometimes embraced this view by invalidating an interpretive rule that is a "new rule" rather than a "an interpretation of an existing rule" on the basis that it should have been issued using the notice-and-comment procedure.[119]

Subpart A discusses agencies' increasing use of interpretive rules. Subpart B describes doctrines of judicial review that make challenges difficult for the beneficiaries of a statute—in comparison with the parties regulated by the statute. The specific application of these administrative law issues to financial regulation is discussed in subpart C.

A. Growing Reliance on Interpretive Rulemaking

Recently concerns have grown over the ever increasing use of interpretive rules by agencies. Some scholars view this development with favor. In the context of the

[116] *Id.* at 1375-76.
[117] *Id.*
[118] *Id.* at 1376-77.
[119] Mission Group Kansas, Inc. v. Riley, 146 F.3d 775, 782 (10th Cir. 1998); United States v. Hoyts Cinemas Corp., 380 F.3d 558, 569 (1st Cir. 2004).

"ossification debate,"[120] which asks whether judicially imposed requirements for additional procedure in the notice-and-comment process are stifling agencies' capacity to issue regulations, increasing use of interpretive rules by agencies is often viewed as exemplary of the "virtues of informality."[121] The D.C. Circuit, however, expressed concern over this practice in *Appalachian Power Co. v. E.P.A.*:

> The phenomenon we see in this case is familiar. Congress passes a broadly worded statute. The agency follows with regulations containing broad language, open-ended phrases, ambiguous standards and the like. Then as years pass, the agency issues circulars or guidance or memoranda, explaining, interpreting, defining and often expanding the commands in the regulations. One guidance document may yield another and then another and so on. Several words in a regulation may spawn hundreds of pages of text as the agency offers more and more detail regarding what its regulations demand of regulated entities. Law is made, without notice and comment, without public participation, and without publication in the Federal Register or the Code of Federal Regulations. With the advent of the Internet, the agency does not need these official publications to ensure widespread circulation; it can inform those affected simply by posting its new guidance or memoranda or policy statement on its web site. An agency operating in this way gains a large advantage. "It can issue or amend its real rules, i.e., its interpretative rules and policy statements, quickly and inexpensively without following

[120] *See* Ronald M. Levin, *More on Direct Final Rulemaking: Streamlining, Not Corner-Cutting*, 51 ADMIN. L. REV., 757, 767 (1999).

[121] Todd D. Rakoff, *The Choice Between Formal and Informal Modes of Administrative Regulation*, 52 ADMIN. L. REV. 157, 165 (2000). *See also* Jamison E. Colburn, *Agency Interpretations*, 82 TEMPLE L. REV. 657, 668 (2009) (arguing that tying judicial deference to a false distinction between legislative and non-legislative rules, as in the *Mead* decision, is unjustified).

> any statutorily prescribed procedures." The agency may also think there is another advantage—immunizing its lawmaking from judicial review.[122]

Even though the flexible informality of interpretive rulemaking gives it advantages over the notice-and-comment process, the values that gave rise to notice and comment are also important: By publicizing the rulemaking, notice creates the opportunity for those affected to react to the rule and thus validates it politically. Taking comments forces the agency to consider the different points of view of many constituents before finalizing the rule—a process that is likely to improve the quality of the rule. Thus, as Richard Pierce, whom the D.C. Circuit quotes above on the flexibility of interpretive rulemaking, observes, the use of interpretive rules with binding effects is "not an acceptable solution to the problem of ossification of rulemaking," because the notice-and-comment procedure is important to both the quality and the political legitimacy of rules.[123]

Overall, however, the debate over the use of interpretive rules generally focuses on the relationship between agencies and regulated parties.[124] This may be a consequence of the fact that the vast majority of cases are brought by regulated parties, and—particularly in the case of financial regulatory statutes—beneficiaries of the statutes have limited access to the courts.

---

[122] Appalachian Power Co. v. E.P.A., 208 F.3d 1015, 1020 (D.C. Cir. 2000) [citation omitted] quoting Richard J. Pierce, Jr., *Seven Ways to Deossify Agency Rulemaking*, 47 ADMIN. L.REV. 59, 85 (1995).

[123] Pierce, *supra* note 122, at 86.

[124] *See, e.g.,* Matthew Stephenson & Miri Pogoriler, *Seminole Rock's Domain*, 79 GEO. WASH. L. REV. 1449, 1486–90 (2011).

B. Doctrines of Judicial Review that Adversely Affect Beneficiary Suits

Would a private citizen or public interest organization be able to seek judicial review of agency action such as the August 2005 guidance statement issued by bank regulators? Most likely the answer is no. The first obstacle is the problem of recognizing the import of the guidance statement. Because regulators make decisions in very specialized areas of industry activity, it may be difficult to find someone other than a regulated party who is aware of the agency action and more importantly is capable of both understanding its significance and explaining it to a court. However, even if this first obstacle can be overcome, it is almost certain that access to judicial review will be denied on the basis of standing, finality or ripeness and possible that, even if review is granted, redress will be denied on the basis of judicial deference to the agency. Below, deference is addressed first, followed by the doctrines determining access to judicial review: standing, finality and ripeness.

1. Deference

When an agency promulgates a regulation that interprets a statute using the notice and comment process, under *Chevron* courts must defer to the regulation if there is ambiguity in the statute and the rule represents a reasonable resolution of that ambiguity.[125] As Justice Scalia has observed, what the *Chevron* rule means in practice depends on the degree to which a judge is willing to read ambiguity into a statute: For a judge who typically finds that "the meaning of a statute is apparent," it will be relatively rare that *Chevron* requires the judge to accept an interpretation which the judge would not

[125] *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–44 (1984).

personally adopt. By contrast, judges who are more wont to read ambiguity into a statute will find that the courts must defer to a much broader range of agency interpretation.[126]

An interpretive rule does not receive the same deference as a notice-and-comment regulation: under *Skidmore* courts need not defer to a reasonable interpretation of an ambiguous statute, but the interpretation is "entitled to respect . . . to the extent that it has the power to persuade."[127] One cost to agencies of increasing their use of interpretive rules could be that courts are more likely to invalidate such rules. This conclusion presumes, however, that such rules are as likely to be reviewed by a court as regulations, and as will be argued below, it is far from clear that this is the case.

Moreover, when an agency interprets its own regulation using an interpretive rule, under *Auer v. Robbins* that rule is treated as "controlling unless plainly erroneous or inconsistent with the regulation,"[128] a standard that is significantly more deferential than *Chevron*. As the D.C. Circuit noted above, it is possible that agencies write deliberately ambiguous regulations in hopes of immunizing the interpretation of those regulations from judicial review.[129]

---

[126] Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 DUKE L.J. 511, 521 (1989).

[127] Gonzales v. Oregon, 546 US 243, 256 (2006), quoting Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944). Note that initially some courts interpreted *Chevron* to apply to interpretive rules as well as regulations and only after *Christensen* and *Mead* were decided did the Supreme Court make it clear that the *Skidmore* standard applied to interpretive rules. Christensen v. Harris County, 529 U.S. 576, 587 (2000); United States v. Mead Corp., 533 U.S. 218, 221 (2001).

[128] Auer v. Robbins, 519 U.S. 452, 461 (1997).

[129] Note, however, that six years after the D.C. Circuit decision the *Auer* standard was modified: "[W]hen the underlying regulation does little more than restate the terms of the statute itself," the interpretive rule is treated as interpreting the statute, not the regulation, and, as long as it does not have the status of a legislative rule, will receive neither *Auer* nor *Chevron* deference. Gonzales v. Oregon, 546 US 243, 257, 268 (2006). For another implicit constraint on *Auer* deference, see Paralyzed Veterans of Am. v. D.C. Arena L.P., 117 F.3d 579, 584 (D.C. Cir. 1997) ("A substantive regulation must have sufficient content and definitiveness as to be a meaningful exercise in agency lawmaking. It is certainly not open to an agency to promulgate mush and then give it concrete form only through subsequent less formal 'interpretations'").

Finally, when a rule involves a change in agency policy, it is possible that "arbitrary and capricious" review will be relevant. Section 706 of the Administrative Procedure Act ("APA") requires that courts "set aside agency action . . . found to be . . . arbitrary, [or] capricious."[130] Although agency inconsistency is not, in itself, reason not to defer to the agency's interpretation,[131] unless "the agency adequately explains the reasons for a reversal of policy," inconsistency may be "a reason for holding an interpretation to be an arbitrary and capricious change from agency practice."[132]

2. Access to Judicial Review: Standing

Auer deference is not the only doctrine that serves to insulate an agency's interpretive rules from the courts. Finality and ripeness, discussed below, will also tend to restrict judicial review of interpretive rules. Standing doctrine, by contrast, serves not only to restrict judicial review of interpretive rules, but also of regulations.

The Constitution requires that there be a "case" or "controversy" in order for a claim to be heard by a federal court.[133] Current case law interprets this requirement to mean that the plaintiff must have suffered an actual or imminent "concrete and particularized injury" which is "fairly traceable to" the actions of the defendant and that the court's favorable decision is likely to redress that injury.[134] A plaintiff will lack standing, if the suit is based on a "generalized grievance" such that the impact on the plaintiff is also "common to all members of the public."[135]

---

[130] APA § 706 (2)(A), 5 U.S.C. § 706(2)(A).

[131] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 863 (1984) ("The fact that the agency has from time to time changed its interpretation of the term "source" does not . . . lead us to conclude that no deference should be accorded the agency's interpretation of the statute.")

[132] Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 981 (2005).

[133] U.S. Const. art. III, § 2.

[134] *See, e.g.,* Massachusetts v. E.P.A., 549 U.S. 497, 517 (2007).

[135] Lujan v. Defenders of Wildlife, 504 U.S. 555, 575 (1992).

Table 1: Comparing Regulations to Interpretive Rules

		Notice and Comment Regulation	**Interpretive Rule** interpreting statute	**Interpretive Rule** interpreting regulation
Level of DEFERENCE		*Chevron*: defer if statute is ambiguous & agency is reasonable	*Skidmore*: defer if agency is persuasive	*Auer*: defer unless clearly erroneous
Is there FINALITY?		Almost always	Varies	Varies
Is there RIPENESS?		Usually	Varies	Varies
Does the party have STANDING?	**Regulated Party**	Almost always	Almost always	Almost always
	Beneficiary – Env. Regulation	Varies	Varies	Varies
	Beneficiary – Financial Reg'n	Unlikely unless competitor	Unlikely unless competitor	Unlikely unless competitor

The statutory foundation for judicial review of administrative action may be found either in the statute authorizing the agency action, which is called the organic statute, or § 702 of the APA, which entitles a "person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute" to judicial review. To have standing under the APA "the interest sought to be protected by the complainant [must be] arguably within the zone of interest to be protected or regulated by the statute . . . in question."[136] The case law is conflicted in interpreting whether the "zone of interest" is to be construed narrowly or broadly.[137]

---

[136] Ass'n of Data Processing Serv. Organizations, Inc. v. Camp, 397 U.S. 150, 153 (1970).

[137] KRISTIN E. HICKMAN & RICHARD J. PIERCE, FEDERAL ADMINISTRATIVE LAW 834 (2010); Cynthia Farina, *Standing in* A GUIDE TO JUDICIAL AND POLITICAL REVIEW OF FEDERAL AGENCIES, JOHN F. DUFFY & MICHAEL HERZ, ED. 36 (2005). Clarke v. Securities Industry Ass'n, 479 U.S. 388 (1987) ("The test is not meant to be especially demanding; in particular, there need be no indication of congressional purpose to benefit the would-be plaintiff."); Air Courier Conference of America v. American Postal

These requirements immediately imply that standing will rarely, if ever, be an issue for a regulated party.[138] In the vast majority of such cases, the injury claimed will be specific to regulated entities, caused by the agency action, remediable by judicial action and within the interests regulated by the statute.[139]

Thus, in the context of challenges to administrative action, standing doctrine serves to determine whether those whom a statute is intended to benefit are permitted to seek judicial review.[140] A beneficiary who brings suit under the APA must meet the "zone of interests" requirement; typically, however, this test does not apply to suits brought under the organic statute.[141] Some regulatory statutes grant standing under sections titled "Citizen suits" to "any person" without additional restrictions:[142] because congressional intent is clear under these statutes, the only limits to standing in these cases are constitutional. When *Lujan v. Defenders of Wildlife* was decided in 1992, the Supreme Court held that there is a constitutional component to the requirement of a particularized rather than a generalized grievance,[143] that "congressional conferral upon *all* persons of an abstract, self-contained, noninstrumental 'right' to have the Executive observe the procedures required by law" does not meet the constitutional requirement for

---

Workers Union, AFL-CIO, 498 U.S. 517 (1991) (arguing that it would "deprive the zone-of-interests test of virtually all meaning" to construe the Postal Reorganization Act as a whole)

[138] *Lujan* at 561. *See also* PETER L. STRAUSS, ADMINISTRATIVE JUSTICE IN THE UNITED STATES, 315 (2002).

[139] *Lujan* at 561 – 62.

[140] STRAUSS, *supra* note 138, at 315.

[141] Farina, *supra* note 137, at 23–24. *But see* Grand Council of Crees v. F.E.R.C., 198 F.3d 950, 955–58 (D.C. Cir. 2000) (holding that persons "aggrieved" under the Federal Power Act must also meet the zone of interests test in order to have prudential standing); ANR Pipeline Co. v. F.E.R.C., 205 F.3d 403, 408 (D.C. Cir. 2000) (holding similarly under the Natural Gas Act).

[142] E.g. Clean Air Act, 42 U.S.C. § 7604(a); Endangered Species Act, 16 U.S.C, § 1640(g); Resource Conservation & Recovery Act, 42 U.S.C. § 6972(a). *See also* Farina, *supra* note 137, at 25.

[143] *Lujan* at 573–74.

an injury,[144] and, thus, that the Constitution limits the congressional power to grant standing to the beneficiaries of a statute. Under the *Lujan* standard, it is unclear even whether a commenter in a notice-and-comment process, who is not otherwise affected by the regulation in question, has standing to sue the agency on the basis of failure to address the comment—though many commentators believe that such an individual is likely to have standing, in part, because this issue did not arise in *Lujan*.[145]

Since *Lujan,* two conflicting views of the role of judicial review of administrative action have resulted in a variety of Supreme Court decisions on constitutional standing that are hard to reconcile as they reflect shifting majorities:[146] one view holds that due to separation of powers concerns, when the beneficiaries of a law are the public in general, the courts are not the correct forum for redress and complainants should look to the political process;[147] and the other that private citizens play an important role in the regulatory process when they act as private attorney generals litigating issues of public interest,[148] so that the main purpose of standing doctrine is to ensure that a plaintiff has a significant personal stake in the litigation.[149] The 5-4 decision in *Massachusetts v. EPA* illustrates this conflict. States, local governments and private organizations sued to establish whether the EPA had statutory authority to regulate greenhouse gases and

---

[144] *Id*. at 573.

[145] *See* Farina, *supra* note 137, at 35–36; STRAUSS, *supra* note 138, at 319–20.

[146] Sidney A. Shapiro & Richard W. Murphy, *Eight Things Americans Can't Figure Out About Controlling Administrative Power*, 61 ADMIN. L. REV. 5, 19 (2009) (describing standing doctrine as “embarrassingly incoherent”); STRAUSS, *supra* note 138, at 314 (describing standing doctrine as “elaborate, turgid and badly conflicted”); HICKMAN & PIERCE, *supra* note 137, at 782 (describing standing doctrine as “impossible to rationalize fully”). *See also* Farina, *supra* note 137, at 29-30, 36.

[147] Antonin Scalia, *The Doctrine of Standing as an Essential Element of the Separation of Powers*, 17 SUFFOLK U. L. REV. 881, 895 (1983).

[148] Ass'n of Data Processing Serv. Organizations, Inc. v. Camp, 397 U.S. 150, 154 (1970).

[149] Massachusetts v. E.P.A., 549 U.S. 497, 517 (2007).

whether its refusal to do so was consistent with the statute.[150] The majority held that Massachusetts had a "particularized injury in its capacity as a landowner" due to the unchallenged claim that sea levels would rise,[151] whereas the minority argued that the "very concept of global warming seems inconsistent with this particularization requirement."[152]

In practice, the application of standing doctrine often appears to reflect a judge's willingness to reach the merits of the case.[153] For this reason, one prominent legal scholar has concluded that "the doctrinal elements of standing are nearly worthless as a basis for predicting whether a judge will grant individuals with differing interests access to the courts" and that the best way to understand its application is as a tool that is manipulated "to rationalize . . . politically preferred results."[154]

Many academics have concluded that the application of standing doctrine and access to judicial review has important pragmatic effects both on how agencies function and on their decisions.[155] As Cynthia Farina observes pointedly, one problem with directing complainants to the political process for relief is that typically the regulatory statute, the administration of which is being challenged, is itself the relief provided by the political process for a widely shared harm.[156] This problem is at its worst when a federal statute grants a broad right to bring suit to any citizen, but is held to exceed the

---

[150] *Id.* at 505.
[151] *Id.* at 522.
[152] *Id.* at 541.
[153] Scott Bice used this phrasing in a conversation.
[154] Richard Pierce, *Is Standing Law or Politics?*, 77 N.C. L. REV. 1741, 1743.
[155] *See, e.g.,* Farina, *supra* note 137, at 20; STRAUSS, *supra* note 138, at 315; Pierce, *supra* note 122, at 94.
[156] Farina, *supra* note 137, at 28.

constitutional limits on standing:[157] then, the political process is telling complainants to look to the courts for redress, while the courts in turn tell them to look to the political process.

The laws governing financial regulation, however, do not in general expand—or restrict—the right to judicial review created by § 702 of the APA.[158] Under the "zone of interest" test, competitors may bring suit when bank regulators permit banks to expand their activities into their territory—and entities like data processors,[159] insurance companies,[160] and mutual funds[161] have done so.[162] While there appear to be no precedents establishing that a private citizen or public interest organization lacks—or has—standing to challenge a bank regulation, this is likely due to the insurmountable difficulty such a plaintiff would face in demonstrating both that the increased risk of financial instability created by faulty regulation constitutes a "particularized injury" going beyond a "generalized grievance" common to the citizenry as a whole and that the injury lies within the zone of interest protected by the regulation.

3. Access to Judicial Review: Finality and Ripeness

Only "final agency action" is subject to review under the APA.[163] The finality of agency action is determined by a two-part test: "the action must mark the consummation

---

[157] *See also* Cass R. Sunstein, *What's Standing after Lujan? Of citizen suits, "injuries," and Article III*, 91 MICH. L. REV. 163 (1992).

[158] Cases such as *Ass'n of Data Processing Serv. Organizations, Inc. v. Camp (ADAPSO)*, 397 U.S. 150, 153–54 & n1 (1970) and *NationsBank of N. Carolina, N.A. v. Variable Annuity Life Ins. Co. (VALIC)*, 513 U.S. 251, 255 (1995), are brought under the APA.

[159] *ADAPSO* at 151.

[160] *VALIC* at 255.

[161] *Inv. Co. Inst. v. Ludwig*, 884 F. Supp. 4 (D.D.C. 1995).

[162] While the dissent in *Nat'l Credit Union Admin. v. First Nat. Bank & Trust Co.*, 522 U.S. 479, 503 (1998) (O'Connor dissent), argued that the decision "all but eviscerates the zone-of-interests requirement," the goal of the majority in this case was only to allow a competitor once again to challenge a financial regulation, *id.* at 493–95 (majority).

[163] APA § 704, 5 U.S.C. § 704.

of the agency's decision-making process" and not be "merely tentative or interlocutory in nature"; and "the action must be one by which rights or obligations have been determined, or from which legal consequences will flow."[164]

Agencies favor the use of interpretive rules, in part because they are not subject to the notice and comment process and thus relatively easy to change; interpretive rules are often described as "non-binding." Thus, agencies typically argue that interpretive rules are not "final agency action" for the purposes of judicial review, because they are subject to change and nothing more than intermediate steps in an on-going process of regulation.

Courts will, however, look at the reality underlying the interpretive rule in question and decide for themselves whether the rule represents the consummation of decision-making and has legal consequences.[165] In *Appalachian Power*, the D.C. Circuit evaluated an EPA guidance document that specified in its text: "The policies set forth in this paper . . . do not represent final agency action and cannot be relied upon to create any [enforceable] rights,"[166] but held that, nonetheless, the document represented a "settled agency policy with legal consequences," and was therefore final agency action.[167] By contrast, EPA letters that reflected "neither a new interpretation nor a new policy" but were part of an "ongoing dialogue initiated by industry" were not reviewable as final agency action.[168]

Even when an interpretive rule represents final agency action, courts may find that the rule is not "ripe" for judicial review—although the two doctrines are not always

---

[164] Bennett v. Spear, 520 US 154, 178 (1997). [internal citations omitted]

[165] As the APA is a statute of general applicability, agencies are not entitled to deference in their interpretation of its terms. *See, e.g.,* Metro. Stevedore Co. v. Rambo, 521 U.S. 121, 137 n9 (1997).

[166] *See, e.g.,* Appalachian Power Co. v. E.P.A., 208 F.3d 1015, 1023 (D.C. Cir. 2000).

[167] *Id.*

[168] Gen. Motors Corp. v. E.P.A., 363 F.3d 442, 449-50 (D.C. Cir. 2004).

distinct. The test for ripeness balances the "fitness of the issues for judicial decision" with the hardship to the parties of withholding court consideration."[169] Final agency actions were not ripe for review when "judicial intervention would inappropriately interfere with further administrative action" and "courts would benefit from further factual development of the issues presented."[170] Thus, agencies may argue that an interpretive rule is not ripe for review, because the court will have better evidence on which to base a decision when the plaintiff brings a challenge after there has been an agency enforcement action.[171]

C. Judicial Review and Financial Regulation

Interpretive rules pose difficulties even for regulated parties that seek to have them reviewed, because the agency may persuade the court that the rulemaking process is incomplete and that the record for the court will be much more suitable for review after the agency has actively applied the rule. Furthermore, if the rule interprets an agency regulation, it will typically be difficult for any challenger to meet the *Auer* standard for invalidating it.

Beneficiaries of regulatory statutes face the greatest obstacles when they seek judicial review, however, because the standing doctrine only limits the access of beneficiaries to the courts. In the area of financial regulation, this limitation is aggravated by the fact that the regulatory statutes themselves do not grant standing to citizens in general, so the only source of standing is the APA. Under the "zone of interests" test, the

---

[169] Abbott Laboratories v. Gardner, 387 U.S. 136, 149 (1967) abrogated by Califano v. Sanders, 430 U.S. 99 (1977).

[170] Ohio Forestry Ass'n, Inc. v. Sierra Club, 523 U.S. 726, 733, 735-36 (1998). *See also* Toilet Goods Ass'n, Inc. v. Gardner, 387 U.S. 158, 164 (1967).

[171] *See, e.g., Appalachian Power* at 1023 n.18; *Gen. Motors Corp. v. E.P.A.* at 448.

competitors of regulated financial institutions have been found to have standing, but others have not.[172]

When the limitations on review created by the use of interpretative rules are combined with the restrictions on citizen lawsuits, financial regulatory agencies are able to act in confident certainty that many of their deregulatory actions will not be challenged. Richard Pierce explained the problem clearly—although he was not discussing financial regulation where restrictive standing is effectively the law: "Restrictive standing . . . would deossify rulemaking primarily by creating a legal environment in which agencies have *de facto* discretion to issue rules that violate statutes and the Constitution because they can predict with confidence that their rules will never be subject to judicial review of any scope at any time. . . . [This solution] would induce agencies to resolve most controversial issues in favor of regulatees."[173]

Congress could, of course, intervene, exercising its authority to oversee agencies, when they fail to balance the interests of regulatees with the public. But, Congress has typically delegated authority to the agencies in order to allow individuals with expertise in highly specialized areas of regulation to make decisions, because it is impractical for Congress to attempt to micro-manage these decisions. Thus, it will often be left to the courts to ensure that agency actions are designed to implement the statutes that Congress has passed.

The two examples in Part II demonstrate that the courts often don't get the opportunity to review deregulatory agency actions. In the case of asset-backed commercial paper, the joint bank regulators dismantled a regulation—apparently because

---

[172] *See supra* text accompanying notes 158–162.
[173] Pierce, *supra* note 122, at 94.

its anticipated effectiveness generated opposition from the banks. In the case of "the business of banking," the OCC was able to use a seriously flawed reasoning process to authorize banks to hold and trade derivatives and equities. These two cases demonstrate that the effect of restrictive standing is not merely a theoretic issue, but has immensely important practical consequences.

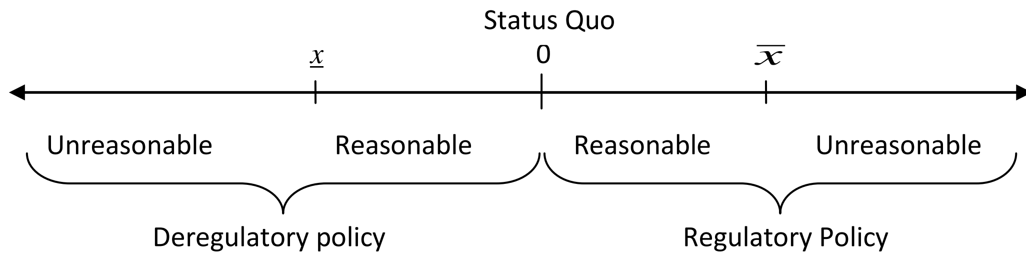
IV. MODEL OF FINANCIAL REGULATION

A spatial model of financial regulation illustrates the important role played in the regulatory process by "private attorney generals" and renders the discussion of the interaction of the various participants in the regulatory process more precise.[174] In particular, the model demonstrates that bias is the anticipated consequence of asymmetry in access to the courts that favors regulatees over the beneficiaries of a statute. Not only does the model focus attention on the key aspects of the problem, but it also establishes the essential elements of a solution to the problem. In this part of the paper, the framework of the model is described and its results are explored using diagrams. The formal details of the model are presented in the appendix.

Only two dimensions of decision-making are considered here: the principal dimension spans regulation and deregulation, and the secondary dimension is the choice of implementing tool: regulation or interpretive rule. Regulated parties, who strictly prefer deregulation, interact with agencies, who may favor any policy along the regulatory continuum, courts, who not only have a preferred policy but also value the rule of law, and the public, which may challenge deregulatory policies. An extension to the

[174] The model was inspired by Emerson H. Tiller & Pablo T. Spiller, *Strategic Instruments: Legal Structure and Political Games in Administrative Law*, 15 J.L. ECON. & ORG. 349 (1999).

Figure 3: The Policy Space



model evaluates the consequences of allowing regulatees to request policies if they pay the agency's costs.

The possible policies are depicted in Figure 3, where the status quo is located at zero. Policies may be regulatory—to the right of zero—or deregulatory—to the left of zero. Possible policies may be reasonable interpretations of existing law or may be unreasonable interpretations. Those policies that are reasonable interpretations of existing law lie between $\underline{x}$ and $\overline{x}$. I assume that the status quo is a reasonable interpretation of existing law.

Policies may be implemented using either regulations or interpretive rules. These two tools for policy-making are differentiated by the cost to the agency, and they may be distinguished by the ability of the public to challenge them.[175]

Agencies have a preferred policy, *A*, and favor policies that are closer to *A* to those that are farther from *A*. Implementing policies is costly, and the costs of promulgating a regulation, k_{reg}, are greater than the costs of implementing an interpretive rule, k_{int}.

---

[175] Because the practical application of *Chevron* deference involves a range of deference, *see supra* text accompanying note 126, the model does not assume a clear difference between *Skidmore* and *Chevron* deference, but instead allows for the possibility that they are similar standards.

Regulatees always prefer deregulatory policies to policies that are more regulatory by comparison. Regulatees can also bring a challenge to any agency policy in court.[176]

Like agencies, courts have a preferred policy, *C*. Courts, however, also value the rule of law. Thus a court will strike down an unreasonable interpretation of the law, whether or not the interpretation advances the court's preferred policy. In addition, courts may be deferential to agency policies.

Judicial deference may take the form of either strong deference or weak deference. Strong deference takes place when the courts always find ambiguity in the statute and thus uphold any agency policy that is a reasonable interpretation of existing law. Weak deference assumes that courts only find ambiguity in the statute if they want to uphold the agency policy. Under weak deference, courts will uphold only reasonable agency policies that are closer to their preferred policy than the status quo.

By considering the two extremes of judicial deference, the model defines the boundaries within which any policy of judicial deference to the reasonableness of agency decision-making will be contained. Thus, both *Chevron* and *Skidmore* deference will lie within the boundaries defined by the model.[177]

Courts review only those agency policies that face a permitted challenge from regulatees or beneficiaries. They decide whether to uphold the agency policy or declare it invalid, reinstituting the status quo. All challenges by regulatees are permitted,[178] but beneficiary challenges will be evaluated under three different regimes: all beneficiary

---

[176] This is a simplification as the challenges of regulated parties are sometimes rejected when the agency action is deemed not final or unripe. These bases for denying review, however, generally only delay review rather than denying it entirely. Thus, the model makes the simplifying assumption that regulatees can always challenge agency policies.

[177] Because *Auer* deference is based on a "clearly erroneous" standard, it is not captured here.

[178] *See supra* text accompanying notes 138–139.

challenges are permitted, all beneficiary challenges are not permitted, only beneficiary challenges of regulations are permitted.

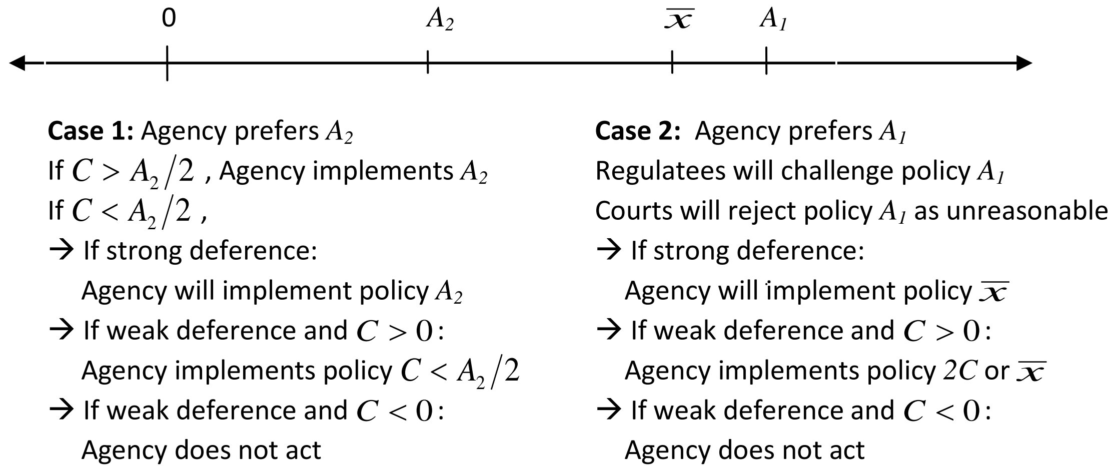
The model assumes that the beneficiaries of financial regulatory statutes—or the public in the form of public interest organizations—will always challenge deregulatory policies, if the courts will permit them to do so. This assumption makes it harder to find deregulatory bias, and thus serves to demonstrate the robustness of the model's results by showing that when beneficiaries have access to the courts equal to that of regulatees the most they can do is offset the influence of regulatees on policy.

This model demonstrates that agencies cannot implement unreasonable regulatory policies, because they will be challenged by regulatees and the courts will invalidate them. It also indicates that an agency with a regulatory bias will only succeed in increasing regulation in an environment with either strong deference or courts that also have a regulatory bias. In the former case, the courts defer to the agency's policy and in the latter the agency will choose to promulgate a regulatory policy that the courts will uphold. Figure 4 depicts these results. The proof of proposition one is in the appendix.

Proposition 1*: Unreasonable regulatory policies cannot be implemented. An agency with a regulatory bias will only succeed in increasing the level of regulation if either there is strong deference or there is weak deference and the courts also have a regulatory bias.*

By contrast, the model also indicates that agencies can implement deregulatory policies that are not reasonable interpretations of existing law, if the public does not have the right to challenge agency actions, or if that right is limited to challenging agency regulations. When the public cannot challenge agency actions, deregulatory actions are

Figure 4: Results—Regulatory Policy (assuming k_{int} not too high)

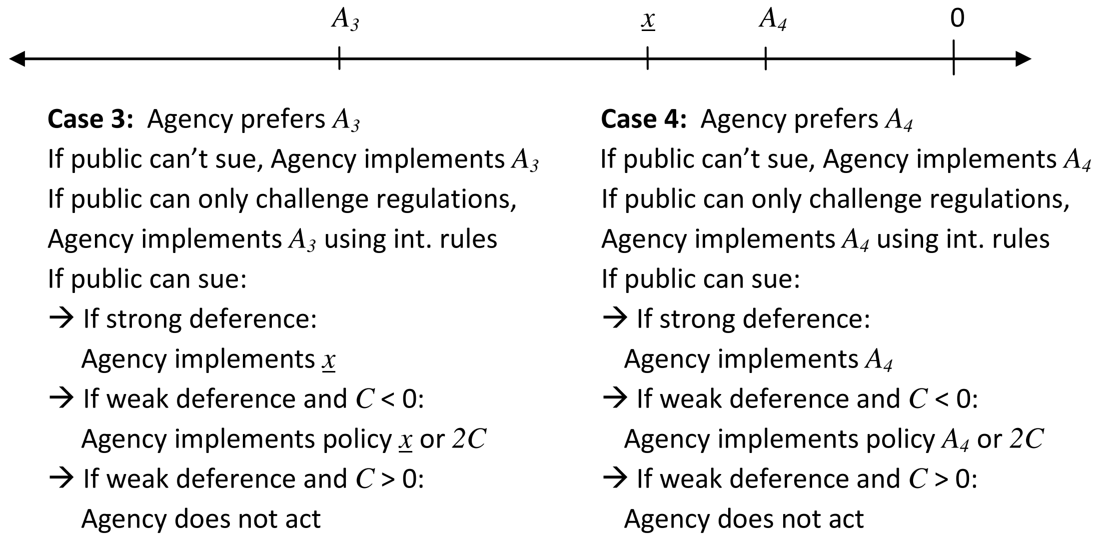


never subject to judicial review. Safe in the knowledge that there is no possibility of judicial review, the agency can implement its preferred policy even if that policy is not consistent with the statute. Similarly, when the public can challenge only regulations, the agency can implement its preferred policy using interpretive rules without worrying about the possibility of invalidation by the courts. These results are depicted in Figure 5 and proved in the appendix.

Proposition 2*: When the agency has a deregulatory bias, the result will depend on the public's ability to challenge the agency's actions in court:*

- *If the public can challenge none of the agency's actions, there are no constraints on the extent of deregulation and regulations that violate statutes may be implemented.*
- *If the public can challenge all of the agency's actions, the courts will ensure that agency policy does not violate statutes.*
- *If the public can only challenge regulations, but not interpretive rules, then the agency will use interpretive rules to avoid any constraints on its actions.*

Figure 5: Results—Deregulatory policy (assuming k_{int} not too high)



Extension: Assume that regulatees can request a policy interpretation, if they pay the costs of the agency in evaluating it, and that agencies may then choose to grant the request, implementing the policy as an interpretive rule at no net cost to the agency. Although the agency's cost expenditures of policymaking will fall, the agency will gain no advantage, because the costs will be offset by the regulatee's choice of a more deregulatory policy than the agency itself would have chosen.[179]

This extension illustrates that one of the consequences of permitting regulatees to request private letter rulings is to facilitate more deregulatory policy than would be implemented in the absence of a policy of considering private letter rulings for a fee.

This model demonstrates that unequal access to the courts results in a structural bias with the result that regulation favors regulated parties. Offsetting this structural bias would require granting beneficiaries access to the courts equal to that of regulated parties.

---

[179] This result is demonstrated in proposition 3 in the appendix.

Because the assumption that beneficiaries will always challenge deregulatory policy is unlikely to be the practical result of granting judicial access, it is possible that additional measures will be needed to offset the deregulatory bias in regulation. These will be explored below.

V. APPLICATION: THE DEREGULATORY EXAMPLES IN LIGHT OF THE LAW AND THE MODEL

A. The August 2005 ABCP Guidance Almost Certainly Fails *Auer* Review

In the example of ABCP, we have an interpretive rule that interprets a regulation, not a statute. For this reason, it is entitled to *Auer*'s stringent standard of review. Thus, even if the courts permitted beneficiaries to bring suit, it is possible that the rule would be upheld by the courts. On the other hand, the evidence that the rule is "inconsistent with the regulation" is extremely strong.

As discussed above, the interpretive rule implements a policy that was considered and rejected during the process of drafting the final regulation.[180] The rule "will deem an ABCP liquidity facility to be in compliance with the requirement for an asset quality test" even if the explicit requirements laid out in the final regulation are not met.[181] A stronger example of a rule that is inconsistent with the regulation that it interprets is, thus, hard to imagine.

In addition, while inconsistency is not a principal focus of courts when reviewing agency actions, agencies are required to adequately explain a change in policy or the action may be invalidated as arbitrary and capricious.[182] Here, the agency issued a 36-

---

[180] *See supra* text accompanying notes 49–50.
[181] *See supra* text accompanying notes 44–45.
[182] *See supra* text accompanying note 132.

page guidance document interpreting the regulation in March 2005, only to approve a different industry-proposed[183] reinterpretation of the regulation in an August 2005, 3-page guidance document with little if any explanation of the reasoning behind the change.[184]

In short the August 2005 ABCP guidance document is an excellent candidate for a strongly-worded rebuke from a judge. Most likely, however, as indicated by the model above, the agencies were willing to issue the document in part because they were confident that no judge would ever have the opportunity to review it.

B. The OCC Analytic Process that Authorized Derivatives Trading Exceeds Reasonable Bounds

The OCC's ever broader interpretation of "the business of banking" demonstrates that a reasonableness standard will only function as a limitation on an agency's authority if the agency's actions are subject to judicial review on a regular basis. In 1988, the mutual fund industry lost its challenge to commodity- and equity-linked deposit accounts offered by banks, before a court that deferred to the OCC's authority under *Chevron*.[185] In subsequent interpretations—each of which was requested by a regulatee—the OCC found that, because banks were already authorized to manage commodity and equity risk, they could engage in a wide variety of commodity and stock transactions, including storing commodities. These decisions were never subject to review by the courts. In a 1995 case challenging the sale of annuities by banks, the Supreme Court held that the

---

[183] *See Fitch*, *supra* note 41 ("Whether this interpretation will be accepted by the regulators still remains to be seen . . .").

[184] *See supra* text accompanying notes 45–47.

[185] Note that this decision took place in the period between *Chevron* and *Mead*, during which it was unclear whether *Chevron* applied to interpretive rules—and many courts assumed that *Chevron* did apply. *See supra* note 127.

OCC had the authority to authorize banking activities beyond those enumerated in the National Banking Act "within reasonable bounds."[186] This decision was specific to the facts of the case and cannot be read as judicial approval of commodity and stock transactions as "the business of banking."

The issue raised by the OCC's actions is whether it is reasonable to approve the management of commodity and stock risk, because that risk is incidental to the payment of returns on a deposit account, and then use the fact that deposit-related commodity and stock risk has been approved to approve the management of commodity and stock risk that has no relationship to deposit taking. The D.C. Circuit implied a negative answer to this question when it held that repeated use of the "logical outgrowth" test exceeds the limits of what is reasonable, because it permits national banks "to constantly expand their field of operations on an incremental basis without congressional action" and provides "no logical stopping point" to permitted banking activities.[187] While the analytic process that the D.C. Circuit rejected in its decision was precisely the same as that used by the OCC to authorize commodity and stock trading, the decision itself was specific to bank sales of crop insurance and thus does not have a direct binding effect on other bank activities authorized by the OCC—unless and until a party with standing challenges the OCC's actions in court.

In short, the courts imposed a reasonableness standard on the OCC, but in the absence of judicial review that standard failed to impose any constraints on the agency's actions. Other than commodity and stock brokerage firms, it is likely that non-regulated parties who sought to challenge the OCC's decisions would have lacked the standing to

---

[186] NationsBank of N. Carolina, N.A. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 258 (1995).
[187] Independent Ins. Agents of America v. Hawke, 211 F.3d 638, 645 (D.C. Cir., 2000).

do so. The brokerage firms, on the other hand, were heavily dependent on bank loans to fund their activities,[188] so it is likely that none was willing to bear the costs of challenging the expansion of the banks' activities. Furthermore, even the commodity and stock brokerage firms might not have had standing as competitors, since many of these decisions affected a new type of financial contract, i.e. a swap contract, that may not at that time have been a product that these firms traded regularly.

VI. RECOMMENDATIONS

The model of decision-making presented above demonstrates the crucial role played by the courts in restraining agencies from exceeding the authority delegated to them by statute. In the area of financial regulation, however, regulated parties have relatively easy access to the courts, whereas the beneficiaries of the regulation do not. For this reason, the regulatory actions of financial regulators are constrained, but their deregulatory actions often are not, as illustrated in the examples above.

One solution might be to impose even more notice-and-comment requirements on the financial regulatory agencies and to limit their use of interpretive rules, in order to ensure that the public is informed about the agencies' actions and that policies like the reinterpretation of the "business of banking" are subject to a public comment process. This solution, while superficially modest, would result in a heavy burden on agencies, because interpretive rulemaking is an unavoidable part of the regulatory process: agencies have too many decisions to make to enforce a requirement that they follow a notice-and-comment process for the majority of them. Increasing procedural

---

[188] This dependence was illustrated in the 1987 stock market crash when the banks were pulling the brokerage firms' credit lines and the Chicago Mercantile Exchange was saved from failure by a last minute extension of credit from the banks. See DONALD MACKENZIE, AN ENGINE NOT A CAMERA 1–4 (2006).

requirements would make the "ossification" problem worse and increase even further the incentive for agencies to find ways to evade these requirements. Furthermore, courts already evaluate interpretive rules to determine whether they constitute "new rules" and must be issued using notice-and-comment.[189] The procedural burdens on agencies are, thus, sufficiently heavy, and solutions will have to address the problem that some rules are, as a practical matter, not subject to judicial review at all.

The most direct solution to this problem is to provide equal access to the courts by expanding standing to include beneficiaries. Because the expansion of standing doctrine requires the cooperation of the Supreme Court and it is unclear that the public will challenge enough deregulatory policies to offset the deregulatory bias in regulation, I also propose creating a division of the Consumer Financial Protection Bureau ("CFPB") that is dedicated to opposing the policy proposals made by regulated parties to financial regulatory agencies. The first recommendation is explained below in subpart A and the second in subpart B.

A. Expansion of Standing

In the area of financial regulation, expanding access to the courts will require both legislative and judicial action. Standing clauses will need to be added to the financial regulatory statutes, establishing clearly the intent of Congress to allow citizen suits, and courts will have to move away from the restrictive approach to constitutional standing that is sometimes embraced by the Supreme Court.

Under current financial law when a non-regulatee challenges an agency action, standing comes from § 702 of the APA, so the plaintiff's interest in the case must lie

---

[189] *See supra* note 119 and accompanying text.

within the "zone of interest" protected by the statute governing the agency action. While a broad interpretation of this test could permit citizen lawsuits against agencies, current case law often supports a narrower view of the test.[190] Thus, amending each financial regulatory statute to expressly permit citizen suits against the relevant agency will clarify congressional intent and the statutory foundation for standing. Such provisions for citizen suits are already familiar ground for the courts, because they are common to almost all environmental statutes.[191] These provisions alleviate many of the judicial system's separation of powers concerns by making it clear that, if the Executive is not carrying out the congressional delegation, Congress has explicitly authorized the courts to act.

Nevertheless, the denial of standing to those who bring only a "generalized grievance," common to the public at large, has at times been held to have constitutional foundations and been used to deny standing even where a contrary congressional intent was clear.[192] The faults of this doctrine are illuminated by the substantial evidence presented here that such a "restrictive standing" approach is incompatible with effective congressional delegation of authority to agencies because it introduces a strong deregulatory bias into every such delegation. Thus, I second Richard Murphy's recent call to allow what he terms "public actions" and to achieve the separation of judicial and political power by using a rule of deference rather than "constitutional standing's categorical rule of access"[193]:

---

[190] *See supra* note 137 and accompanying text.

[191] Sunstein, *supra* note 157, at 165 n.11. *See also supra* note 142.

[192] *See, e.g.,* Lujan v. Defenders of Wildlife, 504 U.S. 555, 573–74 (1992).

[193] Richard Murphy, *Abandoning Standing: Trading a Rule of Access for a Rule of Deference*, 60 ADMIN. L. REV. 943, 980 (2008). Murphy's proposal in fact restates a proposal made by Louis Jaffe fifty years ago. *See* Louis L. Jaffe, *Standing to Secure Judicial Review: Private Actions*, 74 HARV. L. REV. 1265, 1305-06 (1961); Louis L. Jaffe, *Standing to Secure Judicial Review: Private Actions*, 75 Harv. L. Rev. 255, 304-5 (1961).

> Federal courts can, consistent with Article III limitations, resolve public actions, but in doing so, they should uphold the legality of actions taken by political branch officials so long as these actions fall within the space where reasonable jurists could conclude they are legal. More specifically, in the public-action context, a court should uphold an agency's action so long as it comports with a reasonable construction of relevant law (constitutional, statutory, or regulatory) and is based on reasonable factual and policy determinations.[194]

Observe that the benefits of expanding standing to include citizen suits will not be measured by the number of citizen suits that challenge financial regulatory action. Even a small number of suits may act as a significant deterrent to agency overreaching with the result that the threat of such suits alone may be sufficient to constrain regulators' behavior within reasonable bounds.

Critics of this proposal will undoubtedly argue that these benefits will be offset by the excessive burden on both the courts and the agencies created by expanding standing. This argument, however, ignores the fact that both agencies and courts already face a significant burden due to challenges from regulated parties[195]—and that in the absence of a revision of standing doctrine, this burden is very one-sided and forces agencies to be biased against regulation. While expanding standing will increase the caseload faced by courts and agencies, dealing with this burden is essential to maintaining the integrity of the regulatory process.

The more significant concern is that expanding statutory standing will be insufficient to address the problem of regulatory bias, either because the Supreme Court

---

[194] Murphy, *supra* note 193, at 980-81.
[195] *See supra* text accompanying notes 6–10.

denies standing to beneficiaries on constitutional grounds or because too few cases are brought and the deterrent effect on regulator behavior is insufficient. To address this concern I propose creating a division of the CFPB that is dedicated to opposing policies proposed by regulated parties.

B. CFPB Division Dedicated to Opposing Regulatee Proposals

To offset the structural bias in favor of deregulation, it may be necessary to ensure that some of the resources available to financial regulatory agencies are explicitly devoted to challenging the interests of regulated parties. I propose that a division of the CFPB be established that is tasked with drafting documents opposing regulatee requests for private letter rulings or other interpretative rules.

The role played by the CFPB in this proposal is similar to that of state-authorized consumer advocates, whose mission is to represent and advocate for the consumer in actions determining utility rates and regulations. Almost every state has established an office of ratepayer or consumer advocacy[196]—indicating that states have found it necessary to maintain an office dedicated to representing the public interest when regulating a large and influential industry. This article has demonstrated that there is a similar need for consumer advocacy in the federal regulation of financial institutions.

Because of the broad range of financial regulation and vast number of regulatory actions that would fall within the purview of this new division of the CFPB, the financial regulatory agencies should be strongly encouraged to request a brief from the CFPB whenever it is clear that the interpretive rule under consideration will have far-reaching

---

[196] For the list of members of the National Association of State Utility Consumer Advocates, see NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES, *Member Directory*, http://www.nasuca.org/archive/about/membdir.php (last visited Mar. 5, 2012).

or otherwise significant consequences. The CFPB should also be authorized to act independently and to intervene proactively on behalf of consumers in any financial regulatory action that, in its discretion, merits the division's time.

Both the August 2005 ABCP guidance and the OCC private letter rulings were issued at the request of regulatees, and both give the appearance of a failure to weigh carefully the potential of these decisions to result in adverse consequences. For this reason, agencies would be well served if they had a resource to which they could turn that specialized in seeking out such consequences and presenting them to decision makers. Observe, however, that such a division might not affect agency decision-making in situations like the ABCP case, where the agencies chose to reject their own thorough analysis; it is likely to improve decision-making only in situations like the OCC case, where the agency appears to have failed to analyze the potential for adverse consequences from implementing the rule.

While setting up such a division of the CFPB could potentially be expensive, these costs can be defrayed by creating a fee structure such that the agencies charge regulatees for evaluating their rule proposals and these fees are used to finance the costs of the CFPB division.[197]

Creating a CFPB division that is the "go to" source for legal advocacy of consumer protection and a conservative approach to the "safety and soundness" of the financial system could greatly improve the quality of financial regulatory policy by ensuring that arguments not supported by regulatees see the light of day. This would

---

[197] For example, the Internal Revenue Service charges fees for its private letter rulings. The 2011 fee schedule was published in: Internal Revenue Bulletin 2011-1, January 3, 2011, Appendix A: Schedule of User Fees, *available at* http://www.irs.gov/irb/2011-01_IRB/apa.html#d0e4864

make it easier for regulators to weigh all the evidence and come to a balanced decision on regulatory issues and harder for them to choose not to address the potentially adverse consequences of their actions.

VII. CONCLUSION

This paper establishes that a deregulatory bias is structured into the modern financial regulatory system due to the asymmetric access of regulated parties and beneficiaries to the courts. The examples given demonstrate the extremely high costs created by a system where deregulatory agency action is not held to a reasonableness standard, but instead agencies are able to violate statutes and their own regulations at will, confident that their actions will never be reviewed by a court. These examples also raise the possibility that this deregulatory bias is an important contributing cause of our recent financial troubles.

The essential elements creating this structural deregulatory bias are detailed precisely in a model, which demonstrates that expanding standing to include the beneficiaries of financial regulatory statutes can, at best, offset the current deregulatory bias. Because, even in an environment with standing, there may be a deficit of citizen suits, I propose that a division of the CFPB be created and given the mission of opposing the policy proposals of regulated parties. These measures are necessary to offset the structural deregulatory bias inherent in the current system of financial regulation.

APPENDIX: MATHEMATICAL MODEL

A. Policy Space

The policy space has two dimensions: A policy is a pair (x, y) such that $x \in \mathbb{R}$, is a point on the real line, where $x = 0$ is the status quo, $x < 0$ is deregulatory policy and $x > 0$

is regulatory policy, and $y \in \{Reg, Int\}$ where *Reg* represents a notice-and-comment regulation and *Int* represents an interpretative rule.

The real line is divided into three segments $(-\infty,\underline{x}),[\underline{x},\overline{x}],(\overline{x},\infty)$, where the two segments of infinite length represent policies that are not a reasonable interpretations of existing law.

Assumption 1*: The status quo is a reasonable interpretation of existing law or* $\underline{x} \leq 0 \leq \overline{x}$.

B. Utility

Regulated parties have utility over the *x* dimension of the policy space only and their utility is strictly decreasing in *x*: $U_R(x) = -\alpha_R x$.

Agencies have utility over the *x* dimension of the policy space only and a preferred policy, $A \in \mathbb{R}$. Their utility is given by $U_A(x) = -\alpha_A|A-x|$

Courts have a preferred policy, $C \in \mathbb{R}$, but (i) also value the rule of law and (ii) may be deferential to agency policies.

Under weak deference the courts' utility is given by:

$$U_C(x,y) = \begin{cases} -\alpha_C\,|C-x| & \text{if } x \in [\underline{x},\overline{x}] \\ -\alpha_C\,|x| & \text{otherwise} \end{cases}$$

The second part of the utility function indicates that courts value the rule of law, because they will strike down an unreasonable interpretation of the law, whether or not the interpretation advances their own preferred policy.

Under strong deference courts receive a utility of 0, the maximum utility, only when they defer to any reasonable policy, $x \in [\underline{x},\overline{x}]$, by upholding the policy and reject

any unreasonable policy, $x \notin [\underline{x}, \overline{x}]$, by striking it down. Under strong deference, in any other circumstance courts receive a utility of $-\infty$.

The parameters in the utility functions are always positive: $\alpha_i \in (0,\infty)$ for $i = R, A, C$.

C. Actions

First, agencies can issue policies at cost, $k_y > 0$, where $k_{Reg} > k_{Int}$. Assumption 2 restricts the analysis to the interesting cases:

Assumption 2: *The value of agency action always exceeds the cost of implementation or* $k_{reg} < \alpha_A A$, $k_{reg} < \alpha_A \overline{x}$ *and* $k_{reg} < -\alpha_A \underline{x}$.

Second, regulated parties can challenge policies of both types, $y \in \{Reg, Int\}$ at no cost.

Third, the public can challenge policies of both types, $y \in \{Reg, Int\}$ at no cost. I assume that the public challenges all deregulatory actions.

Finally, the court may or may not review the policy based on the following criteria. When a court reviews a policy, it chooses between the policy and the status quo, and incurs no cost. In order for a court to review a policy it must be challenged. Courts review any policy that is challenged by a regulated party. When a policy is challenged by the public, three different regimes will be considered:

Courts review all challenges by the public;

Courts review no challenges by the public;

Courts review only challenges by the public of regulations.

If the court does not review the policy, then the policy remains in force.

D. Analysis

When the Agency has a deregulatory bias and courts will hear a public challenge, under strong deference, the Agency implements $\underline{x}$ if $A < \underline{x}$, and A if $A \geq \underline{x}$. Under weak deference: when $C \leq A/2$, the court prefers A to the status quo, so the Agency implements $\underline{x}$ if $A < \underline{x}$, and A if $A \geq \underline{x}$; when $C > A/2$, the court will not uphold A, so the Agency implements $\underline{x}$ if $2C < \underline{x}$, and $2C$ if $2C \geq \underline{x}$ and $k_{int} < -\alpha_A 2C$. When $k_{int}/\alpha_A < -2C < -A$, the costs of rulemaking exceed the benefits and the Agency does not act.

The case where the Agency has a regulatory bias and any action is challenged by regulatees is symmetric to the preceding analysis. The cases where the public cannot challenge the Agency action and where the public can only challenge regulations are analyzed in the proof of Proposition 2.

E. Proofs

Proposition 1a*: Unreasonable regulatory policies cannot be implemented.*

Proof: Assume agency implements $A > \overline{x}$. Regulatees challenge, because it is a regulatory policy. Because $A > \overline{x}$, the court strictly prefers the status quo (whether the court is strongly or weakly deferential) and strikes the policy down. Conclusion: unreasonable regulatory policies cannot be implemented.■

Proposition 1b*: An agency with a regulatory bias will only succeed in increasing the level of regulation if either there is strong deference or there is weak deference and the courts also have a regulatory bias.*

Proof: Assume the agency has a regulatory bias, $A > 0$.

Case 1: Strong deference

Because the Agency knows that the court will defer to its policy as long as the policy is

less than $\overline{x}$, the Agency maximizes utility by implementing $\underline{x}$ if $A < \overline{x}$, and implementing $\overline{x}$ if $A \geq \overline{x}$.

Case 2: Weak deference

If $C \leq 0$, the court prefers the status quo to any regulatory agency policy, so the court will invalidate any regulatory agency policy, when it is challenged by the regulatee.

Conclusion: a regulatory agency policy will only be upheld if the court has a regulatory bias. ■

Proposition 2*: When the agency has a deregulatory bias, the result will depend on the public's ability to challenge the agency's actions in court:*

If the public can challenge none of the agency's actions, there are no constraints on the extent of deregulation and regulations that violate statutes may be implemented.

If the public can challenge all of the agency's actions, the courts will ensure that agency policy does not violate statutes.

If the public can only challenge regulations, but not interpretive rules, then the agency will use interpretive rules to avoid any constraints on its actions.

Proof:

Case 1: No public challenge. A deregulatory policy will never be reviewed by the courts, because the regulatees don't want to challenge it and the public cannot. Therefore the Agency implements policy A and it is not invalidated.

Case 2: The public challenges all deregulatory actions. Because all deregulatory actions will be challenged, and the courts will not uphold a deregulatory policy that is

less than $\underline{x}$, the Agency will choose not to propose a policy that is less than $\underline{x}$.

(The analysis is now symmetric to that in Proposition 1.)

Case 3: Since the Agency can avoid judicial review by using interpretive rules (and this is the cheaper tool anyhow), the Agency's utility is maximized by implementing A using interpretive rules. ■

Proposition 3: *When regulatees can request a policy interpretation and pay the agency's costs, regulatees will only request policies from agencies with a deregulatory bias and policy will be more deregulatory than if this option for regulatees did not exist.*

Add to the beginning of the sequence of actions above:

First, regulated parties can request a policy interpretation, (x, Int), at a cost k_{Int}.

Second, agencies can grant the policy requested by regulated parties at no net cost to the agency, because the regulated party bears the cost.

Third, the agency can implement its own policy at its own cost, if it rejects the regulated party's policy.

Proof: An agency with a regulatory bias will never grant a deregulatory policy request, so such requests will only be made of agencies with a deregulatory bias. When $A < \underline{x}$ or $A < 2C$, the Agency will implement the most deregulatory policy that courts will uphold on its own, so the regulatee will not be willing to bear the Agency's costs. Thus, consider the case where $\underline{x} < 2C < A < 0$, and where $k_{int} < 2C - A$. If the Agency pays to implement the policy, the Agency's utility is $-k_{int}$. The regulatee will now propose a policy that maximizes regulatee utility by proposing a policy that is as deregulatory as possible, subject to the constraint that the Agency does not reject it. This policy is $A - k_{int}$.

Conclusion: the policy proposed by the regulatee will be more deregulatory than if this option did not exist. ■