

VIRGINIA LAW REVIEW ONLINE

VOLUME 104

JUNE 2018

101–117

ESSAY

REGULATION AND DEREGULATION: THE BASELINE CHALLENGE

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INTRODUCTION

What does it mean to deregulate? Is deregulation just about the repeal of existing rules? In a closed and static system, this definition seems apt. But what if the bounds are porous? Or the internal workings of the system are dynamic? Once a system is structured to allow the option set to change, do the proscriptions embedded in law at Time A remain the appropriate baseline? Or should the baseline evolve, recreating the balance struck at Time A given the option set that exists at Time B? What if the reasons for the balance struck at Time A are myriad, and drawing a line at Time B requires some values to be sacrificed to protect others? What if jurisdictional or other logistical challenges preclude replicating Time A's line at Time B? Is the expectation of such challenges a reason to limit dynamism? Should it matter whether the innovations underlying the dynamism enhance welfare in ways unrelated to the regulatory regime?

These questions are core to Professor Paul Mahoney's thoughtful critique of the deregulation hypothesis, that is, the claim that the 2007–2009 financial crisis was a byproduct of deregulation in the period leading up to it.¹ They also illuminate why the debate over the

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¹ Paul G. Mahoney, Deregulation and the Subprime Crisis, 104 Va. L. Rev. 233, 236 (2018).

deregulation hypothesis remains important. The issue is not just about allocating blame for a crisis that erupted a decade ago, though there is plenty of that in these discussions. Nor can the conflicting views on the deregulation hypothesis be reduced to one's priors about whether the government or the market is to blame when things go wrong, though these predispositions too trickle in. Rather, the important and contested question at the core of the ongoing debate about the role of deregulation in contributing to the financial crisis is what it means to regulate.

Advocates of the deregulation hypothesis typically highlight the ways that finance changed in the decades leading up to the crisis. Gone, or at least radically diminished, are the small, boring banks that dominated the U.S. landscape for most of the twentieth century. The three decades leading up to the crisis witnessed a dramatic rise in the concentration of banking assets among a small number of ever larger and more complex banking organizations.² At the same time, thanks to the rise of securitization and derivatives, financial instruments and the markets in which they traded became increasingly complex, interconnected, and opaque.

Prominent legal academics, like Professors Lynn Stout and Arthur Wilmarth, and economists, like Professors Simon Johnson and Joe Stiglitz, view these changes as central to the crisis and as byproducts, at least in part, of deregulatory maneuvers in the decades before the crisis.³ Mahoney's rebuttal does not deny these radical changes, but rather emphasizes that many of these developments, and the dramatic increase in the issuance of subprime mortgages, would likely have occurred even without Congress smoothing the way for commercial banks to engage in investment banking and for derivatives to spread unregulated.⁴ His account instead places the emphasis on innovation, spurred by macroeconomic developments that undermined the viability of the small commercial banks and thrifts, in contributing to these changes.⁵

² Jeffrey N. Gordon & Kathryn Judge, *The Origins of a Capital Market Union in the United States* 9 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 584, 2018), <https://perma.cc/8EZS-LZM6>.

³ See, e.g., Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 *Harv. Bus. L. Rev.* 1, 1–5 (2011); Arthur E. Wilmarth, Jr., *The Road to Repeal of the Glass-Steagall Act*, 17 *Wake Forest J. Bus. & Intell. Prop. L.* 441, 444 (2017); Simon Johnson, *The Quiet Coup*, *The Atlantic* (May 2009), <https://perma.cc/YEE3-3W67>; Joseph E. Stiglitz, *Capitalist Fools*, *Vanity Fair Hive* (Dec. 9, 2008), <https://perma.cc/QEN3-UKKV>.

⁴ Mahoney, *supra* note 1, at 236–37.

⁵ *Id.* at 286–89.

The two sides in this debate are thus effectively talking past each other. Mahoney shows that subprime lending and securitization were already allowed;⁶ defenders of the deregulation hypothesis argue that the expansion of banks into trading and other investment banking activities fundamentally altered their risk appetites and culture in ways that were critical to the excesses that followed.⁷ Mahoney focuses on the state of the law just before Congress adopted the two critical acts;⁸ deregulation's critics view these acts of Congress as emblematic of an overall deregulatory posture that also pervaded regulators and courts, and thus degraded the law even before Congress intervened.⁹ He argues that competitive pressures from new innovations and high inflation undermined the viability of the old model of banking;¹⁰ they view the decision to allow such innovation as further evidence of an overall deregulatory stance and a failure to fully enforce the spirit of laws meant to keep banking boring.¹¹

The difficult truth is that both sides are right. Mahoney's core contribution is to reveal the danger of nostalgia. Finance, at least in the United States, has long been dynamic, responsive to regulation and macroeconomic developments alike. The stability the United States enjoyed for much of the twentieth century was due both to repressive regulation and a favorable macroeconomic climate. Reinstating the former would not necessarily bring about the latter, and might well just invite greater gamesmanship. We forget this at our peril.

At the same time, critics of deregulation and others are drawing attention to the importance of understanding the myriad mechanisms through which law shapes the structure and resilience of the financial

⁶ *Id.* at 252.

⁷ E.g., Stiglitz, *supra* note 3 (“The most important consequence of the repeal of Glass-Steagall was indirect – it lay in the way repeal changed an entire culture.”).

⁸ Mahoney, *supra* note 1, at 252–53, 265–70.

⁹ See, e.g., Thomas Philippon & Ariell Reshef, *Wages and Human Capital in the U.S. Financial Industry: 1909-2006*, 127 *Q. J. Econ.* 1551, 1578 fig.8 (2012) (developing a deregulation index and showing that over the past century, deregulation increased starting in the 1970s and continuing virtually unabated until leveling off a few years before the crisis at a higher level of deregulation than at any point in the preceding century); Wilmarth, *supra* note 3, at 491.

¹⁰ Mahoney, *supra* note 1, at 237.

¹¹ See, e.g., Stout, *supra* note 3, at 1–5; Stiglitz, *supra* note 3 (“As we stripped back the old regulations, we did nothing to address the new challenges posed by 21st-century markets.”).

system.¹² Laying the demise of the twentieth century Quiet Period entirely at the feet of macroeconomics and market forces without acknowledging the way the law contributed to changes in the competitive playing field could lead to similarly misguided policy prescriptions.

That this dialogue is framed as a fundamental disagreement about deregulation reveals very different understandings regarding the initial balances struck in the regimes that were subsequently changed. There is, in short, no agreement about the correct baseline. To simplify: Defenders of the deregulation hypothesis implicitly assume that the law should evolve to protect the fundamental values it protected at Time A or it should find a way to outlaw change. It is spirit, not substance, that counts. When an environment is dynamic, even static rules can be deregulatory in effect. In contrast, Mahoney and critics of the deregulation hypothesis assume that the law as written at Time A remains the relevant baseline at Time B, regardless of the changes that have occurred or the reasons for those changes. The debate about deregulation matters today not because it reveals a fundamental tension between a static legal regime and a dynamic environment. Determining when a change in the law is merely updating the rules of the game to maintain the status quo in a new environment, or is instead changing the rules of the game, has important implications for the type of processes that ought to accompany the action. Digging into the baseline problem further reveals how failures to update the law can also be deregulatory in effect, and thus might merit closer scrutiny than such inaction often receives.

Given the broad range of issues addressed by Mahoney and advocates of the deregulation hypothesis, this Essay will not try to tackle them all. Rather, it uses the disintegration of the Glass–Steagall divide between investment and commercial banks—what steps along this path are appropriately characterized as deregulatory and the myriad rationales for this type of structural separation—to illuminate the core tensions. This focus is also quite relevant to policy debates today, as there is now a

¹² Stout, *supra* note 3, at 3–4; Wilmarth, *supra* note 3, at 443–45; see also Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 *J. Legal Stud.* S351 (2014); Kathryn Judge, *Investor-Driven Financial Innovation*, 7 *Harv. Bus. L. Rev.* (forthcoming 2018) [hereinafter Judge, *Investor-Driven Financial Innovation*]; Katharina Pistor, *A Legal Theory of Finance*, 41 *J. Comp. Econ.* 315 (2013); Gordon & Judge, *supra* note 2.

renewed interest in structural divides of the type embodied in Glass–Steagall, both within banking and beyond. The Essay concludes with some thoughts about how financial regulation can best incorporate the insights from both sides of this debate.

I. WHAT IT MEANS TO DEREGULATE

The rise of money market mutual funds as a competitor for banks provides a nice starting point for thinking through the challenge of disentangling deregulation from changes external to the regulatory regime. In a Section titled, “Market Forces and the End of Interest Rate Caps,” Mahoney provides a now-familiar account of the ways the rise of interest rates in the 1970s strained banks along numerous dimensions.¹³ A core challenge was how to hold on to deposits. Until that time, Glass–Steagall limited the interest rate a bank could pay on deposits. This was embodied in Regulation Q.¹⁴ This was but one element of an overall repressive financial regime. One way of understanding Glass–Steagall (and there are many)¹⁵ is that it simultaneously handicapped and advantaged commercial banks and thrifts, on the one hand, and investment banks, on the other, by providing each domains where they were effectively free from competition from the other.¹⁶ As a result of a mixture of state and federal laws, for much of the twentieth century, banks were small, local enterprises that compensated for shortcomings in scale and scope by dominating the domains where they were active.¹⁷

Most importantly, banks dominated the issuance of private money-like assets.¹⁸ Recent empirical literature demonstrates the strong demand for these types of assets, as evidenced by investors’ willingness to pay a premium for financial instruments that have some degree of

¹³ Mahoney, *supra* note 1, at 286.

¹⁴ 12 C.F.R. § 217.1 (2010). Regulation Q’s prohibition on interest-bearing demand deposit accounts was effectively repealed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 627, 124 Stat. 1640 (2010).

¹⁵ See *infra* Part III.

¹⁶ Gordon & Judge, *supra* note 2, at 15–16.

¹⁷ *Id.* at 12.

¹⁸ Gary Gorton, *Misunderstanding Financial Crises: Why We Don’t See Them Coming* 10–28 (2012). For more background on what constitutes “money” for these purposes, see Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* 30–40 (2016); Kathryn Judge, *The Importance of “Money,”* 130 *Harv. L. Rev.* 1148, 1154–55 (2017) (reviewing Morgan Ricks, *The Money Problem: Rethinking Financial Regulation* (2016)) [hereinafter Judge, *Importance of Money*].

“moneyness.”¹⁹ Thus, although Regulation Q helped reduce competition among banks, it was banks’ status as the primary source of private money that was key to allowing them to attract and retain deposits while paying relatively little, and often no, interest on those accounts. This was critical to the profitability of banks, which at the time was largely the difference between the interest they earned on outstanding loans and the interest they paid to depositors. As Professor Gary Gorton, among others, has argued, the profitability enabled by cheap financing made bank charters valuable and bank owners risk averse. This is a key factor, even if not the only one, in helping to explain the Quiet Period.

The introduction of money market mutual funds, which Mahoney aptly describes as “an attractive and intuitive alternative to checkable bank deposits,”²⁰ was thus a watershed moment in “financial structure law”—one that fundamentally disrupted a core component of a regime that had allowed small, boring banks to thrive.²¹ The challenge, for both Mahoney and those who advocate the deregulation hypothesis, is that the decline in bank charter value, and the increased competition banks faced on numerous dimensions, is overdetermined.²²

Mahoney’s focus is on the challenge posed by soaring interest rates. In an environment with money market mutual funds, that is, in an environment where firms and individuals could get a more competitive interest rate, without sacrificing the “moneyness” they held dear, it was extremely challenging for banks to retain sufficient deposits and comply with Regulation Q.²³ Mahoney explains how banks fought back, developing a new form of account meant to compete with money market mutual funds, and how Congress allowed banks to experiment and innovate to stave off this new form of competition.²⁴ But in his account, the rise of money market mutual funds was antecedent to, rather than

¹⁹ Arvind Krishnamurthy & Annette Vissing-Jorgensen, *The Aggregate Demand for Treasury Debt*, 120 *J. Pol. Econ.* 233, 258 (2012) (finding a monetary premium that averaged 73 basis points per year between 1926 and 2008).

²⁰ Mahoney, *supra* note 1, at 286.

²¹ Gordon & Judge, *supra* note 2, at 3.

²² For a thoughtful account suggesting that the costs of allowing money market mutual funds to compete for bank deposits was revealed only slowly, over time, see Gordon, *supra* note 12, at S360–66 (2014).

²³ Mahoney, *supra* note 1, at 237–38.

²⁴ *Id.* at 287.

part of, the deregulatory *modus operandi* that preceded the 2007–2009 financial crisis.²⁵

One could just as easily spin a very different narrative from the same set of developments by emphasizing the myriad ways that regulators paved the way to allow nonbanks to issue private money. The most obvious way that regulators helped money market mutual funds become direct competitors for bank deposits was the decision by the Securities and Exchange Commission allowing these funds to use a net asset value (NAV) of \$1.00, even when the value of the underlying assets fluctuated, making shares more money-like.²⁶ But other actors also played a role. States, for example, have long prohibited nonbanks from engaging in the business of banking²⁷ and frequently take the position that accepting deposits is a defining feature of banking.²⁸ Although some states challenged money market mutual funds and the suite of services that investment banks increasingly offered in conjunction with such funds, none ultimately prevented the spread of the funds.²⁹

Most relevant, given Mahoney’s framing, is the question of whether the issuance of money market mutual funds violated the Glass–Steagall separation of investment and commercial banking. Many contemporaries thought so. As James Butera explained at the time,

Glass–Steagall is a two way street in that it not only restricts the securities activities of commercial banks, but circumscribes as well the bank-like activities of securities firms. In particular, Section 21 of the

²⁵ *Id.* at 280–82.

²⁶ See 17 C.F.R. § 270.2a-7 (1984). The importance of the \$1.00 NAV to the success of money market funds as a substitute for deposits has been brought home recently by changes to Rule 2a-7, which now requires that money market mutual funds holding non-government debt and issued to institutional holders use a floating NAV. See U.S. Sec. & Exch. Comm’n, Rule 2a-7 Amendments Adopted by SEC in July 2014 Marked to Show Changes from Previous Rule 2a-7 (2014), <https://perma.cc/YTS9-BEKF>. The net effect has been a massive decline in the money market mutual funds forced to use the floating NAV. Catherine Chen et al., Money Market Funds and the New SEC Regulation, Fed. Res. Bank N.Y.: Liberty Street Econ. (Mar. 20, 2017), <https://perma.cc/DRZ9-LUWX> (finding that “the prime and muni segment of the MMF industry,” which is the segment of the market forced to use floating NAV, “ha[s] fallen by more than half,” losing \$1.1 trillion in assets, as a result of the rule change).

²⁷ Michael S. Barr, Howell E. Jackson, & Margaret E. Tahyar, Financial Regulation: Law and Policy 101–03 (2016).

²⁸ John A. Adams, Money Market Mutual Funds: Has Glass-Steagall Been Cracked?, 99 Banking L.J. 4, 21–22 (1982).

²⁹ Barr et al., *supra* note 27, at 1201–02.

Act prohibits a securities firm [and the like] . . . from engaging . . . ‘to any extent whatever in the business of receiving deposits.’³⁰

John Adams similarly opined at the time that regardless of the normative questions of whether money market mutual funds should be allowed, allowing money market mutual funds to use a \$1.00 NAV, and provide features like check writing and free credit balances crossed the line at the heart of the Glass–Steagall regime.³¹ Paul Volcker, then at the Federal Reserve, recalls readily recognizing money market mutual funds as “a clear instance of regulatory arbitrage,”; in his view, they were a product specifically designed to “skirt banking regulations.”³² Ultimately, the Justice Department decided that money market mutual funds were permissible and Congress decided not to adopt proposed legislation that would have subjected money market mutual funds to reserve requirements akin to those imposed on banks. But that the entry of these funds disrupted the Glass–Steagall balance was quite clear even at the time.³³

This version suggests that the growth of money market mutual funds, in forms that made them ready substitutes for bank deposits, was not external or antecedent to the tearing down of the Glass–Steagall wall but in fact core to that process. Putting these two stories alongside each other shows why Gorton (among many others) is of the view that “competition *and* deregulation” worked together to undermine bank profitability during this period.³⁴

II. WHY THE CHARACTERIZATION MATTERS

When one moves from the details to the bigger picture, there are important commonalities in the various depictions of the three decades leading up to the crisis. Most recognize that innovation and macroeconomic developments strained a repressive regulatory regime that had given both banks and investment banks domains in which they could flourish largely protected from competition by the other. And there is general agreement that in response to these developments,

³⁰ Id. at 1201–03 (quoting James J. Butera, Money Market Mutual Funds: The Legal and Regulatory Background, 28 Fed. B. News 91, 92 (1981)).

³¹ Adams, *supra* note 28, at 9–11.

³² Barr et al., *supra* note 27, at 1203 (quoting Letter from Paul Volcker to SEC concerning Release No. IC-29497 (Feb. 11, 2011), <https://perma.cc/DYK3-DXEG>).

³³ Id. at 1203–04.

³⁴ Gorton, *supra* note 18, at 128 (emphasis added).

Congress and regulators faced a choice: double down on that regime or move away from it. They chose the latter. But despite this level of agreement, the narratives each side tells remain quite different.

Mahoney grounds the end of the Quiet Period in a macroeconomic climate that virtually ensured the demise of the particular model of banking that pervaded during the Quiet Period. As he rightly points out, the increasingly global nature of financial markets during this time further undermined the oligopoly local banks once enjoyed over the process of private money creation, and investors may have been willing at times to hold non-money-like assets in lieu of bank deposits if the costs of deposits was too dear.³⁵ Other innovations, from sale and repurchase agreements to asset-backed commercial paper, would likely have undermined banks' monopoly over private money creation even without the advent of money market mutual funds unless the repressive dimensions of the prior regime had been expanded significantly. Mahoney's account thus successfully casts doubt on the viability of any effort to try to recreate the Quiet Period by reintroducing a far more repressive approach to financial regulation and money creation.³⁶

Just as importantly, even when it succeeded in bringing about stability, the structural limitations imposed on banks and other types of financial institutions in the United States had real costs.³⁷ Mahoney's account provides an important reminder that, when undertaking financial structure law, lawmakers' options are inherently constrained by the building materials and macroeconomic conditions they are facing. Attempts to shape the financial markets without understanding those constraints can bring about unintended consequences that run counter to desired aims.³⁸

³⁵ Mahoney, *supra* note 1, at 259–62.

³⁶ See William D. Cohan, *Bring Back Glass-Steagall? Goldman Sachs Would Love That*, N.Y. Times (Apr. 21, 2017), <https://www.nytimes.com/2017/04/21/business/dealbook/bring-back-glass-steagall-goldman-sachs-would-love-that.html>; Matt Egan, *Trump Wants to Revive a 1933 Banking Law. What That Means is Very Unclear*, CNN Money (May 9, 2017 2:42 PM), <https://perma.cc/79K9-7AVR>.

³⁷ See Charles W. Calomiris & Stephen H. Haber, *Fragile By Design: The Political Origins of Banking Crises and Scarce Credit* (2014); Mark Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 95–101 (1994).

³⁸ E.g., Judge, *Investor-Driven Financial Innovation*, *supra* note 12 (showing how legal interventions can prompt destabilizing financial innovations, and arguing that regulators should take a more systemic and structural approach to rulemaking to minimize such ramifications).

At the same time, something is lost in the refusal to recognize the regulatory decisions and legislative failures to act that contributed to the erosion of a powerful structural separation as part of (rather than merely antecedent to) deregulation. It is precisely because macroeconomic developments and innovation can be expected to test and push against the balance struck in any financial regulatory regime that a theory of deregulation that focuses solely on major repeals by Congress misses the boat. Absent static conditions, even static rules can be deregulatory in effect. This is particularly true in finance, where so much innovation entails efforts to replicate a regulated activity in a form that is just outside the regulatory perimeter.

This is the baseline problem. In a static world, Mahoney's definition suffices. But as he himself emphasizes, financial markets are neither static nor closed, and he is not suggesting that they ought to be. Whether to characterize the actions facilitating the growth of money market funds as deregulatory matters because deregulation implies a change in the existing regulatory regime. Just as importantly, the conflicting views of how best to characterize the actions and inactions that allowed money market funds to flourish suggests very different views of how best to characterize the hypothetical alternative path in which regulators had sought to protect banks' control over private money creation.

The United States legal system rests on the assumption that changing the law is different than updating the law to address new circumstances. Changes in the law generally require approval by both Houses of Congress and the President. In contrast, applying existing law in a new way because novel circumstances necessitate evolution is something that trial courts do daily. This characterization has important implications for the range of actions that regulators can take without going back to Congress. One reason to delegate lawmaking to regulatory bodies is to give technocratic bodies the authority to update the law in a timely fashion when industry-specific developments so warrant.³⁹ When agencies are instead *changing* the law in a fundamental way, this is the type of action that merits Congressional attention.⁴⁰

The aim here is not to suggest that the baseline used for legal purposes is the right baseline for policy purposes; it often is not. Rather the point is to emphasize the importance of the baseline issue.

³⁹ See *Chevron U.S.A., Inc. v. Nat'l Res. Def. Council, Inc.*, 467 U.S. 837, 864–66 (1984).

⁴⁰ *MCI Telecomms. Corp. v. AT&T Co.*, 512 U.S. 218, 231–32 (1994).

Underlying these distinctions is a normative assumption that rule changes merit broad-based engagement and debate; application of established principles to new circumstances does not. To put this distinction into practice, however, requires a common understanding of when the law is changing. In Mahoney's account, the Gramm–Leach–Bliley Act contributed little to the recent crisis precisely because the divide separating investment and commercial banking had eroded long before its passage.⁴¹ Rather than resolving the truth (or error) in the deregulation hypothesis, his careful analysis brings to the fore the importance of understanding the nature of the original balance struck in Glass–Steagall and the myriad actions that led to its demise. If earlier decisions were in fact critical in undermining the balance embodied in Glass–Steagall, this begs the question of why there was not more democratic engagement in those decisions.

To return to the opening framing of the issue, inherent in the debate about deregulation are very different understandings of which actions are protecting the status quo and which actions are changing it. Those who take a more expansive view of the role of deregulation in leading to the crisis often implicitly ground their analysis in a broader understanding of the range of regulatory actions and inactions that were in fact deregulatory. These different views can largely be attributed to different understandings of the nature of the original regulatory scheme and what it means to alter or preserve it in the face of changing circumstances.

The reason neither position is fully satisfying is that there is no single right answer to this quandary. The changed circumstances that are center stage in Mahoney's account precluded replicating the previous protections granted to banks without simultaneously implementing a far more repressive financial regime. Decisions had to be made one way or the other. To do nothing would have been a choice to allow the regime to erode, but to defend the regime would also have required new judgments. We have no good paradigm for understanding how the law should evolve, or what the process for evolution ought to look like, when the law itself has helped spur the dynamism now demanding a response and the multifactor balance the law previously embodied cannot be replicated in the new environment.

⁴¹ Mahoney, *supra* note 1, at 238, 259–62.

III. RULES AND THE REASONS FOR THEM

Having established why the baseline matters and why it is so difficult to establish in the face of change, the question is where do we go from here. If the question at issue was merely one of statutory interpretation, rather than how best to regulate finance, we would have familiar frames in which to ground our analysis, from purposivism to textualism. At the other end of the spectrum, if we resided in an economist's dream world, we might have perfect alignment between policy aims and tools, with no overlap or deficiencies, and at least one tool for each aim.⁴² But we cannot construct reality to fit models any more than we can use purely legalistic thinking to answer pressing policy questions.

The reasons for most laws are numerous, and this is no less true in finance. Moreover, because of the inherent endogeneity between the legal regime and the financial system that emerges from it,⁴³ and the inevitably incomplete information that shapes policy decisions in this domain, rationales too can evolve over time. Again, the Glass–Steagall separation between investment and commercial banking is illustrative. One view, reflected in the work by Gorton, is that in protecting banks from both external competition and vigorous competition with each other, the regime made bank charters valuable and thus made bank managers and shareholders more risk averse.⁴⁴ Few think this could be readily recreated today. Other rationales have also been questioned. For example, a core concern animating Senator Carter Glass was that conflicts of interests would cause commercial banks to underwrite low-quality securities, a proposition challenged by subsequent empirical work on the activities of universal banks prior to the passage of the Glass–Steagall Act.⁴⁵

Nonetheless, the debate about whether to use structural separations to limit the scope of banks remains alive and well. This is both because the aims the structural separation was meant to achieve were diverse and because that separation proved to have benefits (and costs) beyond those envisioned by its promoters. According to Professor Adam Levitin, for example, the “unintended genius of Glass-Steagall” was that in “splitting

⁴² See Jan Tinbergen, *On the Theory of Economic Policy* 1–5, 27–32 (1952).

⁴³ Pistor, *supra* note 12, at 315; Gordon & Judge, *supra* note 2, at 2.

⁴⁴ Gorton, *supra* note 18, at 27–28.

⁴⁵ Randall S. Kroszner & Raghuram G. Rajan, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933*, 84 *Amer. Econ. Rev.* 810, 810 (1994) (citing other sources expressing similar viewpoints).

up the financial services industry into commercial banks, investment banks, and insurance companies, Glass-Steagall broke up the political power of the financial services industry.⁴⁶ What Levitin's frame highlights is that once we recognize financial markets and regulation to both be inherently dynamic, setting up a structure that allows for a fair fight among informed and well-financed participants may be the best way to ensure the system will continue to evolve in ways that are not overly beholden to any one of these groups.

Others have similarly suggested that there may have been great virtues in Glass-Steagall that were not fully apparent until it was gone. Professor Joseph Stiglitz has argued "[t]he most important consequence of the repeal of Glass-Steagall was indirect—it lay in the way repeal changed an entire culture."⁴⁷ As he explains it,

[c]ommercial banks are not supposed to be high-risk ventures; they are supposed to manage other people's money very conservatively. It is with this understanding that the government agrees to pick up the tab should they fail. Investment banks, on the other hand, have traditionally managed rich people's money—people who can take bigger risks in order to get bigger returns. When repeal of Glass-Steagall brought investment and commercial banks together, the investment-bank culture came out on top. There was a demand for the kind of high returns that could be obtained only through high leverage and big risktaking.⁴⁸

In a similar spirit, Professor John Coates has argued that the Volcker Rule's⁴⁹ prohibition on proprietary trading is better understood as a structural law intended to change the culture of banks than a mere activities restriction meant to curb risk taking.⁵⁰

The culture issue is interesting because a wide swath of policymakers are paying increased attention to the important role that bank culture can play in the success of any regulatory effort, whether aimed at stability or

⁴⁶ Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 *Harv. L. Rev.* 1991, 2060–61 (2014) (reviewing several books about the Financial Crisis of 2007–2008).

⁴⁷ Stiglitz, *supra* note 3.

⁴⁸ *Id.*

⁴⁹ 12 U.S.C. § 1851 (2012).

⁵⁰ John C. Coates IV, *The Volcker Rule as Structural Law: Implications for Cost-Benefit Analysis and Administrative Law*, 10 *Cap. Markets L.J.* 447, 453–58 (2015).

consumer protection.⁵¹ Nonetheless, culture is difficult to regulate directly. As Professor Larry Lessig long ago highlighted, social meanings are constructed, dynamic, and shaped by law, but that does not mean lawmakers have the power to dictate or control social meaning.⁵² When seeking to alter the social meaning of a behavior (or the culture that permeates an institution), lawmakers will often have to think creatively and expansively about the interventions most likely to bring about the desired effect.

Whether Glass–Steagall should be reinstated is beyond the scope of this Essay, just as it is outside Mahoney’s critique of the deregulatory hypothesis. Like Mahoney, I am skeptical that reinstating a hard separation between banks and investment banks is the best path forward. But that view is tangential to my analysis, as it is to his. The core point here is to acknowledge the difficulty of updating any balance struck at a particular point in time, under particular circumstances. New developments may well cast doubt on the original rationales or undermine the capacity of chosen tools to accomplish desired aims, but they can also yield new insights into the benefits of particular types of interventions.

IV. LOOKING AHEAD

The analysis here may seem to do little more than problematize any effort to sort out a root cause of the financial crisis. But, in muddling through the shortcomings of both the deregulatory narrative and Mahoney’s rebuttal, and in exploring the mismatch between the dynamism inherent in finance and a legal system that tends to focus on form over context, the analysis also lays the groundwork for addressing these procedural shortcomings.

At the core, the baseline problem reveals the need for a more robust and ongoing discussion about the myriad aims a regulatory regime is designed to further and the various mechanisms through which it is expected to further those aims. Absent a static environment, a legal

⁵¹ William C. Dudley, President and Chief Executive Officer, N.Y. Fed. Res. Bank., Remarks at the U.S. Chamber of Commerce: The Importance of Incentives in Ensuring a Resilient and Robust Financial System (Mar. 26, 2018) (transcript available at <https://perma.cc/FHM6-GVQ7>); David Zaring, The International Campaign to Create Ethical Bankers, 3 J. Fin. Reg. 187, 187–190 (2017).

⁵² Lawrence Lessig, The Regulation of Social Meaning, 62 U. Chi. L. Rev. 943, 957–58 (1995).

scheme will change in substance even if not in form. This means that even inaction can be deregulatory. A flipside is that actions that appear to be regulatory, in the sense of imposing new or heightened obligations on parties or by nominally expanding restrictions, may in substance be doing little more than updating the form of the regime to maintain the original balance struck. As reflected in the discussion of the Glass–Steagall divide between banks and investment banks, experience may reveal both advantages and disadvantages that could not have been known in advance. But as that discussion further reveals, there is no built-in mechanism for assessing such benefits and drawbacks other than moments when there are proposals to change the form of the law. This is reflected in the fact that most of commentators singing the praises of the unexpected benefits were doing so only after the crisis, but it also comes through in the slow degradation of the Glass–Steagall divide in the decade prior to the passage of Gramm–Leach–Bliley. The analysis here thus suggests the value of institutionalizing review of how a particular regime is working and the changes that may be undermining or enhancing its efficacy without waiting for a crisis or a major legislative change to prompt consideration.

The analysis here also has important implications for the scope of such review. The discussion of culture, for example, demonstrates not only the importance of ongoing learning, but also the value of thinking creatively about the relationship between means and ends. Currently, at the one point when rigorous assessment is often formalized—the adoption or modification of a regulation—the analysis is often cramped into a cost-benefit analysis that is not only speculative but requires these types of dynamics to be collapsed into a paradigm ill suited to reveal what is at stake.⁵³ A far more expansive approach is needed.

The analysis also provides yet another reminder of the challenges that arise from the financial regulatory architecture in the United States. In an environment where a decision by a market regulator can have first-order implications on the viability of banks under the purview of prudential regulators, there is a need for alternative institutions or mechanisms that can take a more global view. The Financial Stability Oversight Council and the Office of Financial Research, both still relative newcomers to the stage, are theoretically well positioned to play

⁵³ John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 *Yale L.J.* 882, 885–89 (2015); Gordon, *supra* note 12.

this type of role.⁵⁴ They cannot do so, however, without broad support and leadership from a Treasury secretary who recognizes the need for an expansive lens when assessing the relationships among innovation, legal change, and aims like systemic resilience.⁵⁵

Clarifying aims and their relationship to tools is not meant here to serve as a straitjacket. Lawmaking is a messy process and efforts to flatten multifaceted regimes into two dimensions are destined to elide core tradeoffs. It instead can serve as a prism to shape ongoing learning, encouraging rigorous analysis of whether a law is achieving its intended aims and the tradeoffs at stake in using a particular tool. The aim here is to enable a richer and more multidimensional learning process than a tool like cost-benefit analysis can provide. And it draws attention to the need for rigorous examinations to occur more frequently, and with broader input across the regulatory spectrum.

The effort to try to clarify and refine understandings of what a regulatory regime is meant to achieve and how it is meant to achieve that aim could help to address the core tensions in the ongoing debate about the deregulation hypothesis. Even when contested and plural, these frames can serve as the elusive baseline needed to understand whether a changed environment in fact caused a finely wrought balance to shift, and it can help to inform how policymakers should respond given such developments. Although laying out the details for how to institutionalize these types of changes is beyond the scope of this Essay, Mahoney's thoughtful Article serves as a wonderful prompt for examining the significant shortcomings of the current regime and the value of doing better.

⁵⁴ U.S. Dep't of the Treasury, About the FSOC, <https://perma.cc/DBB9-G7BHaspx> ("The Financial Stability Oversight Council has a clear statutory mandate that creates for the first time collective accountability for identifying risks and responding to emerging threats to financial stability."); Office of Financial Research, About the OFR, <https://perma.cc/DBB9-G7BH>. ("The Office of Financial Research (OFR) helps to promote financial stability by looking across the financial system to measure and analyze risks, perform essential research, and collect and standardize financial data.")

⁵⁵ There are reasons to suspect that the current administration is not setting these bodies up to fulfill their more ambitious mandates. See, e.g., Rebecca Savransky, Trump Slashing Staff, Budget at Office of Financial Research: Report, The Hill (Dec. 6, 2017 9:00 AM), <https://perma.cc/4Z78-P52R> (describing cuts to the OFR staff and budget).

CONCLUSION

Ultimately, Professor Mahoney's critique of the deregulation hypothesis works, even if not quite in the way he intends. In his willingness to both grapple with detail and take a big-picture view, Mahoney provides the material needed to understand why any effort to paint the crisis as solely the product of regulation, deregulation, innovation, or changing macroeconomic conditions is going to elide other critical elements. In financial markets and financial regulation, these forces are constantly feeding on and shaping each other. It is these interactions that produce, reproduce, and change the financial system. For regulation to succeed, it must embrace and build on an understanding of the richness of these dynamics.

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