

Chapter 2

Understanding Regulatory Capture: An Academic Perspective from the United States

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In the wake of the Financial Crisis of 2008, the huge Deepwater Horizon oil spill in 2010, and other industrial catastrophes, the media and academic journals are now replete with charges of that industries have captured their regulators. There are well-documented reports of constantly revolving doors in which the regulators and the regulated frequently change places, of huge amounts spent by industries in lobbying both legislators and regulators, and of close social relationships that exist between senior regulators and executives. A recent Bloomberg BusinessWeek profile describes the “chummy relationship” between the chairman of Citigroup, Dick Parsons, and the Secretary of the United States Treasury, Timothy Geithner, whom Parsons apparently calls “Timmy” – a term that one leading Wall Street analyst observes ‘does not exactly acknowledge the authority of the Secretary, a post once occupied by Alexander Hamilton’.¹

¹ Mayo, M. (2012). *Exile on Wall Street: One Analysts Fight to Save the Big Banks From Themselves*. Hoboken, N.J. Wiley. It is perhaps worth noting that the same profile observes that Parsons ‘also got along well with [Comptroller of the Currency, John] Dugan, whom Parsons calls a “good guy”’. Leonard, D. (2011). ‘Dick Parsons, Captain Emergency’,

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Sometimes it seems almost as if the United States Treasury (not to mention the staff of the White House itself) is run by a cadre of officials who were either recently members of Goldman Sachs or who had spent most of their waking hours interacting with the CEOs of Goldman, JP Morgan, Citi and other New York banking giants. One might be excused for assuming that the atmosphere between Big Finance and its regulators more accurately resembles the congeniality of an

Bloomberg Businessweek, 24.03.2011, available online at http://www.businessweek.com/magazine/content/11_14/b4_222084044889.htm.

exclusive club than the formal relationship between regulators and a powerful industry. One might then also reasonably wonder whether such “chums” might treat each other rather more favourably than strangers².

“Capture” has therefore become a prominent element in public policy debates on financial regulation. As a theory of private distortion of public purpose, the concept seems important for diagnosing regulatory failures culminating in the 2008 Financial Crisis (Crisis) and for lessons on how to prevent future crises. The capture of financial regulators by elements of the financial industry is now often offered to explain why regulators did not take apparently obvious action to curb excessive industry practices that might have contributed to the Crisis, and as a reason for delayed implementation and substantial dilution of rules designed to reform the financial system.

Capture: an elusive concept

“Regulatory capture” has long played an important role in efforts to explain alleged regulatory failure. Suggesting that one interest group among many in a field contesting for recognition of their disparate interests has seized control of the umpires, such that the game is no longer taking place on a level playing field, or that regulatory systems are even created by a strong interest group in order to stifle competition, capture is used by proponents of both regulation and deregulation to make their case. In a world of giant financial institutions, powerful chief executives, and huge bonuses despite poor financial performance, it seems that capture is to blame, one way or the other. For those in favour of more regulation, the industry’s ability to influence regulators must be curbed. For those in favour of less regulation, one of the reasons for reducing regulatory influence is to prevent favoritism by captured regulators.

² See Johnson, S. (2009). ‘The Quiet Coup.’ *The Atlantic*, May, and Johnson, S. and J. Kwak (2010). *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*. New York, Pantheon Books.

Capture is a perplexing concept when invoked in *any* area of economic regulation. It is frequently *misdiagnosed* because critics ‘leap from an event (however embarrassing) to make large-scale inferences about an agency’s entire culture’, and it is often *mistreated* because ‘there is far too much fatalism – some of it strategic, no doubt – about the possibility of ameliorating capture or even preventing it’³. The concept is generally problematic because it is at once a theory of legislative and regulatory motivation *and* a vituperative accusation levelled at results unfavorable to one of the contesting groups, even if those results might indeed strike the right balance among competing interests – “we wuz robbed”, as many a losing boxer and his trainer have grumbled at the end of a fight. The accusation is likely to be made even if the actual result was the *right* one, or one that was *inevitable* given the legislative mandate under which the regulator is operating.

Capture might also manifest itself in various forms, ranging from the blatant (for example, where an official is bribed to make a decision) to the more nuanced types of ‘deep’ or ‘cultural’ capture that involve a consanguinity among elite classes of regulators and executives⁴. In the latter situation, regulators and executives might share similar backgrounds, traditions, understandings of the markets and fundamental philosophies, talk to each other frequently and almost exclusively, share implicit understandings; the quintessential “old boys’ club”. Thus an appearance of impartiality on the part of a regulator might belie an inherent bias that, in various subtle ways, systematically favours that part of the industry with which the regulator most closely identifies.

³ Carpenter, D. & D. Moss (2012). ‘Introduction.’ Draft chapter (as of 28.10.11) in: Carpenter and Moss, eds (forthcoming). *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*.

⁴ Hanson J & Yosifon D, (2003), *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 University of Pennsylvania Law Review. 129, 202–84; Kwak (forthcoming). ‘Cultural Capture and the Financial Crisis’, Draft chapter (as of 24.10.11) in: Carpenter, D. and D. Moss, eds (forthcoming). *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It*.

Capture in financial regulation

When one starts to apply the notion of capture to *financial* regulation, the concept becomes more problematic than ever. In the United States (US), for example, additional elements bedevil the analysis.

There are *various kinds of* financial regulators. Some, for example the Office of the Comptroller of the Currency (OCC), are specifically directed to favour the industry they charter. The OCC is a prestigious agency within the Treasury Department founded back in 1863 primarily to create and propagate a national (or federal) banking system, which was intended to smother the chaotic state-chartered system that had enjoyed a monopoly in US banking after the demise of the Second Bank of the United States (1836). National banks, in the words of the US Supreme Court in 1873, are ‘national favourites’. Though seldom expressed in such blunt terms, the growth and prosperity of the national banking system continues to be vigorously promoted by the OCC as a part of its implicit mandate under the National Bank Act. State-chartered banks, the tenacious counterparts to national banks, also continue to survive under the aegis of their own state chartering agencies. Bank holding companies have likewise enjoyed considerable protection by the agency directly responsible for approving their formation and promoting their prosperity, the Board of Governors of the Federal Reserve System (Fed). As we saw during the Crisis, both the Fed and the Treasury make no bones about the fact that when financial stability is threatened they consider it their first duty to protect the banks from failure in order to preserve the entire financial system. It is often declared that the passage of the Dodd-Frank Act in 2010 has put an end to the notion that any financial institution will be considered too big to fail, but few believe that this is really how the Act will be applied in another crisis.

Quite apart from these “chartering” agencies, there are other important kinds of financial regulators, such as the Federal Deposit Insurance Corporation (FDIC), the Consumer Financial Protection Bureau (CFPB), the Securities and

Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and state insurance commissioners. Each has a different specific mission. The FDIC acts as manager and protector of the federal deposit insurance funds, and as receiver for banks and systemically important holding companies and non-bank financial institutions when they fail. The CFPB acts as a market umpire to protect consumers from improper financial products and promote proper market disclosures. The SEC and CFTC protect the overall transparency and integrity of the securities, futures and derivatives markets. State insurance commissioners regulate the insurance activities of the financial companies, no matter how large. These various agencies have often taken differing positions, sometimes in direct opposition to each other or to the Fed or the OCC. Very public examples of such clashes range from disputes over the reporting of loan loss reserves, the eligibility of trust preferred securities as appropriate components of capital, and the ability of a holding company to shelter its derivatives business inside its insured bank subsidiary. In this respect the regulatory fragmentation of the US system, far from being the chaotic structure for which it is often criticized, provides some of the “factional” elements that James Madison in the Federalist No. 10 considered so important for generating a sound result through partisan competition. So, although the public focus tends to be on the Fed and the Treasury, it is not self-evident exactly *whom* has been captured or how the captured agency might be able to act in the face of powerful conflicting regulatory interests without being exposed for improper bias. With this regulatory array it would be difficult in practice for any particular sector of the industry to secure the comprehensive capture of financial regulators.

The problem with capture as an analytical concept in financial regulation goes even deeper. Capture presupposes the competition of clearly delineated, divergent interests in which one stakeholder seizes control or exerts improper influence over the regulatory arbiters who are meant to be upholding an objective public interest. This idea might make some sense in the case of market regulators, such as the SEC, CFTC

and CFPB, where the regulatory structure assumes a division between public (regulatory) action and private (industry and consumer) interests, in which the former strikes a balance over the contesting claims of the latter. But is this really an accurate depiction of the structure of financial markets and their relationship to financial regulators?

It is true that the activities of private market participants require financing and that this financing has generally come from non-governmental lenders and investors. In this respect banks have perhaps always been “private”. However, in performing a critical role in government finance the largest banks have also long possessed a “quasi-public” character even as “private” entities. The system of national banks created by the US National Bank Act of 1863 was deliberately created to establish a national currency and provide financing to a severely cash-strapped federal government during the Civil War. For this reason, the courts recognized national banks to be not only ‘national favourites’ but also ‘instrumentalities of the state’⁵. Such status had also earlier been extended to the First and Second Banks of the United States, which operated under direct congressional charters as quasi-central banks and this recognition took place long before the creation of a US central banking system in 1913.

These entities enjoyed quasi-public status because of the *public* functions they perform. Most important is their role as transmission belts of monetary policy, through which the central bank manages the money supply. They also play a central role as primary dealers and investors in huge volumes of public debt. Dealing and investing in government debt has long received privileged regulatory treatment, exemption from the prohibitions otherwise placed on US banks against dealing and investing in private equity (the Glass-Steagall wall) and, when it comes to US government obligations, even from the prohibition against proprietary trading under the

⁵ Baxter, L.G. (2012). ‘Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance’, *Review of Banking and Finance Law*, 31 (Fall 2012, forthcoming)

Volcker Rule. In addition, banks in the US are also critically important repositories for other failing financial institutions in situations where government simply lacks the resources to liquidate those institutions. Vivid examples of this “receivership” role are the acquisitions of Bear Sterns and Washington Mutual by JP Morgan Chase and of Merrill Lynch by Bank of America during the Crisis in 2008⁶.

These public roles are important: they imply that large banks, despite the “private market” rhetoric, are semi-public institutions. In this context capture can become a confusing concept. After all, if banks perform public functions, why would there *not* be capture – perhaps even in both directions? Intense bank-regulatory influence would seem to be essential for the proper discharge of the quasi-public functions described. Capture, from this perspective, is simply inevitable and may be to a certain extent actually desirable. We do want exchanges of expertise in complicated areas of financial regulation. We do want experts as regulators, and regulatory experts as financial executives. We depend on constant interaction between the industry and regulators; indeed, bank supervision would be hard to imagine without it. And we would want some degree of coordination between government and banks for the implementation of monetary policy and the maintenance of financial stability.

Addressing capture with institutions and processes

If this view is correct, then the “problem of capture” in financial regulation might be better reframed in less tendentious terms. Some degree of capture is surely inevitable. If capture is understood as becoming undesirable when the degree of influence by one legitimate stakeholder in the regulatory process over another has become unbalanced, then avoiding or reducing the distortions created by capture – that is, disproportionate industry influence – becomes essentially a question of promoting principles for maintaining transparency and accountability. Because they focus on a systemic process, no

⁶ *Ibid*

single solution is likely to prevent distortions on its own.

These principles can be grouped into five general categories: adequate regulatory capacity; meaningful transparency; meaningful access by stakeholders; external checks; and internal checks.

1. Adequate regulatory capacity

Americans treat regulators rather badly. Financial regulators are underpaid relative to the market for their skills; they are also the first to be blamed when congressional and presidential policies fail. Sometimes regulators deserve castigation but very often they are placed in the impossible position of having to carry out grossly ambitious, whipsawing and often incoherent legislative and executive mandates with inadequate resources. The recent huge extension by the Dodd-Frank Act to their regulatory mandate, followed by subsequent denials of congressional funding, provides a clear example of the regulator's predicament. Basically this is because, despite a general American acceptance of the importance of regulation,⁷ the most effective short-term political strategy is to treat regulation as if it is a fundamentally illegitimate intrusion into a preordained free market. Of course this view is both historically and functionally absurd, but it is much easier to sell in the sound bites of Disneyworld economics and election year politics.

America also has a complicated regulatory framework that would have delighted cartoonists Heath Robinson and Rube Goldberg. This ramshackle regulatory structure is often criticized as a source of regulatory confusion, buck-passing and failure. My personal view is that this concern is overblown: there are many ways to structure sound regulatory institutions, and the US economy is massive enough to justify a multiplicity of specialized agencies. Perhaps it is just as well they are sometimes at odds with each other.

⁷ Kwak, J. (2012b). 'Americans Like Regulation.' The Baseline Scenario, 13.03.2012, available online at <http://baselinescenario.com/2012/03/13/americans-like-regulation/>

Instead, the more important factors for ensuring adequate regulatory capacity are that:

- (i) the missions of the agencies be clearly defined and coordinated;
- (ii) the regulatory agencies be adequately funded;
- (iii) regulators be properly incentivized through public funds, not promises of ultimate private reward from those they regulate;
- (iv) regulators possess or can obtain expertise that understands the businesses they regulate; and
- (v) regulators be rotated, just like executives in good companies, so that they do not develop too narrow a focus of their responsibilities or too close an affinity with those they regulate.

All of these factors for regulatory adequacy are, of course, easier said than done. In financial services, pay disparities between regulators and the industry are particularly acute, notwithstanding the somewhat higher salaries paid by the financial agencies⁸. Other forms of incentives, such as enhanced status and special appeals to public minded recruits, might be important⁹.

Unfortunately an obstacle is that public hostility toward regulators seems to be getting worse, not better, as election year rhetoric surrounding budget cuts intensifies. Yet the trade-off is as obvious as it is inevitable: the less resource capacity the regulators possess, the more dependent they will have to be on the industry they supervise¹⁰.

⁸ Philippon, T. and A. Reshef (2008). 'Wages and Human Capital in the U.S. Financial Industry: 1909-2006.' NBER Working Paper, No. 13405.

⁹ Baxter, L. G. (2011). ' "Capture" in Financial Regulation: Can We Channel it Toward the Common Good?' *Cornell Journal of Law and Public Policy*, 21(1): 175-200.

¹⁰ McCarty, N. (2012). 'Complexity, Capacity and Capture', Draft chapter (as of 07.13.11) in: Carpenter, D. and D. Moss, eds (forthcoming). *Preventing Regulatory Capture: Special Interest Influence in Regulation and How to Limit It*.

2. Meaningful transparency

Adequate *input* by all significant stakeholders is required by the principle of participatory democracy and is surely vital for developing informed policy and its accurate implementation under the circumstances of the market and the industry. Given the extremely technical nature of finance and the close relationship between banking and government, it is natural that industry and regulators will develop very close associations. This closeness surely distorts perceptions over time and inevitably precludes consideration of other interests that ought also be placed in balance.

Various tools and techniques exist or have been proposed for promoting a proper balance. Sunlight through transparency – that Brandeisian ‘best of disinfectants’¹¹ – remains as sound as ever. Bankers resist transparency for various reasons. They are practised in strictly protecting client confidentiality and they do not want to share information that might be useful to competitors. Together with central bankers they also fear that disclosure would reveal financial institution dependence on liquidity supports, and that this knowledge would be misunderstood by the markets and lead to runs on institutions and perhaps even to general financial instability.

These arguments against transparency are dubious. The first – protecting client confidentiality – is usually not endangered when detailed but anonymized bank information is disclosed, and if a client position is so large that it would be recognized this information is usually known to the market anyway. The second – protecting information from competitors – is no more important than in any other industry, so it is unclear why banks should enjoy a special privilege in this regard. And the third – protecting the market from misunderstanding the liquidity needs of banks – seems really to have ended up protecting the central bank and financial

institutions from political and shareholder accountability more than preserving financial stability. For example, the Fed fought tooth and nail to resist Freedom of Information Act demands by two news media for disclosures relating to its emergency lending during and soon after the Crisis. When disclosure was finally forced, the information proved very embarrassing for both domestic and foreign financial institutions and the Fed itself. Had the Fed’s actions been known during the passage of the Dodd-Frank Act, different policy choices might well have been made, both regarding the support powers of the Fed and the permissible scale and operations of financial institutions.

The greater transparency imposed on the Fed by Dodd-Frank has helped produce more informed views on financial regulatory policy. Basel II and III also strive to promote greater disclosure to the markets. Additionally, more rigorous disclosure requirements could help prevent biased decision making that might arise from the revolving door between regulators and their industry. Greater disclosure all round would at least enable other stakeholders and the media to focus a spotlight on improper collusion.

3. Realistic stakeholder access

Participatory democracy also implies meaningful *access* to the process of regulation by all legitimate stakeholders. In the financial world this problem is particularly acute because financial institutions possess immense influence by reason of their size, resources and lobbying power. There is a strong argument for correcting this imbalance through devices and institutions that strengthen the ability of other stakeholders – customers, smaller financial institutions, specific niche industries, and so on – to represent their interests and be properly heard and responded to by the agencies that are charged with recognizing and protecting their interests.

Such correctives can take various forms. General public comment during the rulemaking process is one important vehicle but, as scholars have demonstrated, business comment appears to have

¹¹ Brandeis, L. (1913). ‘What Publicity Can Do’, *Harper’s Weekly*, Dec. 20, 1913, available at: <http://www.law.louisville.edu/library/collections/brandeis/node/196>.

much more influence than private inputs¹². When it comes to the highly technical dimensions of financial regulation, such as working out the details of the Volcker Rule, the collective action problems for the general public seem particularly profound. Their mass action comments are often composed of little more than worthless form letters¹³. Industry input is much better organized and informed, and because of this it is also much more influential.

There are other possibilities. Ayres and Braithwaite propose a model of ‘tripartism’, in which non-industry groups would have full access to all the information before regulators, a seat at the negotiating table during the dealmaking process, and standing to sue or prosecute that is equal to that of the regulator itself¹⁴. Another approach might be to use a model from public utility regulation, where utility regulators in many jurisdictions are expressly charged by their authorizing legislation to consider and uphold the public interest. In some situations this role is institutionalized by the specific creation of a representative of the public interest who is engaged in the decision making process. A potential model for applying tripartism in financial services regulation can perhaps also be found in insurance regulation, where some states have developed proxy advocates for supporting the public interest in regulatory proceedings¹⁵.

¹² Yackee J & Yackee S (2006). *A Bias Toward Business? Group Influence on the U.S. Bureaucracy*, 68 J. POL. 128 and Yackee S (2012). “Reconsidering Agency Capture During Regulatory Policymaking.” in Daniel Carpenter and David Moss (Eds.), *Preventing Regulatory Capture: Special Interest Influence, and How to Limit It* (forthcoming)

¹³ Krawiec, K. (2011). ‘Don’t “Screw Joe The Plummer”: The Sausage-Making of Financial Reform. Working Paper, 09/2011, available at http://scholarship.law.duke.edu/faculty_scholarship/2445/.

¹⁴ See Ayres, I. and J. Braithwaite (1991). ‘Tripartism: Regulatory Capture and Empowerment’, *Law & Social Inquiry*, 16(3): 435-96. and Ayres, I. and J. Braithwaite (1992). *Responsive Regulation: Transcending the Deregulation Debate*. New York. Oxford University Press

¹⁵ Schwarcz, D. (2012). ‘Preventing Capture Through Consumer Empowerment Programs: Some Evidence from Insurance Regulation.’ Draft chapter (as of 28.10.11) in: Carpenter, D. and D. Moss, eds (forthcoming). *Preventing Regulatory Capture: Special Interest Influence in Regulation and How to Limit It*.

4. External checks

Various external checks surround the modern regulatory process, some more effective than others. The media can cast light on the process and generate public review. Congressional committees and inspectors general often engage in far-reaching investigations of the actions of the financial regulators, sometimes with very critical effect. Some judges, too, have strongly criticized the leniency of agencies in settlements with the industry, as was most recently demonstrated by Judge Rakoff’s rejection of two settlements by the SEC against Bank of America and Citigroup. (Judge Rakoff’s decision to reject the Citi settlement has been remanded by the Second Circuit Court of Appeal for having gone too far.) Perhaps there is greater scope for judicial checks on the excessive influence of particular stakeholders, though this check remains limited and highly dependent on the specific nature of disputes¹⁶. Finally, as already noted, the agencies themselves are sometimes at odds with each other in ways that enrich the public debate, necessary to promote sound policy outcomes.

These traditional checks seem inadequate to ensure a balance of interests because so many regulatory decisions, from emergency lending by the Fed to daily regulatory sanctions or approvals, go unnoticed. Furthermore, when it comes to complex and highly technical rulemaking, the relative expertise of interested parties can be extremely lopsided, with industry representatives having by far the greater knowledge and understanding of the issues and, as a result, effectiveness of comment in the rulemaking process. Groups of independent experts are not well organized into coherent committees capable of providing sufficient balance to the cacophony of pro- or anti-industry views¹⁷.

¹⁶ Magill, E. M. (2012). ‘Courts and Regulatory Capture’, Draft chapter (as of 11.29.11, cited with permission) in: Carpenter, D. and D. Moss, eds (forthcoming). *Preventing Regulatory Capture: Special Interest Influence in Regulation and How to Limit It*.

¹⁷ Balleisen, E. (2011). ‘The Global Financial Crisis and Responsive Regulation: Some Avenues for Historical Inquiry’, *University of British Columbia Law Review*, 44(3): 557-87.

This imbalance seems likely to distort how the agency perceives the issues and interprets its empowering legislation, even if there might in fact be alternative views just as important yet inarticulately held by stakeholders who lack the basic competence to represent them.

Such shortcomings in the representative process have led to various suggestions for new external checks on the regulatory process. The author has proposed a self-funding and independent consulting organization that would have to be consulted on key issues of regulatory policymaking. An example of such a model in the US is the MITRE organization which is primarily focused on military contracting but which has indeed sometimes provided advice to financial agencies¹⁸.

A much broader proposal is that of an agency or “Sentinel” that would have power to demand information, have expertise to evaluate this information and the financial policies being adopted by the agencies, and have the responsibility to report its views to Congress and the executive branch. With purview over the whole financial system, the Sentinel would bring a broader perspective to bear than might otherwise be held by the specific agency whose action is under review. Being independently funded and situated, the Sentinel would also be in a position to offer impartial views as between the various financial agencies¹⁹.

Another broad proposal is a ‘Public Interest Council’ that would consist of an expert independent government agency appointed by Congress and located outside the executive branch, charged with participating in the regulatory process ‘as the designated representative of the public interest in preserving long-term financial stability and minimizing

systemic risk’. Like the Sentinel, the Council would possess neither legislative nor executive powers; it would, however, have wide authority to collect information from both government agencies and private market participants, conduct investigations, publicize its findings and advise Congress and regulators to take action ‘with respect to issues of public concern’²⁰.

The difficulty with each of these ideas is that they are predicated on a substantive public interest that can be identified in some detached way by experts. Yet it is unlikely that any of the agents in the process would acknowledge or even perceive that their positions were not in fact the best ones for the public interest, and it is has become naive to expect otherwise. As one critic of the Sentinel idea has put it, ‘it is misleading to suggest that these [regulatory] judgements do not have a strong political dimension to them. They cannot be put on autopilot, or entrusted to a group of disinterested “wise men”’²¹. Proposing the addition of new layers to the regulatory process is also a questionable strategy, politically and financially. The regulators tend to under-resourced as it is, and regulatory burden in financial services has become a rallying cry for the industry, sometimes with good reason. In the United States at least, proposing to allocate yet more funds to yet more external public agencies would have little prospect of success in today’s Congress.

Another promising and potentially meaningful check, however, is also emerging in the United States, following similar developments in the United Kingdom. This is a cadre of privately funded and diverse expert organizations akin to the “shadow banking committee” that played a prominent role in critique of financial regulatory policy in the United States in the 1980s and 1990s. The original shadow banking committee is now known as the *Shadow Financial Regulatory*

¹⁸ Baxter, L. G. (2011). ‘“Capture” in Financial Regulation: Can We Channel it Toward the Common Good?’ *Cornell Journal of Law and Public Policy*, 21(1): 175-200.

¹⁹ See Barth, J. R., G. Caprio Jr. and R. Levine (2012). *Guardians of Finance: Making Regulators Work for Us*, Cambridge & London, MIT Press and Levine, R. (2010). ‘The governance of financial regulation: reform lessons from the recent crisis.’ BIS Working Paper 329.

²⁰ Omarova, S.T. (2012). ‘Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation.’ *Journal of Corporation Law*, 37, forthcoming

²¹ Davies, H. (2010). ‘Comments on Ross Levine’s Paper “The governance of financial regulation: reform lessons from the recent crisis.”’ BIS Working Paper 329.

Committee, an independent committee sponsored by the American Enterprise Institute. Additional examples are the *Centre for Economic Policy Research*, *PublicCitizen*, *new deal 2.0*, *Project on Government Oversight (POGO)* and *Americans for Financial Reform*.

In another chapter in this book, Christine Farnish, chair of Consumer Focus, describes the experience in the United Kingdom of such initiatives and their potential for promoting more effective consumer input on financial regulation. Bodies like these are independent of the industry itself and presumably reflect independent perspectives and accumulating financial expertise. One might anticipate that such organizations will develop the capability of providing extensive expert input into the regulatory process, with the muscle to assure public coverage and regulatory and congressional attention.

5. Internal checks

One of the most effective means of restoring equilibrium in interests in financial services is not external checks and balances, but internal change within the industry itself. This might be through cultural change, perhaps a return to a more restrained approach to market competition, away from the trading culture and back to advisory professionalism. A frequently heard lament is for the days before Goldman Sachs became a public company, when the investment banking culture was dominant and personal liability more real. Viewed in this light the emphasis on increased capital levels – more skin in the game on the part of the owners of financial firms themselves and less reliance on other people’s money – represents an attempt to restore a greater sense of personal responsibility for risk-taking.

There might also be other ways to adjust the internal attitudes of financial executives, such as changes to liability rules. For example, fiduciary duties can be extended to cover more genuine “clients”, a matter on which the SEC presented recommendations for broker-dealers and investment advisers under the mandate of Section 913 of the Dodd-Frank Act (SEC 2011) and which is fiercely resisted by industry groups. Elsewhere, I

have argued that the fiduciary duty of the board and top executives, traditionally focused exclusively on shareholders, should to be adapted to reflect the fact that a critical third party, though not always recognized, is inevitably present in the boardroom, namely the public that subsidizes the industry so heavily.²²

These kinds of proposals tend to arouse great hostility from the industry, as we saw with the enactment of Section 404 of the Sarbanes-Oxley Act in 2002. Yet a vivid personal experience for me was the change in how fellow executives and I focused on financial reporting once we became aware that we were personally on the hook for their reliability. There is nothing like personal liability in the midst of great corporate brumes to focus the mind on what is important.

Conclusion

Capture in the somewhat quasi-public industry of financial services is quite chameleonic. It is the seemingly perverse result of an unavoidably close and intense interaction between regulators and the industry, yet it is hard to imagine a financial services industry free of the phenomenon. The complex interaction between regulators and industry makes it hard to solve the problems of distortive influence through any one technique; instead, a more effective approach – to deploy a cluster of rather traditional solutions – continues to be necessary. This hardly comes as a surprise, given the exceptionally complex nature of financial markets, their volatile and rapid evolution, and the complicated and often conflicting policies that we support.

²² Baxter, L.G. (2012). ‘Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance’, *Review of Banking and Finance Law*, 31 (Fall 2012, forthcoming).