
NOTES

DANGER LURKING IN THE SHADOWS: WHY REGULATORS LACK THE AUTHORITY TO EFFECTIVELY FIGHT CONTAGION IN THE SHADOW BANKING SYSTEM

Financial crises can be incredibly politically destabilizing and can make life miserable for millions of people, particularly the poor and the disadvantaged, who often lack the savings to weather the storm unscathed. Yet what is often lost in debates about financial crises is that they are, in large part, creatures of law: the risky behavior at their root is possible only because the law allows it, and the crisis-response tools available to financial policymakers are determined by the legal limits on these policymakers' authority. In the wake of the 2007–2008 financial crisis, one must then ask not only what *policy* changes will help to avoid future financial crises, but also what *legal* changes will help to achieve this goal.

This Note argues that significant legal change is necessary to mitigate the systemic risk posed by the reliance of investment banks, money market mutual funds (MMMFs), and other entities in the “shadow banking system”¹ on forms of short-term funding that serve as functional substitutes for deposits. Reliance on these “deposit substitutes” makes the shadow banking system both highly profitable in good times and highly vulnerable to damaging bank run–like behavior in bad times, as demonstrated by the 2007–2008 financial crisis. Although several commentators have debated what policies will best address this risk, they have for the most part neglected whether federal financial regulatory agencies actually have the requisite authority to regulate deposit substitutes in the first place — and, this Note argues, these agencies rather surprisingly do not. Accordingly, Congress should confer upon the Federal Reserve (the Fed) the authority to regulate deposit-substitute funding, defined broadly and functionally, and if Congress fails to do so,² the Financial Stability Oversight Council (FSOC)³ should request such legislation by invoking section 120(d)(3) of the Dodd-Frank Act.⁴

¹ Lynne L. Dallas, *Short-Termism, The Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 283–84 (2012) (describing the shadow banking system).

² Although an assessment of current political reality might suggest that it is doubtful that such legislation can be passed, the focus of this Note is what should be done to prevent future financial crises, not what may or may not be politically feasible at the moment.

³ FSOC is a federal government organization that identifies, monitors, and responds to threats to financial stability, and that facilitates collaboration amongst financial regulators. FSOC's members include the Secretary of the Treasury, the heads of federal financial regulatory

The Note proceeds as follows. Part I lays out the case for regulating deposit substitutes as a general matter. It explains how shadow banks' reliance on deposit substitutes for funding creates systemic risk. Part II examines potential existing statutory bases of authority for regulating deposit substitutes, concluding that financial regulators currently lack the authority to regulate deposit substitutes effectively, and that Congress should clearly establish such authority. Part III then argues that this conferral of authority should define deposit substitutes broadly and functionally to stave off attempts by shadow banks to use financial innovation to engage in harmful regulatory arbitrage. Part III concludes by arguing that this new regulatory authority should be conferred on the Fed.

I. SHORT-TERM FUNDING AND SYSTEMIC RISK

The shadow banking system's reliance on very short-term liabilities makes it vulnerable to contagious runs like those that plagued the traditional banking system prior to the creation of federal deposit insurance. The potential for such contagious runs represents a systemic risk, and accordingly there is a strong case for regulating the manner in which the shadow banking system funds itself.

Though commentators often refer to the "banking system," in fact the United States has two separate banking systems, each governed by different legal regimes. The first is the traditional "depository" banking system, which is comprised of all entities that have a banking charter. This Note refers to such entities as "banks." The second is the "shadow" banking system, which is comprised of all financial intermediaries that do not have a banking charter but nevertheless offer services that are similar to those offered by commercial banks. The most obvious examples of such intermediaries are investment banks like Goldman Sachs, which in a formal legal sense are actually not "banks" at all, even if they are owned by bank holding companies. For the sake of consistency and simplicity, this Note refers to these entities as "shadow banks," even though some of them, such as MMMFs and hedge funds, bear only a passing resemblance to traditional banks in terms of their structures or investment strategies. The crucial legal distinction between banks and shadow banks is that banks are allowed to fund themselves with deposits, whereas shadow banks are prohibited from

agencies, an independent insurance expert, and representatives of state regulators. *About FSOC*, U.S. DEP'T TREASURY, <http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx> (last updated Apr. 25, 2013).

⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.); *id.* § 120(d)(3), 12 U.S.C. § 5330 (2012).

doing so by federal law.⁵ Nevertheless, over time shadow banks have come to rely on forms of funding that effectively function as substitutes for deposits — and that carry all of the same risks that deposits do when left unregulated and uninsured.

In order to explain just what those risks are, section I.A provides an overview of depository banking and of how banks' reliance on depository funding makes contagious, damaging bank runs possible. Section I.B provides an overview of the shadow banking system and explains how it too is vulnerable to contagious, damaging bank runs. Section I.B then briefly explains how the shadow banking system's manner of funding itself creates systemic risk that should be monitored and regulated.⁶

A. *Bank Runs in the Traditional Depository Banking System*

Banks are financial intermediaries (entities that take money from investors, pool it, and then use their investing expertise to invest it in other enterprises) that provide transaction services (services that enable money to change hands in time or space without hard currency having to be involved). Banks' ability to combine these two roles allows them to serve an especially important function in our economy. Like all businesses, banks fund themselves through a combination of debt liabilities (often referred to simply as "liabilities") and equity (often referred to as "capital"). However, banks are the *only* entities that are legally permitted to fund themselves with deposits.⁷ This restriction exists both because of the importance of deposits to depositors, and because of the dangers associated with bank runs.

Deposits are an especially valuable form of debt from the perspective of all parties involved. For depositors, deposits serve as safe and easily accessible "storage lockers" for their money.⁸ Imagine how difficult it would be for you to physically store large amounts of cash yourself — you would face not only the daunting task of authenticating, accounting for, and transporting all of the money, but also serious security risks.⁹ You could, of course, store all that money in long-term investments, but such investments have two major disadvantages. First, many long-term investments are illiquid, which means they cannot be withdrawn and converted to cash on short notice. Second, even

⁵ See 12 U.S.C. § 378.

⁶ Both sections I.A and I.B draw heavily on the work of Professors Gary Gorton and Morgan Ricks. See generally GARY B. GORTON, MISUNDERSTANDING FINANCIAL CRISES (2012); Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75 (2011).

⁷ See 12 U.S.C. § 378.

⁸ See Ricks, *supra* note 6, at 76.

⁹ See *id.*

high-quality, very liquid investments like Treasury bonds are subject to volatility due to the rising and falling of market interest rates.¹⁰

Thus, individuals who store their money in long-term investments may find themselves unable to access the money they have stored for a long period of time, or surprised that there is less money in storage than they had thought. Deposits do not have these problems, as they have three key features that make them unique among financial instruments. First, they are demand-debt instruments, which means they give depositors the legal right to withdraw their money at will. Second, they give depositors the ability to withdraw their money at virtually no cost. And third, they are subject to only negligible interest rate risk.

Because of the liquidity advantage that deposits offer depositors, banks are able to offer very low interest rates on deposits, which makes them a very cheap source of funding — usually the cheapest available.¹¹ Thus, the more a bank is able to fund itself with deposits, as opposed to other liabilities or equity, the more profitable it tends to be. This is why banks make such great efforts to convince consumers to open checking and savings accounts with them.

Deposits also serve a crucial function for our economic system as a whole: maturity transformation, which is the channeling of individuals' short-term money reserves into long-term investments.¹² This transformation occurs via fractional-reserve banking. Because it is unlikely that all depositors will withdraw all of their money at the same time, banks need to keep only a fraction of total deposits on reserve as cash — the balance can be channeled into longer-term investments. Maturity transformation thus increases the supply of investment capital available to businesses and other economic agents, effectively creating money.¹³ Therefore, under normal circumstances, deposits make everybody in the financial system better off: banks benefit from cheap funding; depositors benefit from safe short-term storage for their money; and the economy as a whole benefits from a greater supply of investable capital.

In a crisis, however, deposits can make the traditional depository banking system vulnerable to contagious, destabilizing runs: First, depositors become worried that their bank will fail, which could cause them to lose access to their money for some period of time, or possibly

¹⁰ *Id.* at 79.

¹¹ See Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 449 (noting that insured deposits provide banks with a “funding advantage”).

¹² See Ricks, *supra* note 6, at 98–101.

¹³ See *id.* This is the “money multiplier” effect. See *Multiplier Effect*, INVESTOPEDIA, <http://www.investopedia.com/terms/m/multipliereffect.asp> (last visited Oct. 27, 2013).

forever. Fearful that they will not get to the bank in time, the depositors then all converge on the bank at the same time to withdraw their funds, “running” on the bank. Because deposits are demand-debt instruments that must be honored immediately, and because banks keep only a fraction of total deposits on reserve as cash, the bank then burns through its cash reserves fairly quickly and must start selling off its assets in order to obtain cash to meet the withdrawals. However, the bank can sell off these assets for only a fraction of their book value, either because of the discount due to their longer-term nature, or because of a glut in the market due to other banks selling off similar assets at the same time (which would be the case if the other banks are also being run on), or both. These sales at impaired prices cause losses for the bank, decreasing its shareholders’ equity. If the situation continues for long enough, the bank will eventually run out of shareholders’ equity, become insolvent, and fail.

This failure would likely make depositors at similar banks nervous about the safety and soundness of *their* banks, causing more runs and more bank failures (the “contagion” effect). Since banks effectively create money, these failures would in turn reduce the money supply and cause interest rates to rise, thereby drying up the supply of credit, disrupting the payment system, and slowing economic growth. This process tends to occur very rapidly, and because it feeds on fear, it often becomes a self-fulfilling prophecy.

Of course, contagious runs in the depository banking system have become rare, and federal deposit insurance is to thank for it.¹⁴ The vast majority of depositors have accounts insured up to their full value, which means that even if their bank were to fail, there is little risk that they would be unable to access the funds in their deposit accounts for even a brief period of time. Thus, most depositors lack an incentive to run on their bank, even if they are worried that their bank might fail.

B. Bank Runs in the Shadow Banking System

Shadow banks, such as investment banking operations, MMMFs, and hedge funds, are financial intermediaries that serve many of the same functions as banks but are legally prohibited from issuing deposits by 12 U.S.C. § 378,¹⁵ which was enacted in 1933 as part of the Glass-Steagall Act¹⁶ in order to combat the perceived hazards of com-

¹⁴ See RICHARD SCOTT CARNELL ET AL., *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 47 (4th ed. 2009).

¹⁵ Technically, § 378 prohibits only securities underwriters and dealers from issuing deposits, but in practice, this prohibition encompasses virtually all shadow banks.

¹⁶ Pub. L. No. 73-66, 48 Stat. 162 (1933).

binning commercial banking and investment banking activities.¹⁷ Despite this formal prohibition on issuing deposits, over the last few decades shadow banks have come to rely heavily on various forms of short-term funding that serve as functional substitutes for deposits,¹⁸ such as short-term repurchase agreements (“repo”),¹⁹ commercial paper,²⁰ MMMF shares,²¹ and prime brokerage accounts.²² Each of these forms of short-term nondeposit funding is capable of serving the three key functions of deposits described above. First, each is a form of demand debt: repo and commercial paper creditors can “withdraw” their funds by choosing not to roll their balances over, which can typically be achieved overnight in the case of repo and within ninety days in the case of commercial paper, and MMMF shares and prime brokerage balances are usually redeemable upon request. Second, such “withdrawals” are essentially costless to the investor — in practice they are not typically associated with withdrawal fees or penalties. And third, each of these deposit substitutes is subject to only negligible in-

¹⁷ See *Inv. Co. Inst. v. Camp*, 401 U.S. 617, 629–34 (1971) (describing Congress’s motivations in enacting the Glass-Steagall Act).

¹⁸ See, e.g., William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the New York Bankers Association’s 2013 Annual Meeting & Economic Forum: Fixing Wholesale Funding to Build a More Stable Financial System (Feb. 1, 2013) (remarks as prepared for delivery available at <http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html>) (describing such funding as “deposit-like”).

¹⁹ Repurchase agreements are very short-term (often overnight) loans secured by collateral (typically a bond). See GORTON, *supra* note 6, at 38. If the borrower (the shadow bank) fails during the very short period in which the loan is outstanding, the lender (who is analogous to a depositor) can sell the collateral without going through a bankruptcy procedure. Typically, when a repo loan matures it “rolls over,” meaning that the lender leaves its money with the borrower and enters into another, identical repo agreement. Thus, most repo lenders (who are like depositors) maintain what is effectively a continuous balance with the borrower (the shadow bank).

²⁰ Commercial paper is also a form of short-term loan, typically with a maturity date of no longer than ninety days. See James L. Pray, Comment, *A. G. Becker v. Board of Governors of the Federal Reserve System: Commercial Paper is Not a Security Under the Glass-Steagall Act*, 9 J. CORP. L. 321, 325 (1984). Unlike repo, commercial paper does not enjoy safe-harbor protection in bankruptcy proceedings, and it may not be backed by collateral. See Nathan Goralnik, Note, *Bankruptcy-Proof Finance and the Supply of Liquidity*, 122 YALE L.J. 460, 492 (2012).

²¹ MMMFs are mutual funds “that may legally invest in ‘only certain high-quality, short-term investments issued by the U.S. government, U.S. corporations, and state and local governments.’” Daniel E. Levin, Note, *Breaking the Buck: The End for Money Market Mutual Funds as We Know Them*, 28 REV. BANKING & FIN. L. 747, 755 (2009) (quoting SEC. & EXCH. COMM’N, INVEST WISELY: AN INTRODUCTION TO MUTUAL FUNDS (2008)). Unlike other kinds of mutual funds, MMMF shares maintain a stable, day-to-day value of one dollar per share, and they pay daily distributions of dividend and capital gain income that function analogously to interest payments. *Id.*

²² Prime brokers clear trades, provide leverage, and issue credit lines to hedge funds and other investors. GORTON, *supra* note 6, at 39. Prime brokerage accounts essentially function as checking accounts for the prime brokers’ clients, who are typically hedge funds. *Id.* Prime brokers use these balances to fund their investing activities. *Id.*

terest rate risk, as these substitutes usually offer rates of return just above the market rate for deposits.²³

With deposit insurance capped at \$100,000 per account,²⁴ institutional investors with large sums of money at their disposal, such as multinational corporations and pension funds, often face a choice between investing their money in largely uninsured deposit accounts, or investing in repo, commercial paper, MMMF shares, or prime brokerage accounts, which serve all of the same functions as deposit accounts yet offer a higher rate of return.²⁵ These advantages over deposit accounts, in turn, explain how over the past few decades the shadow banking system has grown into a multi-trillion dollar industry,²⁶ and how the total amount of deposit substitutes outstanding, which is now over \$10 trillion,²⁷ has come to dwarf that of FDIC-insured deposits held by banks.²⁸ This growth has, of course, been largely invisible to the average depositor, whose savings are under the FDIC insurance cap and who cannot directly invest in deposit substitutes, as these investment opportunities are typically available only to large institutional investors.

Deposit substitutes thus share all of the characteristics of deposits that make the depository banking system vulnerable to contagious, damaging bank runs in the absence of an effective deposit insurance scheme. It follows that the shadow banking system's reliance on deposit substitutes will make it, too, vulnerable to contagious, damaging bank runs if deposit substitutes are left uninsured. And in fact, the United States' experience with MMMFs in the 2007–2008 financial crisis provides a vivid illustration of what such a run in the shadow banking system looks like.

When Lehman Brothers failed on September 15, 2008, the Reserve Primary Fund (RPF), one of the world's most important MMMFs, had 1.2% of its assets invested in Lehman debt securities like commercial

²³ See Ricks, *supra* note 6, at 93.

²⁴ See 12 U.S.C. § 5241 (2012). The deposit insurance cap has been temporarily increased to \$250,000 due to the financial crisis, but it will return to \$100,000 at the end of 2013. See *id.*

²⁵ See Adair Turner, Chairman, Fin. Servs. Auth., Cass Lecture 2012 at Cass Business School: Shadow Banking and Financial Instability 26 (Mar. 14, 2012) (transcript available at <http://www.fsa.gov.uk/static/pubs/speeches/0314-at.pdf>) (noting that deposit substitutes are “low risk” but deliver a “yield uplift over conventional risk-free instruments”).

²⁶ In just the short period between 2002 and 2007, assets in the shadow banking system grew from \$27 trillion to \$60 trillion. FIN. STABILITY BD., SHADOW BANKING 8 (2011). Further, the ratio of the total assets of investment banks to the total assets of commercial banks grew from about 6% in 1990 to about 30% in 2006, an increase of 376%. GORTON, *supra* note 6, at 191.

²⁷ Morgan Ricks, *A Regulatory Design for Monetary Stability*, 65 VAND. L. REV. 1289, 1298 fig.1.2 (2012).

²⁸ See Ricks, *supra* note 6, at 85–86. Although some nonfinancial firms use deposit substitutes to fund their working capital, such activity makes up only a small percentage of the total amount of deposit substitutes outstanding. See *id.* at 80–81.

paper, enough for its share values to “break the buck” (that is, decrease in value to under \$1 per share, which for an MMMF would constitute failure) if the assets lost significant value.²⁹ Upon realizing that Lehman was in serious danger of failure, many RPF shareholders simultaneously issued redemption requests — in essence, running on the fund.³⁰ At the start of Monday of that week, RPF had \$63 billion in total assets; by the end of that Tuesday, the redemption requests totaled nearly \$34 billion.³¹ RPF tried to sell off assets to meet the redemption requests, but it encountered great difficulty doing so because the credit markets were barely functioning.³² By the end of that Tuesday, RPF could no longer come up with cash with which to pay off the redemption requests, and it was forced to break the buck and fail.³³ RPF’s failure triggered a panic amongst shareholders of every other major MMMF.³⁴ By the end of the week, U.S. MMMFs had experienced \$310 billion in withdrawals, or 15% of their total assets.³⁵

The failure of MMMFs in turn had a major effect on the rest of the financial system. At the time, MMMFs were major buyers of commercial paper,³⁶ which many financial institutions and nonfinancial corporations use to fund their day-to-day cash needs.³⁷ As MMMFs failed, large corporations such as General Electric and Ford suddenly found themselves without buyers for their commercial paper, and they began to have trouble funding *their* day-to-day operations.³⁸ Had the federal government not then intervened to guarantee the MMMFs’ obligations, it is likely that the United States would have experienced, in the words of then-Treasury Secretary Henry Paulson, businesses “slash[ing] their inventories and cut[ting] back operations . . . [with] massive job cuts spreading throughout an already suffering economy,” ultimately resulting in “damage approaching that of the Great Depression.”³⁹ Even with the guarantee in place, twelve of the thirteen most

²⁹ See *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5 FDIC Q., no. 2, 2011, at 31, 33; James B. Stewart, *Eight Days*, NEW YORKER, Sept. 21, 2009, at 58, 70.

³⁰ See Stewart, *supra* note 29, at 70.

³¹ See *id.* at 70, 73.

³² See *id.* at 70.

³³ See *id.* at 70, 72.

³⁴ See Nicola Gennaioli, Andrei Shleifer & Robert Vishny, *Neglected Risks, Financial Innovation, and Financial Fragility*, 104 J. FIN. ECON. 452, 453 (2012).

³⁵ *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, *supra* note 29, at 33.

³⁶ At the height of the crisis, MMMFs had \$3.5 trillion in assets and 30 million retail customers. HENRY M. PAULSON, JR., *ON THE BRINK* 234 (e-book ed. 2013).

³⁷ See Stewart, *supra* note 29, at 69.

³⁸ See PAULSON, *supra* note 36, at 227–28; Stewart, *supra* note 29, at 73.

³⁹ PAULSON, *supra* note 36, at 228. This run on MMMFs was of course neither the first, nor the last, run in the shadow banking system during the recent crisis. In fact, in August 2007, be-

important financial institutions in the United States were in serious danger of failure.⁴⁰ The runs stopped only after the federal government aggressively stepped in to implement guarantees, emergency loans, and capital infusions.⁴¹

The foregoing discussion makes clear how shadow banks' reliance on deposit substitutes for funding creates systemic risk, which may be defined as:

the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.⁴²

Further, there is little reason to believe that shadow banks will adequately police this systemic risk on their own. First, banks face a collective action problem: even if they all came to an agreement to self-insure, individual banks would have an incentive to cheat on the agreement in order to earn extra profits in the short term, a problem that would be exacerbated by intense pressure from shareholders to improve profitability. More important, however, is the problem of externalities. Runs cause *systemic* damage, not just damage to the shadow banks themselves, and yet when shadow banks' managers determine what level of protections to implement, they will likely care only about the latter. At the same time, history suggests that if a run occurs, the shadow banks will not have to fully internalize its costs because the government typically steps in during panics to implement guarantees or bailouts. These externalities make it likely that, if left to its own devices, the shadow banking system would implement suboptimal protections. There is therefore a strong case for regulating the shadow banking system's reliance on deposit substitutes.

II. STATUTORY AUTHORITY TO REGULATE DEPOSIT SUBSTITUTES

Do regulators have the authority to regulate deposit substitutes? Despite the fact that runs in the shadow banking system were a major feature of the 2007–2008 financial crisis, the Dodd-Frank Act contains no provisions aimed at mitigating the threat that such runs pose to fi-

fore MMMFs encountered any trouble, there was a run in the market for asset-backed commercial paper. See Ricks, *supra* note 27, at 1307. Runs also eventually plagued the markets for repo, commercial paper, and prime brokerage. See GORTON, *supra* note 6, at 191–92; Ricks, *supra* note 6, at 87.

⁴⁰ PAULSON, *supra* note 36, at 182, 194.

⁴¹ See Morgan Ricks, *Reforming the Short-Term Funding Markets* 8 tbl.1 (Harvard Univ. John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 713, 2012).

⁴² Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008).

financial stability,⁴³ and there have been few significant post-Dodd-Frank regulatory developments aimed at preventing them.⁴⁴ In light of this situation, several commentators such as Professors Morgan Ricks, Gary Gorton, Andrew Metrick, Nouriel Roubini, and Stephen Mihm, and the Financial Stability Board have issued proposals to regulate deposit substitutes.⁴⁵ But these proposals put the cart before the horse because financial regulatory agencies cannot regulate deposit substitutes unless they have statutory authority to do so. Ricks appears to be the only commentator who has written on whether financial regulators have the statutory authority to regulate short-term nondeposit funding, and he has concluded that “[r]egulators have powerful tools at their disposal to impose short-term funding limits on major classes of nonbank financial firms.”⁴⁶ Unfortunately, there is good reason to doubt this is the case, as the existing statutory framework leaves serious gaps with regard to regulators’ authority to regulate deposit substitutes. These gaps are a major problem because shadow banks will likely exploit any gaps in coverage to avoid regulations that raise their cost of funds. Consequently, this Part argues that Congress should clearly confer authority to regulate the use of deposit substitutes, and if it fails to do so, FSOC should issue a report to Congress under section 120(d)(3) of the Dodd-Frank Act to request such legislation.

Congress has divided authority to regulate the shadow banking system amongst several agencies, with the divisions based on the legal form of the shadow bank being regulated. Accordingly, this Part proceeds in several subparts that focus on the particular legal forms a shadow bank may take. Section II.A analyzes the existing sources of regulatory authority over bank affiliates; section II.B focuses on unaffiliated broker-dealers and MMMFs; and section II.C examines other financial entities. Section II.D then discusses the “activities or practic-

⁴³ See, e.g., GORTON, *supra* note 6, at 197–98 (criticizing the Dodd-Frank Act for not addressing the systemic risk created by shadow banking and short-term funding); CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, *MANIAS, PANICS AND CRASHES* 300–01 (6th ed. 2011) (same).

⁴⁴ See Ricks, *supra* note 41, at 9–11 (criticizing various reforms for failing to address deposit substitutes); Dudley, *supra* note 18 (criticizing SEC’s MMMF regulations for failing to mitigate threat of runs by MMMF shareholders).

⁴⁵ See Ricks, *supra* note 41, at 1–3, 12–18 (proposing a licensing scheme for money market debt instruments that is similar to deposit insurance); Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2010, at 261, 284–89 (proposing reforms for MMMFs and repo financing); NOURIEL ROUBINI & STEPHEN MIHM, *CRISIS ECONOMICS* 231–32 (2010) (advocating “banning investment banks and broker dealers from doing any kind of short-term borrowing”); FIN. STABILITY BD., *supra* note 26, at 3–6, 12–13 (advocating a “wide-net” surveillance program for nonbank credit intermediation activities).

⁴⁶ Ricks, *supra* note 41, at 25; see also *id.* at 21–26 (discussing potential sources of regulatory authority).

es” authority provided for by section 120 of the Dodd-Frank Act.⁴⁷ Ultimately, this Part concludes that federal financial regulatory agencies lack the authority to regulate many shadow banks.

A. *The Federal Reserve and Bank Affiliates*

Although the statutory definition of “bank affiliate” is somewhat complex, in general bank affiliates are (i) companies that control banks that are members of the Federal Reserve System, or (ii) the banking subsidiaries of such banks.⁴⁸ Ricks argues that the Fed “has a substantial legal basis for imposing limits on short-term funding by bank affiliates.”⁴⁹ This statement is true only up to a point. The most obvious potential source of statutory authority for the Fed to regulate bank affiliates’ use of deposit substitutes is section 165(g) of the Dodd-Frank Act, which provides the Fed with broad authority to engage in rule-making to limit short-term debt activities by bank holding companies (BHCs) with over \$50 billion in assets.⁵⁰ And therein lies the rub: there are hundreds of BHCs whose total assets place them below this threshold.⁵¹ Section 165(g)’s \$50 billion cap is therefore a critical gap in the current regulatory regime. Further, there is a small chance that section 165(g) may be vulnerable to regulatory arbitrage because it defines short-term debt as “such liabilities with short-dated maturity that the Board of Governors [of the Federal Reserve System] identifies, by regulation, except that such term does not include insured deposits,”⁵² and it may be possible for financial wizards to create a deposit substitute that in a formal legal sense would not have a short-dated maturity.⁵³ Thus, section 165(g)’s coverage could actually be quite limited.

The Fed could also claim authority to regulate deposit substitutes under the provisions of the Bank Holding Company Act of 1956,⁵⁴ specifically 12 U.S.C. § 1844. This argument is problematic for several reasons. First, if it is correct, Congress would not have needed to pass section 165(g) of the Dodd-Frank Act, for section 165(g) would have

⁴⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act § 120, 12 U.S.C. § 5330 (2012).

⁴⁸ See 12 U.S.C. § 371c(b).

⁴⁹ Ricks, *supra* note 41, at 21.

⁵⁰ See Dodd-Frank Wall Street Reform and Consumer Protection Act § 165(g), 12 U.S.C. § 5365(g).

⁵¹ See *Top 50 Holding Companies*, NAT’L INFO. CENTER, <http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx> (last visited Oct. 27, 2013); *BHCPR Peer Group Average Reports*, NAT’L INFO. CENTER, http://www.ffiec.gov/nicpubweb/content/BHCPRRPT/BHCPR_Peer.htm (last visited Oct. 27, 2013).

⁵² Dodd-Frank Wall Street Reform and Consumer Protection Act § 165(g)(3), 12 U.S.C. § 5365(g)(3).

⁵³ The fact that such an instrument does not yet exist admittedly might suggest that the definition is airtight, though one cannot wholly write off the threat of arbitrage.

⁵⁴ 12 U.S.C. §§ 1841–1852.

just conferred authority that the Fed already possessed. Second, it is not clear that section 1844 applies to bank liabilities. Section 1844(b) authorizes the Fed to “issue such regulations and orders . . . as may be necessary to enable it to administer and carry out the purposes of [the Bank Holding Company Act] and prevent evasions thereof.”⁵⁵ Since one of the purposes of the Bank Holding Company Act is to protect systemic financial stability,⁵⁶ this provision could be seen as a source of authority for the Fed to regulate deposit substitutes. However, section 1844(b) says nothing about liabilities or funding, but at the same time specifically confers authority to issue “regulations and orders relating to the capital requirements for bank holding companies,” and contains language regarding what the Board shall do “[i]n establishing capital regulations pursuant to this subsection.”⁵⁷ Thus, section 1844(b) may be limited to providing authority to regulate capital.⁵⁸

Section 1844(e), however, provides that “the Board may, whenever it has reasonable cause to believe that the continuation by a bank holding company of any activity . . . constitutes a serious risk to the financial safety, soundness, or stability of a bank holding company subsidiary bank[,] . . . order the bank holding company . . . to terminate such activities”⁵⁹ Section 1841, the definitional section of the Bank Holding Company Act, does not define “activity,” which suggests that the term should be construed broadly, and therefore could potentially cover funding activities. Nevertheless, section 1844(e) only provides the Fed with the authority to issue a regulation ordering the *termination* of an activity, not to limit it or regulate it on an ongoing basis.⁶⁰ Further, section 1844(e) has never been successfully used to regulate a major banking organization,⁶¹ despite the fact that it has been on the books since 1978.⁶²

In sum, the Fed’s Dodd-Frank section 165(g) authority does not allow it to regulate a large number of BHCs; its 12 U.S.C. § 1844(b) authority probably cannot be used to regulate bank liabilities; and its § 1844(e) authority can probably only be used to order the termination

⁵⁵ *Id.* § 1844(b).

⁵⁶ *See id.* § 1843(j)(2)(A); § 1843(k)(1); § 1844(c)(2)(A).

⁵⁷ *Id.* § 1844(b).

⁵⁸ Of course, increased capital requirements could help to mitigate the threat of failure caused by a bank run. But they would do nothing to prevent a run in the first place, unlike more direct forms of regulation such as insurance.

⁵⁹ 12 U.S.C. § 1844(e)(1).

⁶⁰ Although the Fed could threaten to terminate a BHC activity if the BHC does not take a certain course of action, this does not undermine the broader point that the Fed is limited to a narrow range of policy responses if it desires to regulate BHCs’ use of deposit substitutes.

⁶¹ Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 951, 1025 (2011) (quoting a senior Fed official).

⁶² Act of Nov. 10, 1978, Pub. L. No. 95-630, §§ 105(a), 106(b), 92 Stat. 3641, 3646, 3648–49.

of activities. Even if the Fed's authority currently extends to the most important institutions that rely on deposit substitutes, the Fed probably cannot regulate the use of deposit substitutes by many bank affiliates.

B. The SEC, MMMFs, and Unaffiliated Broker-Dealers

The Securities and Exchange Commission (SEC) retains some authority to regulate shadow banks, but its reach extends only to MMMFs and some unaffiliated broker-dealers, which are companies that trade securities for their own account or on behalf of customers⁶³ but which are not affiliated with a bank that is a member of the Federal Reserve system.⁶⁴ The SEC clearly has the authority to regulate the use of deposit substitutes by MMMFs under the Investment Company Act of 1940,⁶⁵ and it has recently moved in the direction of doing so.⁶⁶ Nevertheless, many experts on financial regulation (including former Treasury Secretary Timothy Geithner) have criticized the SEC's reticence to implement meaningful reform, and it is yet unclear what form these regulations will take.⁶⁷ Unfortunately, this means that in the one area that financial regulators clearly have authority to regulate the use of deposit substitutes, they may lack the will to do so. With regard to broker-dealers that are not affiliated with a BHC, 15 U.S.C. § 780(c)(3)(A) confers upon the SEC the authority to establish rules "as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers."⁶⁸ However, commercial paper is *explicitly exempted* from the SEC's section 780(c)(3)(A) authority.⁶⁹ Thus, the SEC lacks the authority to regulate one very important type of deposit substitute when used by unaffiliated broker-dealers.

⁶³ See *Broker-Dealer*, INVESTOPEDIA, <http://www.investopedia.com/terms/b/broker-dealer.asp> (last visited Oct. 27, 2013).

⁶⁴ See 12 U.S.C. § 371c(b) (defining the term "affiliate"). LPL Financial is an example of an unaffiliated broker-dealer. See *About Us*, LPL FINANCIAL, <http://www.joinlpl.com/independent-financial-advisor/lpl-financial.html> (last visited Oct. 27, 2013).

⁶⁵ 15 U.S.C. §§ 80a-1 to 64 (2012); see 15 U.S.C. § 80a-6(c) (ability to provide exemptions); *id.* § 80a-22(c) (rulemaking authority regarding securities transactions); *id.* § 80a-37(a) (general rule-making provision).

⁶⁶ See Press Release, SEC, SEC Proposes Money Market Fund Reforms (June 5, 2013), available at <http://www.sec.gov/news/press/2013/2013-101.htm>.

⁶⁷ See David Zaring, *Money Market Fund Overhaul Is Early Test for Dodd-Frank*, N.Y. TIMES DEALBOOK (May 31, 2013, 2:10 PM), <http://dealbook.nytimes.com/2013/05/31/money-market-fund-overhaul-is-early-test-for-dodd-frank>.

⁶⁸ 15 U.S.C. § 780(c)(3)(A); see also Ricks, *supra* note 41, at 23.

⁶⁹ See 15 U.S.C. § 780(c)(3)(A).

C. Other Financial Entities

Some financial entities, such as certain hedge funds, finance companies, and unaffiliated asset-backed commercial paper conduits, are neither bank affiliates, nor unaffiliated broker-dealers, nor MMMFs.⁷⁰ Although such entities are not currently major issuers of deposit substitutes, it is possible that they could be in the future. This is problematic because no primary financial regulator currently has authority to supervise and regulate them.

The Fed could be given the authority to regulate the short-term nondeposit funding activities of these nonbank financial entities pursuant to section 113 of the Dodd-Frank Act. Under section 113, if FSOC finds that “material financial distress at [a] U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States,” it can designate the company for regulation by the Fed⁷¹ (which could include limits on short-term funding imposed under the Fed’s section 165(g) authority).⁷² Further, section 113(a)(2)(J) specifically lists “the amount and types of the liabilities of the company, including the degree of reliance on short-term funding” as a relevant factor in making a determination under section 113(a).⁷³

However, a successful designation requires both a vote of two-thirds of the voting members of FSOC and an affirmative vote by the Secretary of the Treasury,⁷⁴ plus it must be done on an entity-by-entity basis.⁷⁵ Simply put, and as Ricks has argued, this is not a process built for speed or for bringing many nonbank financial entities under the federal government’s regulatory ambit in one fell swoop.⁷⁶ Further, designees can contest their designation in court,⁷⁷ which is bound to drag out the process even further.

⁷⁰ Ricks, *supra* note 41, at 23.

⁷¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act § 113(a)(1), 12 U.S.C. § 5323(a)(1) (2012).

⁷² See *supra* p. 739.

⁷³ Dodd-Frank Wall Street Reform and Consumer Protection Act § 113(a)(2)(J), 12 U.S.C. § 5323(a)(2)(J).

⁷⁴ *Id.* § 113(a)(1), 12 U.S.C. § 5323(a)(1).

⁷⁵ See *id.* § 113, 12 U.S.C. § 5323.

⁷⁶ Ricks, *supra* note 41, at 24 (“Clearly, this designation tool was not designed to impose generally applicable limitations on the financial industry. . . . At most, a handful of very large firms should be expected to qualify.”).

⁷⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act § 113(h), 12 U.S.C. § 5323(h).

D. Dodd-Frank “Activities or Practices” Authority

Section 120(a) of the Dodd-Frank Act states that FSOC “may provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards . . . for a financial activity or practice . . . [that] could create or increase the risk of significant liquidity, credit, or other problems spreading” throughout the financial system.⁷⁸ However, if FSOC issues a recommendation under section 120(a), financial regulatory agencies need not follow the recommendation: under section 120(c)(2), they can simply disregard it so long as they “explain in writing to the Council” their choice within ninety days after the date on which the recommendation was issued.⁷⁹ This could allow agencies to resist implementing it, possibly due to financial industry lobbying and political influence, which would in turn result in an inconsistent regulatory response that could create opportunities for regulatory arbitrage. Even if regulators do follow a recommendation by FSOC, they would still be constrained by the existing limits on their authority. FSOC’s section 120(a) authority is therefore of only limited utility in the fight against runs in the shadow banking system.

* * *

As one can see, it is surprisingly unclear whether our existing statutory framework gives regulators the authority they need to regulate the threat of bank runs in the shadow banking system. Because regulating the shadow banking system’s reliance on deposit substitutes is crucial to ensuring the future stability of our financial system, Congress should clearly confer authority to regulate deposit substitutes. If Congress fails to do so, FSOC should request such legislation by invoking section 120(d)(3) of the Dodd-Frank Act, which provides that “in any case in which no primary financial regulatory agency exists for the nonbank financial company conducting [such] financial activities or practices . . . , [FSOC may] recommend[] . . . legislation that would prevent such activities or practices from threatening the stability of the financial system of the United States.”⁸⁰ The next questions to ask are how this authority should be conferred, and who should be entrusted with it.

⁷⁸ *Id.* § 120(a), 12 U.S.C. § 5330(a).

⁷⁹ *Id.* § 120(c)(2), 12 U.S.C. § 5330(c)(2).

⁸⁰ *Id.* § 120(d)(3), 12 U.S.C. § 5330(d)(3).

III. THE CASE FOR A BROAD AND FUNCTIONAL STATUTORY DEFINITION OF DEPOSIT SUBSTITUTES

This Part argues for taking a broad, functional approach to defining deposit substitutes when conferring authority to regulate their use. Section III.A begins by addressing the question of how we got here — how is it that new, unregulated forms of short-term funding were able to develop right underneath policymakers' noses over the course of the past few decades? The answer is that the shadow banking system's reliance on deposit substitutes developed through a process of regulatory arbitrage and financial innovation. Thus, section III.A concludes that any conferral of regulatory authority over deposit substitutes must enable regulators to stave off future attempts at evading regulation, and it argues that a broad, functional approach represents the best way to achieve this goal. Section III.B then presents a separate argument for a broad, functional approach to regulating deposit substitutes: defining deposit substitutes too formally or narrowly could leave regulations vulnerable to legal challenges based on the Supreme Court's decision in *Board of Governors of the Federal Reserve System v. Dimension Financial Corp.*⁸¹ Section III.C then extends the arguments of sections III.A and III.B to argue for a broad, functional definition of deposit substitutes in the statute that confers authority to regulate them. Section III.D argues that the Fed is best suited for the task of regulating deposit substitutes.

A. Regulatory Arbitrage and Financial Innovation

Financial innovation, defined broadly as the process of inventing and adopting new financial products and services or new ways of providing them,⁸² has the power to do tremendous good for society by reducing the cost of credit for businesses and individual consumers, reducing the cost of financial services, and increasing consumer choice.⁸³ Yet there is considerable evidence that financial innovation has a dark side,⁸⁴ part of which is its ability to facilitate harmful regulatory arbitrage,⁸⁵ which is the deliberate structuring of products and transac-

⁸¹ 474 U.S. 361 (1986).

⁸² This definition is an amalgam of several existing definitions of financial innovation. See, e.g., Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505, 518 (1998); Thorsten Beck et al., Financial Innovation: The Bright and the Dark Sides 4 (Sept. 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1991216>.

⁸³ See, e.g., Robert E. Litan, *In Defense of Much, but Not All, Financial Innovation*, BROOKINGS INST. 3–4 (Feb. 17, 2010), <http://www.brookings.edu/research/papers/2010/02/17-financial-innovation-litan>.

⁸⁴ See Beck et al., *supra* note 82, at 2–4 (noting significant debate in economics literature over the costs and benefits of financial innovation).

⁸⁵ See, e.g., Michael S. Knoll, *The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage*, 87 OR. L. REV. 93, 94 (2008); Beck et al., *supra* note 82, at 4.

tions to avoid socially beneficial regulations.⁸⁶ Indeed, the rise of the shadow banking system, and thus the story of the 2007–2008 financial crisis, is largely one of innovation and regulatory arbitrage.

The explosive growth in the shadow banking system's reliance on deposit substitutes was a response to the policies and the economic conditions of the 1970s and early 1980s, during which deposit insurance was capped at \$100,000 per account, Regulation Q limited the interest rates that could be offered on demand deposit accounts,⁸⁷ inflation rates were high, and there was a rise in the number of institutional investors with large holdings of money, like pension funds.⁸⁸ Because of the latter trend, the market for deposit-like products rapidly expanded, at a time when deposits were of only limited appeal in terms of either security (because of the deposit insurance caps) or yield (because of Regulation Q). As a result, pressure mounted for the development of substitutes for deposits, and this is exactly what happened — with shadow banks capitalizing on the resulting new sources of cheap funding.

In particular, shadow banks developed MMMFs by building off of innovations and techniques developed in the market for certificates of deposit (CDs) in the 1950s and 1960s,⁸⁹ and they also developed new funding techniques that relied more heavily on repo and commercial paper. Although repo was not itself invented during this period, the 1970s and 1980s nevertheless saw substantial innovation in repo, specifically the development of bankruptcy-proof repo (which was achieved through changes to the Bankruptcy Code in 1984),⁹⁰ and the creation of General Collateral Finance (GCF) repo by the Depository Trust and Clearing Corporation.⁹¹ These innovations permitted repo to become the important source of funding for the shadow banking system that it is today.⁹²

Thus, the rise of the shadow banking system is a tale of financial innovation through regulatory arbitrage and regulatory accommodation — the creation of new financial products and services (such as

Regulatory arbitrage is itself not necessarily harmful, as it is possible for regulations to be inefficient and for them to impede productive activity. See Litan, *supra* note 83, at 2.

⁸⁶ See Michael Bennett, Practitioner Note, *Complexity and Its Discontents: Recurring Legal Concerns with Structured Products*, 7 N.Y.U. J.L. & BUS. 811, 835 (2011).

⁸⁷ See Gorton & Metrick, *supra* note 45, at 263, 269.

⁸⁸ See GORTON, *supra* note 6, at 132–33.

⁸⁹ See Pouncy, *supra* note 82, at 534.

⁹⁰ See Gorton & Metrick, *supra* note 45, at 277. In 2005 Congress further expanded the definition of repo, broadening the category of repo transactions that qualify as bankruptcy-proof. *Id.* at 277–78.

⁹¹ GORTON, *supra* note 6, at 132–33.

⁹² See *id.* at 132; Gorton & Metrick, *supra* note 45, at 266 (arguing that “the bankruptcy safe harbor for repos has been crucial to the growth of shadow banking”).

MMMFs) and changes to existing products and services (such as repo and commercial paper) and how they were used. The rise of the shadow banking system is but one of many historical examples of the financial sector devising new forms of short-term funding to evade regulatory restrictions.⁹³ Unsurprisingly, innovations like these have often coincided with speculative bubbles and the runs and panics that follow them.⁹⁴

The lesson that should be taken from this historical account is that our mode of regulation must be conscious of and responsive to the possibility of regulatory arbitrage through financial innovation. The best way of achieving this goal is to take an approach to regulation that (1) defines the object of regulation in a functional manner for the purposes of conferring authority to regulate it and determining the scope of regulations,⁹⁵ and (2) uses generally applicable standards instead of specific rules.

First, a functional approach is superior to a formal one because it is adaptable to changing circumstances. If the statute that confers authority on regulators to regulate deposit substitutes defines the affected transactions by their function, regulators will have little trouble establishing their authority to regulate a given innovation, which might not be the case if their authority is restricted to financial instruments or institutions that meet a certain legal definition or take a certain legal form. Similarly, if the applicability of a regulation is based on function, regulators do not have to worry about issuing new regulations to achieve the same regulatory effect. Further, uncertainty as to whether a given innovation would be subject to regulation would encourage financial actors to consult with regulators, and would slow the process of innovation in this area, better enabling regulators to monitor and regulate it.

Second, standards are more flexible and adaptable to change than are rules.⁹⁶ Though it is true that a formal, rules-based approach would provide more certainty to financial institutions with regard to how their conduct might be regulated, and might also provide for greater democratic accountability by more carefully bounding regulators' authority, here the severe danger posed by runs and regulatory

⁹³ See KINDLEBERGER & ALIBER, *supra* note 43, at 62–69.

⁹⁴ See generally *id.*

⁹⁵ Cf. Ricks, *supra* note 41, at 27–28 (arguing for a functional approach).

⁹⁶ See, e.g., Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Address to the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference: Regulation and Financial Innovation (May 15, 2007) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070515a.htm>) (arguing that "principles-based policy responses that can be applied consistently" are a better means of regulating new financial instruments and institutions than are ad hoc rules).

arbitrage suggests that sacrificing these benefits in favor of regulatory flexibility is well justified.

B. Dimension Financial and the Dangers of Formalism

Another reason to favor a broad functional approach to regulating deposit substitutes is the vulnerability of a formalist approach to legal challenges predicated on the Supreme Court's decision in *Board of Governors of the Federal Reserve System v. Dimension Financial Corp.*⁹⁷ It is remarkable that this unanimous 1986 decision has gone virtually unnoticed in the recent literature on the financial crisis, given its potential implications for the scope of financial regulators' authority. Specifically, *Dimension Financial* suggests that courts should reject attempts by financial regulators to convert conferrals of authority based on formal definitions of the financial products, services, or institutions to be regulated into conferrals of authority based on functional definitions. The decision thus illustrates the danger that formalist judicial review will thwart attempts by regulators to mitigate the threat posed by harmful regulatory arbitrage, further highlighting the advantages of taking a functionalist approach from the outset.

In 1956, Congress passed the Bank Holding Company Act (the Act), which defined the term "bank" as any institution that issues deposits or makes commercial loans.⁹⁸ In the years following the Act's passage, nonbank financial institutions began to fund themselves with a variety of close substitutes for deposits, including negotiable order of withdrawal (NOW) accounts, certificates of deposit, and commercial paper.⁹⁹ The Fed responded by amending its regulatory definition of "bank" to encompass these nonbank financial institutions,¹⁰⁰ and the institutions responded by challenging this definition as exceeding the Fed's authority.¹⁰¹

The Court, in a unanimous opinion written by Chief Justice Burger,¹⁰² sided with the regulated parties,¹⁰³ applying *Chevron* deference and concluding that the Fed's interpretation violated the plain meaning of the statute, thus failing at *Chevron* step one.¹⁰⁴ The Court began by rejecting the Fed's attempt to characterize NOW accounts as demand deposits and thus bring them within its regulatory purview.¹⁰⁵

⁹⁷ 474 U.S. 361 (1986).

⁹⁸ *Id.* at 363 (citing 12 U.S.C. § 1841(c) (1982)).

⁹⁹ *See id.* at 363–64.

¹⁰⁰ *See id.* at 364 (citing 12 C.F.R. § 225.2(a)(1)(A)–(B) (1985)).

¹⁰¹ *See id.*

¹⁰² Justice White took no part in the consideration or decision of the case.

¹⁰³ *Dimension Financial*, 474 U.S. at 374–75.

¹⁰⁴ *See id.* at 368 (citing *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842–43 (1984)).

¹⁰⁵ *See id.* at 367–68.

Although the Court explicitly acknowledged that NOW accounts were functionally equivalent to demand deposits, it nevertheless struck down the Fed's definition because NOW accounts technically did not give depositors a "legal right" to withdraw on demand, as the text of the statute required "deposits" to do.¹⁰⁶ The Court also rejected the Fed's attempt to cast repo and commercial paper as "commercial loan substitutes," reasoning that this distinction violated the commonly understood definition of the term "commercial loans," as reflected in the Act's legislative history and previous Fed administrative decisions.¹⁰⁷

Finally, the Court looked to the purpose of the Act, and rejected the Fed's contention that Congress intended to regulate institutions that are "functionally equivalent" to banks.¹⁰⁸ The Court reasoned that because the Act defined with specificity certain transactions that constitute "banking," Congress therefore intended to limit the Fed's regulatory authority to those formal categories.¹⁰⁹ Although the Court acknowledged that "there is much to be said for regulating financial institutions that are the functional equivalent of banks," it determined that "[i]f the Bank Holding Company Act falls short of providing safeguards desirable or necessary to protect the public interest, that is a problem for Congress . . . to address."¹¹⁰

The *Dimension Financial* Court's broad reasoning raises troubling implications for financial regulators' ability to combat regulatory arbitrage. The Court's interpretation of the terms "demand deposit" and "commercial loans" strongly suggests that the terms in a statutory grant of authority to financial regulators should be given meaning based only on their definition elsewhere in the statute, or else based on the commonly accepted definition of the terms at the time the statute was passed.¹¹¹ Thus, *Dimension Financial* suggests that such terms are to be construed both narrowly and as if they were frozen in time, which leaves little room for regulators to combat regulatory arbitrage by adopting more expansive interpretations of the terms in their authority-conferring statutes. While one might welcome this approach from a separation of powers perspective — after all, letting agencies set the bounds of their own authority is a troubling proposition — over time such an approach could allow harmful regulatory arbitrage to go unchecked.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 369–73.

¹⁰⁸ *Id.* at 373–74.

¹⁰⁹ *See id.* at 374.

¹¹⁰ *Id.*

¹¹¹ Although the Court discussed the evolving meaning of the term "commercial loan," its ultimate concern seems to have been what the term meant when the statute was passed. *See id.* at 369–73.

Moreover, *Dimension Financial* severely hampers regulators' ability to appeal to statutory purpose. Specifically, *Dimension Financial* suggests that if an authorizing statute uses *any* formal terms in defining the object of regulation, this is *itself* sufficient to defeat a claim of functional regulatory authority. That is, *Dimension Financial* implies that if the statutory grant of authority is in any way formal, then it cannot be in any way functional. The Court ostensibly based this conclusion on the need to respect legislative compromises embedded in the statutory text,¹¹² but this aspect of its holding could apply broadly, even in instances where no legislative compromise was in fact possible. Indeed, under the facts of *Dimension Financial*, it was literally impossible for Congress to have reached a legislative compromise whereby it would regulate deposits but not NOW accounts, because NOW accounts did not exist in 1956 when the Act was passed.

Thus, the Supreme Court's decision in *Dimension Financial* demonstrates how authority-conferring statutes that rely on formal categories may hamstring financial regulators in the battle against regulatory arbitrage. By contrast, a functional conferral of regulatory authority would pose no problems under *Dimension Financial*, as the Court stated that congressional intent is the touchstone of its statutory analysis, and there would seem to be no impediment to Congress making clear that its intent is to define regulatory authority functionally. Therefore, *Dimension Financial* further shows the need for a functional approach to defining deposit substitutes in the statute that confers authority to regulate them.

C. *Defining Short-Term Nondeposit Funding Broadly and Functionally*

Based on the foregoing considerations, a simple and flexible conferral of authority to regulate deposit substitutes would be best. Specifically, when Congress confers the authority to regulate deposit substitutes, or when FSOC invokes section 120(d)(3) to request such authority, the statutory text should confer authority to regulate "any financial instrument that serves as a close substitute for deposits or that is potentially vulnerable to bank run-like phenomena, including but not limited to repurchase agreements, commercial paper, shares of money market mutual funds, and prime brokerage accounts."

This broad and deliberately ambiguous definition should help to prevent regulatory arbitrage and will give regulators the necessary flexibility to combat it. First, the definition has the beneficial effect of focusing both regulators and regulated parties on the problem at which the statute is aimed, namely bank runs, instead of on technical legal

¹¹² See *id.* at 374.

and financial formalities. Second, the definition is not limited to a particular legal form — although it clearly provides authority to regulate repo, commercial paper, MMMF shares, and prime brokerage accounts, it also contains a catch-all provision, and it does not use specific terms like “liability” or “debt” that clever financial engineers could attempt to innovate around. Lastly, the definition’s ambiguity with respect to its two operative terms, “close substitute” and “bank run–like phenomena,” should give regulators leeway under *Chevron* to reinterpret their authority as circumstances require, most particularly when the threat of bank runs rears its ugly head.

D. On Whom to Confer Regulatory Authority

The next question is on whom this new authority should be conferred. There are two possible approaches. Under the first, authority to regulate deposit substitutes could be conferred on the primary financial regulatory agencies. However, splitting up this responsibility could result in an inconsistent regulatory approach, whereby some financial entities are subject to more stringent rules than others, creating a serious risk of regulatory arbitrage. Further, splitting authority in this manner would make international policy coordination more difficult. This approach also raises the tricky problem of choosing who should be the financial regulator for entities that use deposit-substitute funding but are not currently subject to primary financial regulatory authority.

The better approach would be to confer authority on a single regulator. This approach would ensure consistency and would make international coordination far easier. The Fed is the best choice here, given the resources at its disposal, its political independence, and its experience with regulating financial institutions of widely varying types. FSOC should therefore request that Congress confer authority on the Fed to regulate the use of deposit-substitute funding by the shadow banking system.

CONCLUSION

Financial regulators currently lack the authority to regulate deposit substitutes effectively, which is troubling given the role that such funding can play in causing or exacerbating financial crises. Congress should confer authority on the Fed to regulate deposit substitutes, defined broadly and functionally, and if Congress fails to do so, FSOC should request such legislation by invoking section 120(d)(3) of the Dodd-Frank Act. Doing so would be an important step toward preventing history from repeating itself.